IAA INVESTMENT ADVISER ASSOCIATION

May 8, 2023

Via Electronic Filing

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

Re: Safeguarding Advisory Client Assets (SEC Rel. No. IA-6240; File No. S7-04-23)

Dear Ms. Countryman:

The Investment Adviser Association (**IAA**)[1] commends the Commission for undertaking to strengthen and modernize the regulations around how investment advisers safeguard client assets.[2] The IAA and our members strongly support enhanced protection of advisory clients. We have long called for making the current custody regulatory framework under the Investment Advisers Act of 1940 (**Advisers Act**) more workable and effective in achieving the Commission's important investor protection goals and are committed to working constructively with the Commission to achieve these goals.

We disagree, however, with the Commission's proposed approach to our shared objectives. We appreciate that the Commission intends for the Proposal to "maintain[ ] the core purpose of protecting client assets from loss, misuse, theft, or misappropriation by, and the insolvency or financial reverses of, the adviser."[3] However, the Proposal goes well beyond this

[1] The IAA is the leading organization dedicated to advancing the interests of investment advisers. For more than 85 years, the IAA has been advocating for advisers before Congress and U.S. and global regulators, promoting best practices, and providing education and resources to empower advisers to effectively serve their clients, the capital markets, and the U.S. economy. The IAA's member firms manage more than $35 trillion in assets for a wide variety of individual and institutional clients, including pension plans, trusts, mutual funds, private funds, endowments, foundations, and corporations. The IAA thanks Dechert LLP for the contributions that the firm made to this letter. For more information, please visit www.investmentadviser.org.

[2] *Safeguarding Advisory Client Assets*, 88 Fed. Reg. 14672 (Mar. 9, 2023), available at https://www.govinfo.gov/content/pkg/FR-2023-03-09/pdf/2023-03681.pdf (**Proposal**).

[3] Proposal at 14676.

core purpose. In particular, we are deeply concerned by the dramatic expansion of the concept of custody to include discretionary authority and the virtually boundless scope of assets in myriad different markets and presenting a wide-ranging spectrum of different risks that the Proposal seeks to cover with the same broad-brush requirements.

Our concerns are exacerbated by the proposed requirements for advisers to enter into written agreements with and obtain reasonable assurances from qualified custodians with respect to duties that custodians,[4] which are themselves regulated entities, primarily or exclusively owe to their customers.[5] By attempting to deputize investment advisers to enforce qualified custodians' conduct – in many cases mandating a specific business relationship between an adviser and a custodian where none existed before – the Commission is requiring advisers to do indirectly what the Commission is not doing or cannot do directly. To the extent the Commission is concerned with the risk of *custodial* misconduct or financial reverses and wishes to promote minimum standard custodial protections, we urge it to proceed only after careful study and in collaboration with the appropriate regulators.

We respectfully offer our perspectives and recommendations on these and other aspects of the Proposal. Our comments are intended to promote more appropriately-targeted, risk-based, and reasonably-designed safeguarding practices, while providing robust investor protections.[6]

I. EXECUTIVE SUMMARY

The IAA strongly supports the Commission's goal of protecting advisory client assets against misuse or misappropriation, or losses that may result from an adviser's insolvency or bankruptcy. However, we have overarching concerns with several of the central features of the Proposed Rule[7] that we believe will undermine the Commission's goal, prove impractical, and impose significant costs on investment advisers that far exceed any perceived benefits. These outsized burdens will affect all advisers but could be particularly challenging for smaller

[4] We use the terms "qualified custodian" and "custodian" interchangeably throughout this letter.

[5] We use the terms "client" to refer to an investment adviser's client, "customer" to refer to a custodian's customer, and "investor" generically to cover both, plus investors more generally.

[6] We reiterate our concerns that the short comment periods now routinely provided by the Commission make it extremely challenging for commenters, including the IAA, to provide extensive and meaningful responses. *See, e.g., Joint Letter Requesting Extension to the Comment Period for Safeguarding Advisory Client Assets Proposed Rule* (Mar. 3, 2023), available at https://investmentadviser.org/resources/iaa-joint-trades-letter-requesting-extension-of-comment-period-for-safeguarding-client-assets-proposal/. A federal court recently held that while legally permissible, the Commission's comment period for its proxy voting advice proposal may have been "unnecessarily short or even frustratingly short." *U.S. Chamber v. SEC*, Summary Judgment Memorandum, Case No. 3:22-cv-00561 (M.D. Tenn. Apr. 24, 2023). We believe that by consistently not allowing sufficient time for commenters to provide meaningful feedback, the Commission will have difficulty creating thoughtful and effective rules and will likely miss important insights, feedback, and perspectives that could improve the proposed rules or highlight potential unintended consequences.

[7] Proposed Rule 223-1 under the Advisers Act (**Proposed Rule** or **safeguarding rule**).

advisers. And investors may ultimately bear new or increased costs and/or decreased choices as a result of this new regime.

First, the Commission incorrectly presumes the acquiescence of, and underestimates the challenges for, qualified custodians to the proposed requirement that advisers enter into agreements with and obtain certain assurances from these custodians. The premise for these two key elements of the Proposed Rule, which, together we refer to as the **QC Requirements,** appears to be that these requirements will strengthen advisers' hands in negotiating custodial arrangements with qualified custodians that protect client interests. In practice, however, imposing these requirements would not change the fundamental business considerations that have shaped the current market for custody services without creating new costs. Accordingly, we believe that the premise of the QC Requirements is incorrect, and that the Commission's efforts to indirectly mandate the terms of agreements between investors and their custodians will prove harmful to investors' interests. The QC Requirements would require not only that qualified custodians accommodate a new, standard set of undertakings layered on top of their existing regulatory obligations, but also that they agree to customized terms that address the trading authority of the adviser with respect to each account. We believe that the Commission incorrectly presumes the acquiescence of qualified custodians in this regard and underestimates the challenges posed by the QC Requirements.

Even if advisers had the leverage to persuade custodians to change their business imperatives, it would be operationally and administratively extremely burdensome and costly for a custodian to negotiate the standard set of undertakings with all the advisers for whose clients it provides custodial services. It would be even more challenging for custodians to negotiate, maintain, and then comply with thousands of customized agreements relating to trading authority. The aggregate effect of the QC Requirements would be to make the custody business more bespoke and expensive, with significantly higher liability and risk exposure.

Moreover, even if the Proposed Rule were to succeed in forcing the adoption of the QC Requirements, custodians could be expected to narrow and focus their business only on their largest and most profitable client and adviser relationships, and to charge clients of smaller advisers more, to the extent they actually accept them as custodial customers. At the same time, these added costs are likely to favor custodians with the greatest scale and resources over which to spread costs and operational burdens. Thus, the Proposal would create an uneven playing field for advisers, resulting in reduced investor choice in the long term.

We propose an internal controls approach, in lieu of the QC Requirements. Our recommended approach would provide significant protections without the drawbacks of the QC Requirements.

Second, the Proposed Rule is attempting to indirectly regulate through investment advisers a group of service providers over which the Commission does not have regulatory jurisdiction. The structure of the current Custody Rule is to require the engagement of a regulated qualified custodian as a means to place checks on an adviser's ability to misappropriate client assets in connection with its advisory services.[8] It is the qualified custodian's responsibility, as the holder of assets, to ensure their safekeeping. An investment adviser should not be obligated to act as enforcer of a custodian's compliance with customer protection requirements or be subject to heightened regulatory risks for conduct by a separately regulated third party that it does not control.

The proposed safeguarding rule – which, after all, is under the Advisers Act, which regulates advisers, not banks or broker-dealers, is – and should be – designed to address risks the adviser controls, not all risks that may arise in custodying assets at a third party. Many requirements of the Proposed Rule, however, would compel the adviser to police commercial terms between clients and custodians on matters unrelated to the investment advice provided by the adviser. We believe that this type of "backdoor" regulation is inappropriate, turns on its head the regulatory purpose of the Custody Rule, and imposes regulatory burdens unfairly, as we have noted in the similar context of the Commission's proposed rule on outsourcing by investment advisers.[9] It is also ineffective because the Commission will not be able to enforce these requirements directly.

Moreover, qualified custodians, such as banks, trust companies, and futures commission merchants (**FCMs**), are each subject to their own regulatory regimes, with separate regulators that have specific expertise in regulating the safekeeping and assurance of assets in their respective industries. The Proposed Rule will interact with, be implemented within, create uneven requirements across, and encounter resistance within each of these regimes in different ways.

Appropriate policymaking in this area should only come after careful cost-benefit analysis and collaboration with appropriate bank and other regulators, and it should be focused on demonstrable gaps in investor protections. Minimum standard custodial protections should also apply to *all* investors, not only advisory clients whose advisers have actual or constructive custody of client assets. We believe strongly that the Commission's investor protection mandate would be best served by ensuring that the assets of all investors – whether advisory clients, customers of broker-dealers or banks, or self-directed investors – are appropriately safeguarded

[8] The current custody rule (Rule 206(4)-2 under the Advisers Act (**Custody Rule**)) was designed to require investment advisers to maintain client funds and securities to "provide for a more robust set of controls over client assets designed to prevent those assets from being lost, misused, misappropriated or subject to advisers' financial reverses." *See Custody of Funds or Securities of Clients by Investment Advisers*, 75 Fed. Reg. 1455 (Jan. 11, 2010), available at https://www.govinfo.gov/content/pkg/FR-2010-01-11/pdf/2010-18.pdf. The current Custody Rule also requires the engagement of an independent public accountant as a further guardrail to prevent an adviser's misappropriation of client assets. We discuss independent public accountants in Section VII.A.

[9] *See* Letter to the Commission, *Outsourcing by Investment Advisers*, from the IAA (Dec. 23, 2022), available at https://investmentadviser.org/resources/iaa-letter-to-sec-on-service-provider-outsourcing/ (**Initial Outsourcing Letter**) and Letter to the Commission, *Outsourcing by Investment Advisers*, from the IAA (Apr. 20, 2023), available at https://investmentadviser.org/resources/iaa-submits-supplemental-letter-on-outsourcing-proposal/ (**Supplemental Outsourcing Letter** and together with the Initial Outsourcing Letter, the **Outsourcing Letters**).

and provided the same level of protections and preference, for example, in a custodian's insolvency.

Third, the recharacterization of discretionary authority as having custody is unnecessary to protect investors, would create enormous challenges for advisers, and would ultimately harm investors. We are very concerned that the proposed expansion of the breadth of the definition of custody to include discretionary authority, which would greatly expand the adviser activities within the scope of the rule, would make trading on behalf of clients impracticable. It would be especially difficult for advisers to trade in asset classes that do not settle on a delivery versus payment (**DVP**) basis. Ultimately, this recharacterization of custody would harm investors by limiting their investment universe and the number of investment advisers that can bear the burden of compliance with the rule.

Moreover, the Commission has not demonstrated with any meaningful evidence or cost-benefit analysis that discretionary trading authority presents risks that are in any way proportionate to the vast new burdens and expenses that the Proposed Rule would impose on advisers considered to have custody of client assets. In fact, more than 20 years of experience with the scope of the current Custody Rule have demonstrated the opposite: discretionary authority in itself does not create meaningful custody risks. The Commission cannot and does not cite sufficient examples or evidence of such risks to justify imposing the expense and burden of the Proposal on the more than 90 percent of SEC-registered investment advisers that exercise discretion. Thus, the hurdle for expanding the definition of custody in this way is high, and the Proposal, particularly its dramatically underdeveloped cost-benefit analysis, does not come close to meeting it.

Fourth, the Commission has not provided a sufficient rationale to justify abandoning the current Custody Rule framework for privately offered securities and upending the market practices and (in some cases) the regulatory regimes of other asset classes that have a low risk of misappropriation or loss. The provisions of the Proposed Rule that would apply to privately offered securities fail to reflect their low risk of misappropriation or loss. As the Commission has long recognized, the very features of private securities that make them incompatible with traditional custody arrangements also mean that the risk of misappropriation or loss is exceedingly small. For example, falsifying the subscription or LLC agreement for a private fund or the purchase agreement for private company stock simply does not afford the wrongdoer the ability to transfer a client's interest in these funds or companies in the same way as fraudulently accessing a client's brokerage or bank account. A key difference is the fact that such a transfer of a privately offered security requires the consent and express action of a third party (the fund manager or the company) that has a powerful interest in protecting the integrity of the securities it issues and has identification processes and transfer restrictions in place for this purpose.

The Commission cannot and does not cite a record or history of actual misappropriation or loss of privately offered securities that is remotely proportionate to the burdens and costs that the Proposed Rule would impose on investment advisers, and by extension, their clients and funds. In the face of these minimal risks and substantial existing safeguards, the Commission would impose a massive new regulatory apparatus that would require effectively real-time verification and tracing of all covered privately offered securities transactions, in addition to audit requirements. The Commission has not provided a sufficient rationale to abandon this framework for privately offered securities. Similar points can be made about the provisions of the Proposed Rule that would apply to a range of other asset classes as well.

Fifth, we strongly recommend an internal controls approach in lieu of the proposed framework. We recognize that not all asset classes present only minimal risks of misappropriation or loss, whether or not they are held with a qualified custodian, and that these risks can change, depending on the circumstances. However, we believe that focusing the adviser's role in safeguarding client assets on adopting and implementing written, reasonably designed policies and procedures that include effective risk-based internal controls to mitigate the risk of loss, misuse, and misappropriation (the **internal controls approach**) would more effectively address the spectrum of risks across different assets and markets, as well as achieve the Commission's goal of protecting advisory client assets more broadly. This alternative approach to safeguarding client assets would avoid the impracticalities, weaknesses, and flaws in the Proposed Rule and would be proportionate to the actual risks presented by different asset classes, advisory practices, and business models. Our proposed alternative would retain the existing requirement for client assets to be held with a qualified custodian where the adviser has actual or constructive custody (excluding authorized trading), and where it is appropriate for a qualified custodian to custody the assets, and it would focus many elements of the proposed safeguarding regime on the investment adviser implementing an internal controls approach. This approach, like Rule 206(4)-7 (the **Compliance Rule**), would be risk-based and centered on principles, recognizing that risk is not binary, and allow for scaling up or down depending on the nature of the risk in question.

Moreover, an internal controls approach would be flexible enough to address the wide range of different types of investments and trading practices. It would be able to reflect the lower risks that arise where (such as with derivatives and certain commodities) there is an existing regulatory regime and where (such as with privately offered securities and syndicated loans) transfer of the asset requires the cooperation of a third party that has an incentive to assure the integrity of the investment in question. In essence, we believe that the Commission has underestimated the effectiveness and utility of this regulatory approach in comparison to many of the other more intrusive and ineffective tools that we summarize above and address below. We urge the Commission to refocus this rulemaking on this approach.

Sixth, we make several recommendations to improve and streamline the Proposal. We recommend several additional revisions that we believe would improve the Proposal and alleviate unnecessary burdens on advisers, including: (i) replacing the adviser asset segregation requirement with an internal controls approach; (ii) making the exceptions from surprise examinations more practical and effective; (iii) excepting certain types of accounts and transfers from the Proposed Rule; (iv) making the proposed changes to the recordkeeping rule less burdensome; and (v) simplifying custody-related reporting on Form ADV.

Finally, the Commission severely underestimates the negative impacts of the Proposal. We feel compelled to highlight on behalf of our members that the Proposed Rule is the latest in a series of rulemaking proposals that are unprecedented in their scope and speed, including the Outsourcing Proposal,[10] the Private Fund Advisers Proposal,[11] the Regulation S-P Proposal,[12] and the Cybersecurity Risk Proposal,[13] among others. We are concerned that the Commission has not considered their cumulative effect on investment advisers, and particularly smaller advisers. For many of our members, the costs and burdens that these proposals would impose should they all be adopted as proposed would be enormous.

We offer below comments that further develop these themes and recommendations and that address the specifics of the Proposed Rule. We believe that our recommendations, including a shift to an internal controls approach, would do a better job in furthering the Commission's objectives of protecting investors while reducing operational and compliance burdens on advisers, minimizing complexity, preserving investor choice and access to valuable fiduciary advice, and better tailoring safeguards to actual risks.

Specifically, we make the following comments and recommendations:

SECTION II. QC Requirements

A. The QC Requirements would disrupt the relationships among advisers, clients, and qualified custodians, would not achieve their intended purpose, and would impose costs and negative unintended consequences far beyond those acknowledged in the Proposal. They are also an inappropriate means to regulate custodians. Instead, we recommend an internal controls approach, which would provide significant protections without the dramatic disruptions of the QC Requirements.

B. If the Commission nevertheless adopts the QC Requirements, changes are necessary to make them more workable. We recommend certain carveouts, exceptions, and refinements.

[10] *Outsourcing by Investment Advisers*, 87 Fed. Reg. 68816 (Nov. 16, 2022), available at https://www.govinfo.gov/content/pkg/FR-2022-11-16/pdf/2022-23694.pdf (**Outsourcing Proposal**).

[11] *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, 87 Fed. Reg. 16886 (Mar. 24, 2022), available at https://www.govinfo.gov/content/pkg/FR-2022-03-24/pdf/2022-03212.pdf (**Private Fund Advisers Proposal**).

[12] *Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Customer Information*, 88 Fed. Reg. 20616 (Apr. 6, 2023), available at https://www.govinfo.gov/content/pkg/FR-2023-04-06/pdf/2023-05774.pdf (**Regulation S-P Proposal**).

[13] *Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies*, 87 Fed. Reg. 13524 (Mar. 9, 2022), available at https://www.govinfo.gov/content/pkg/FR-2022-03-09/pdf/2022-03145.pdf (**Cybersecurity Risk Proposal**).

SECTION III. Definition of Custody: Activities and Assets

A. The definition of custody should not include discretionary authority, and should not turn on whether assets settle on a DVP or a non-DVP basis.

B. The Proposed Rule should be calibrated to the actual safeguarding risks that an asset presents because it would otherwise impede investment without meaningfully improving investor protection.

SECTION IV. Definition of Qualified Custodian

A. The Commission should clarify the meaning of possession or control.

B. The Commission should eliminate certain conditions in the definition of foreign financial institution.

SECTION V. Certain Assets That Cannot be Maintained with a Qualified Custodian

A. The Commission should clarify and modify the conditions for certain assets that cannot be maintained with a qualified custodian because, as proposed, they would be operationally difficult, costly, and ineffective.

SECTION VI. **Adviser Segregation of Client Assets**

A. The adviser segregation aspect of the Proposal is not targeted to achieve the Commission’s goals.

B. The requirement would lead to unintended consequences.

C. We recommend replacing this requirement with an internal controls approach.

SECTION VII. **Exceptions from Surprise Examinations**

A. Advisers should not be responsible for monitoring the activities of independent public accountants performing financial statement audits of client accounts.

B. We make several recommendations to improve the annual audit provision, including to codify certain aspects, make the audit approach easier to use, address issues relating to special purpose vehicles (**SPVs**), and eliminate liquidating audits.

C. The Commission should not limit the surprise examination exception for advisers with discretionary authority to DVP settlement.

D. We make recommendations relating to standing letters of authorization.

SECTION VIII. **Other Recommendations.** We offer several additional specific recommendations to improve the safeguarding rule.

We also offer recommendations to improve the proposed changes to the Recordkeeping Rule (**SECTION IX**) and Form ADV (**SECTION X**).

Finally, we address the proposed transition period and compliance date (**SECTION XI**) and the Proposal's economic analysis (**SECTION XII**).

II. WRITTEN AGREEMENTS AND REASONABLE ASSURANCES

The Proposed Rule would require an adviser to maintain client assets with a qualified custodian pursuant to a written agreement between the qualified custodian and the adviser.[14] In addition, the adviser would need to obtain reasonable assurances in writing from the custodian regarding certain protections for the safeguarding of client assets.[15] As noted above, we refer to these, together, as the QC Requirements.

We appreciate that the Commission did not propose to require, in most cases, that the reasonable assurances be part of the written agreement between the adviser and custodian. As a practical matter, however, to make them a binding commitment and to demonstrate that the adviser took appropriate steps to obtain them, the reasonable assurances would likely be included in the written agreement. Even if the reasonable assurances were not included in the written agreement, the negotiating and administrative burdens would be similar. Accordingly, we discuss both the written agreements and reasonable assurances requirements together.

For the reasons we discuss below, we strongly oppose the QC Requirements as proposed.

A. The QC Requirements Would Disrupt the Relationships Among Advisers, Clients, and Qualified Custodians

As the Commission acknowledges, the QC Requirements would be a substantial departure from current industry practice relating to adviser-custodian relationships. Moreover, custodians do not today provide many customers with certain of the terms that the rule would impose.[16]

Accordingly, the Proposal represents a radical restructuring of potentially millions of private contractual relationships.[17] The scale of this change warrants careful focus because the

[14] *See* Proposed Rule 223-1(a)(1)(i).

[15] *See* Proposed Rule 223-1(a)(1)(ii).

[16] Proposal at 14691.

[17] According to the Form ADV data analyzed in the IAA's most recently published *Investment Adviser Industry Snapshot*, there are 64.7 million advisory clients. *See IAA-NRS Investment Adviser Industry Snapshot 2022* (June

Proposal fails to appreciate or accurately quantify the significance of this change.[18] Today, the client – not the adviser – contracts directly with the custodian to provide it with custody services. As a result, the adviser has no privity of contract with the custodian with respect to that agreement. To address concerns that advisers may misuse their authority with respect to assets over which they are considered to have custody, the Commission would demand that advisers insert themselves into a private contractual relationship without regard to the intentions or desires of the other parties to that relationship.

The QC Requirements are among the most serious examples of the Commission seeking to impose indirect regulation on third parties by imposing contracting requirements on advisers. The Commission should not use authority granted for the purpose of regulating advisers to expand its jurisdiction over other financial institutions (which are, themselves, otherwise regulated entities) or to turn advisers into the "watchdogs" of custodians.

Moreover, we believe that these requirements would fail to achieve their purpose, prove costly, impose negative unintended consequences, and ultimately do little to advance the protection of investors.

1. The QC Requirements would not achieve their intended purpose.

The premise for the QC Requirements appears to be that they will strengthen advisers' hands in negotiating custodial arrangements with qualified custodians that protect advisory clients' interests. In practice, advisers have generally been unable to implement changes to custodians' contracts to meet the conditions of guidance that the staff has provided in the past, for example with respect to inadvertent custody. This has been especially the case with respect to custodians subject to the jurisdiction of other regulators. It is thus wholly unrealistic to believe that the QC Requirements could be effectively implemented, much less that they could be implemented without significant harmful impacts to investors' interests.

First, despite past challenges in negotiating changes to custody agreements, the QC Requirements would require far more, demanding that qualified custodians accommodate new undertakings, broaden their liability, and customize terms that address the trading authority of

2022), available at https://investmentadviser.org/wp-content/uploads/2022/06/Snapshot2022.pdf (**Industry Snapshot**). In addition, according to the Proposal, 92.0 percent of advisers exercise discretion. Proposal at 14762. Advisory contracts generally not only specify whether an adviser has discretion to trade on behalf of a client, but also the client's investment objectives and any related or unrelated restrictions or limitations. Advisers' trading authority is circumscribed by these investment objectives and terms and limitations. Advisers thus may have many different versions of authority. The proposed requirement for a written agreement between an adviser and custodian specifying the adviser's agreed-upon level of authority would require both advisers and custodians to review all of their respective agreements with an adviser's clients to determine which version of authority is applicable to each of these clients. Accordingly, we believe that this requirement would affect millions of relationships.

[18] For example, the Proposal assumes that each custodian and adviser would spend only one hour each negotiating these terms per custody agreement. Proposal at 14763.

the adviser with respect to each account. Given our members' past experience, we anticipate that qualified custodians will balk at these requirements.[19]

Second, there are many reasons to believe that most qualified custodians would not be willing to accommodate these changes. In particular, the custody business is best performed at scale, and it would be operationally and administratively extremely burdensome and cost prohibitive for a custodian to negotiate, maintain, and then operationalize and comply with vast numbers of customized agreements relating to trading authority. Even assuming the capacity of qualified custodians to increase their staffing, legal support, and operational complexity, the aggregate effect of the QC Requirements would be to make the custody business more bespoke and expensive, with significantly higher liability and risk exposure. Custodians would understandably resist these changes.

Third, the terms that the Commission has proposed are commercially infeasible. For example, the Proposal would require an adviser to obtain reasonable assurances in writing from the qualified custodian that it will indemnify the client (and will have insurance arrangements in place that will adequately protect the client)[20] against the risk of loss in the event of the qualified custodian's own negligence, recklessness, or willful misconduct.[21]

The resistance of custodians to negotiating terms is likely to be even more acute with respect to these terms, which would carry higher costs and potential legal exposure for the custodians. Generally, custodians provide customers a security guarantee as part of their custody agreements. This guarantee, with some conditions, covers losses in a client's account from unauthorized activity, which, we believe, is designed to address misappropriation. Compensation for other losses under the custody agreement is generally limited to fees paid. These arrangements are wholly outside of an adviser's control, and it would be unrealistic to expect that an adviser could convince or compel custodians to take on additional liability through a written agreement that custodians are not otherwise required to assume.

[19] In addition, as has occurred in a variety of recent rulemakings, the Commission has proposed inflexible and prescriptive requirements without working through how they apply to the many permutations and business models that advisers have developed to serve investors. For example, under the Proposal, it is unclear how the rule would apply to an adviser that is hired by another adviser (whether SEC-registered or not) to act as a sub-adviser or in wrap-fee programs. To that end, we ask the Commission to codify and expand the Sub-adviser IAA No-Action Letter (defined below) to provide an exception from the surprise examination requirement where an investment adviser acts as a sub-adviser in an investment advisory program, and the primary adviser is responsible for complying with the safeguarding rule. *See Investment Adviser Association*, SEC Staff No-Action Letter (Apr. 25, 2016), available at https://www.sec.gov/divisions/investment/noaction/2016/investment-adviser-association-042516-206(4).htm (**Sub-adviser IAA No-Action Letter**).

[20] We do not understand how an adviser could be expected to assess the adequacy of (indeed, second guess) a custodian's (often a large financial institution's) insurance. Also, the Commission may be conflating direct, first-party liability with third-party liability.

[21] Proposed Rule 223-1(a)(1)(ii)(B).

We are skeptical that a custodian – even more so one that is not under the Commission's jurisdiction – would agree to promise an adviser that it will indemnify a customer, expand its liability by lowering the standard of conduct from gross negligence to simple negligence, have insurance that would be deemed to "adequately" protect the customer, or be willing to allow a third party (an adviser) to access its systems to assess the implementation of its safeguarding efforts. Even if a custodian were to agree to provide reasonable assurances, it is uncertain whether an adviser could enforce an indemnification clause that is a third-party promise to the custodian's customer, or that an insurance policy would cover a custodian's misconduct.

Similarly, the Proposed Rule would require an adviser to obtain reasonable assurances in writing from the qualified custodian that the existence of any sub-custodial, securities depository, or other similar arrangements with regard to the client's assets would not excuse any of the qualified custodian's obligations to its customer.[22] We appreciate the Commission's efforts to help clients and advisers recover losses caused by a sub-custodian in the event of a loss of client assets. However, we believe that custodians would be unwilling to take on more liability for sub-custodians than their contractual arrangement with the customer calls for and, as we discuss below, it is highly unlikely that custodians would take on additional liability without receiving compensation for their increased exposures.[23]

In addition, the Proposal does not appear to account for the variety of qualified custodian types in imposing these contracting requirements. For example, depending on the asset classes in which an adviser invests client assets, the adviser may need to negotiate not just with a greater number of custodians, but also custodians with different business models and account documentation.

For all of these reasons, we believe that, given the severe misalignment of the proposed requirements with the custodians' incentives, these requirements would prove wholly infeasible for an adviser to negotiate.

2. The QC Requirements would impose costs and negative unintended consequences far beyond those acknowledged in the Proposal.

The QC Requirements would impose significant costs and negative unintended consequences, many of which could ultimately fall on advisory clients, whether directly or indirectly. These costs and consequences include, among others:

The Proposal would necessitate creating and/or customizing vast numbers of custody agreements at great expense and significant burdens in diverted time and effort. Even if qualified custodians agreed to enter into written agreements with advisers or provide reasonable assurances as proposed, advisers and custodians would likely incur significant negotiation and

[22] Proposed Rule 223-1(a)(1)(ii)(C).

[23] There may also be reasons related to a custodian's safety and soundness that would preclude or at least restrict it from agreeing to increased exposure.

implementation costs. The Proposal contemplates one written agreement per custodian, but this assumes away the complexity of negotiating, whether in one document or many, provisions that reflect the level of the adviser's authority and other terms corresponding with large numbers of advisory contracts that may vary in relevant respects. In addition, even if custodians were to agree to lower their indemnification standard, many custody agreements have a gross negligence standard that would have to be changed to a simple negligence standard and to provide for each individual custodial customer to be a direct beneficiary of these provisions with respect to the services to that customer.[24] It is unlikely that the capacity exists among legal, operational, and business professionals at advisers and custodians to accomplish this massive undertaking in the time that the Proposal contemplates.[25]

Advisory clients are likely to bear the negative impacts of custodians' increased liability and insurance. For the reasons discussed above, we believe the terms that the QC Requirements mandate would prove commercially challenging, if not infeasible. However, even if feasible, it is unrealistic to expect custodians to agree to take on additional liability without additional compensation to manage the increased risk. We are concerned that advisory clients, including many retail investors, will bear these increased costs to custodians, whether directly or through indirect negative impacts.

The costs and consequences of the QC Requirements could reshape the market for advisory and custody services in a manner that should make the Commission wary. Even if the Proposed Rule were to succeed in forcing the adoption of the QC Requirements, custodians could be expected to narrow and focus their business only on their most profitable client and adviser relationships, while increasing the costs to those clients. Smaller advisers would similarly face increased costs and may also face reduced service options because their volume of business may not be at an economical scale for custodians in light of the Proposed Rule's increased burdens. At the same time, these added costs are likely to favor only those custodians with the greatest scale and resources over which to spread costs and operational burdens. Each of these economically rational and thus predictable effects would tend to favor greater concentration in the investment advisory industry and lead to fewer custodial options, and fewer and more expensive choices for investors.

An adviser's compliance with the safeguarding rule would become dependent on actions of each custodian, creating the potential for unintended and undesirable outcomes. For example, if a custodian does not comply with an element of the written agreement or provide one of the reasonable assurances, an adviser would not be able to continue to carry out its advisory services for certain clients unless and until the client selects another custodian and triparty negotiations are again finalized. This would also be disruptive and likely expensive for clients because changing custodians could trigger an adverse taxable event for the client if it has to sell its positions due to its new custodian not offering the same investment options. It makes

[24] We understand that custody agreements with broker-dealer custodians typically do not set forth a standard of care.

[25] Written agreements and reasonable assurances could also necessitate repapering advisory contracts to make new disclosure of material information to clients.

little sense for the Commission to insist that advisory services be dependent on a third party in this manner, yet this consequence follows from the Commission's use of the Advisers Act to regulate custody services and a custodian's relationship with its customer. The inability of an adviser to carry out its services, and the difficulties imposed on its clients, would ultimately harm investors rather than protect them.

In sum, as discussed below, the Commission's economic analysis severely underestimates the costs and burdens of the Proposal on advisers, and the Commission fails to take into account the extent to which investors will ultimately bear the increased costs of the rule. We believe that these costs would outweigh the benefits.

3. The QC Requirements are an inappropriate means to regulate custodians.

The Proposed Rule attempts to indirectly regulate through investment advisers a group of service providers over which the Commission does not have regulatory jurisdiction, particularly banks, trust companies, FCMs, and foreign financial institutions (**FFIs**). The structure of the current Custody Rule is to require the engagement of qualified custodians as a means to place checks on an adviser's ability to misappropriate client assets in connection with its advisory services. However, many requirements of the Proposed Rule would compel the adviser to police commercial terms between custodians and their customers on matters unrelated to the investment advice provided by the adviser. For example, the proposed requirement that an adviser obtain reasonable assurances related to a custodian's indemnity and insurance coverage has no nexus with the advisory services provided by the adviser. In this way, the Proposal expands far beyond a concern regarding the insolvency or misconduct of advisers – risks that are an appropriate subject of the Advisers Act – to address risks of insolvency and misconduct arising from regulated institutions under the purview of other regulators.

We believe that this type of "backdoor" regulation is inappropriate because it imposes regulatory burdens unfairly, as we have noted in the similar context of the Commission's proposed rule on outsourcing by investment advisers.[26] It is also ineffective because the Commission will not be able to enforce these requirements directly. By its very nature, a regulatory regime imposed through an immense number of contracts negotiated by many parties of differing knowledge, business models, size, and skill will encompass significant variations. In addition, banks, trust companies, FCMs, and FFIs are each subject to their own regulatory regimes, with separate regulators that have specific expertise in regulating the safekeeping of assets in their respective industries and jurisdictions. The Proposed Rule will interact with, be implemented within, create uneven requirements across, and encounter resistance within each of

[26] *See* the Outsourcing Letters.

these regimes in different ways.[27] The inevitable end result would be the uneven application of the regulatory regime and the unfair distribution of relative regulatory burdens and benefits.

We believe that the Commission should address the risks that it believes are presented by third parties, including qualified custodians, directly, including in coordination with the appropriate regulators where the Commission does not have authority. To the extent the Commission is concerned with the risk of custodial misconduct and wishes to promote minimum standard custodial protections, we urge it to proceed cautiously, and only after conducting detailed fact-finding and taking note of the existing sophisticated regulatory regimes and market practices, and then only where needed to address specific and material gaps in investor protections.

If the Commission then determines that minimum standard custodial protections are necessary, they should apply to all investors, not only advisory clients whose advisers have custody of client assets. Not only would direct regulation of custodians be more appropriate, it would be fairer, more efficient, and more effective. To the extent the Commission seeks to promote minimum standards across all custodied assets of investors, it should seek to directly bolster the regulation of qualified custodians over which the Commission has jurisdiction[28] and to work with other federal functional regulators, foreign financial regulatory authorities, the Financial Stability Board, IOSCO, and state regulators, as appropriate.

4. An internal controls approach would provide significant protections without the dramatic disruptions of the QC Requirements.

As an alternative to the QC Requirements, and several of the other proposed elements of the safeguarding rule, the Commission could instead require advisers to adopt and implement an internal controls approach. The Proposal already recognizes the value of such an approach in its discussion of the privately offered securities exception, and this approach could be expanded to address any risks that the Commission believes the current Custody Rule does not already address. This alternative would also be analogous to the Commission's approach in its recent adoption of rules to shorten the securities transaction settlement cycle.[29] In the T+1 Final Rule, the Commission provided that, in lieu of a written agreement, a broker-dealer may choose to establish, maintain, and enforce written reasonably designed policies and procedures.

[27] Extending the QC Requirements (and other proposed requirements) to FFIs could also result in a number of additional unintended consequences. Advisers could potentially be subject to registration and other, potentially conflicting, regulatory requirements in foreign jurisdictions as well as foreign anti-money laundering and other reporting requirements, which we discuss more fully below in Section IV.B. This regulatory overreach would also be unfair to advisers that have structured their business models in reliance on the current regulatory environment.

[28] The Commission could exercise its existing rulemaking authority under the Securities Exchange Act of 1934 (**Exchange Act**) to promulgate rules governing registered broker-dealers.

[29] *See Shortening the Securities Transaction Settlement Cycle*, 88 Fed. Reg. 13872 (Mar. 6, 2023), available at https://www.govinfo.gov/content/pkg/FR-2023-03-06/pdf/2023-03566.pdf (**T+1 Final Rule**).

To illustrate the value of this approach, consider the risks that arise when the agreement between an advisory client and its custodian inadvertently purports to give the investment adviser the ability to transfer client securities (what the Commission staff refers to as inadvertent custody). The current regime, on which the Commission is doubling down, insists on attempting to compel specific action by the custodian, even though experience demonstrates that custodians will not change their business model and increase their expenses significantly because advisers have asked them to. It would be much more effective instead to require the investment adviser in these situations to establish an internal controls approach that is appropriate to its organization and activities. Depending on the adviser's size and staffing capacity, these may include limiting the number and type of personnel who can access client accounts, separating the duties of those personnel with operational and those with investment responsibilities, closely monitoring these personnel and client accounts, prohibiting personnel from exceeding the authority expressly granted to them in the advisory contract, and periodically testing for compliance and other controls.

We believe that a similar approach to the safeguarding rule would provide more flexibility and reduce compliance and operational burdens on advisers. Requiring advisers to adopt and implement an internal controls approach that can scale to each adviser's business model and risks – as well as evolve as circumstances change – would be an effective approach to ensure that adequate protections are in place to detect, prevent, and mitigate the risks the Proposal seeks to address. We strongly recommend that the Commission take this alternative approach rather than adopt the QC Requirements.

B. If the Commission Adopts the QC Requirements, Changes Are Necessary to Make Them More Effective

For the reasons discussed above, we urge the Commission to reconsider the QC Requirements. Should the Commission nevertheless determine to keep these requirements in any final rule, they should be substantially modified and narrowly tailored to address specific concerns and not impose unnecessary or duplicative requirements. We offer several suggestions below to make these requirements more effective.

1. Do not attempt to regulate the standard of care owed by custodians through the Advisers Act.

The Proposed Rule would require an adviser to obtain reasonable assurances in writing from the qualified custodian that it will exercise due care in accordance with reasonable commercial standards in discharging its duty as custodian and will implement appropriate measures to safeguard client assets from theft, misuse, misappropriation, or other similar types of loss.[30] As noted above, qualified custodians are regulated through a variety of regimes, each of which is designed to address the risks of the relevant type of institution. We do not believe it is appropriate for advisers to bear the burden of imposing and enforcing uniform regulatory

[30] Proposed Rule 223-1(a)(1)(ii)(A).

requirements for qualified custodians, and we question whether the Commission is the best situated regulator to make these decisions when, in many cases, state, federal, and foreign laws vest those responsibilities in, and rely on, the expertise of other regulators.

2. Exclude requirements related to the adviser's level of authority.

The Proposed Rule would require the written agreement to specify the investment adviser's agreed-upon level of authority to effect transactions in the custodial account as well as any applicable terms or limitations.[31] We appreciate that the Commission recognizes the significant challenges advisers have had – in response to staff guidance – getting many custodians to amend their custody agreements with customers to limit the adviser's authority to reflect the advisory contract.[32] However, imposing a new requirement on advisers would not remove these challenges. For example, even if an adviser is able to gain visibility into the level of authority granted in a custody agreement, requiring that the level of authority stated in the custody agreement align with the level of authority in the advisory contract for every client is impractical because, among other things, clients vary authorities over time and custodians simply may not be able to accommodate client-by-client variations. Imposing this requirement by rule can only shift the fundamental business considerations that have shaped the current market for custody services by creating new costs, particularly if the Commission is expecting that these customized contracts would transform all custodians into transactional monitors, operationalizing checks on whether an adviser has sufficient authority under the custody agreement for each transaction.[33]

We also do not believe that the Commission's objective should be "to help empower advisers to modify or eliminate their unwanted ability in a custodial agreement to better reflect their client intentions."[34] It would be far more effective for the adviser to implement an internal controls approach to manage this risk. This approach would allow the adviser to tailor its controls to the relative risk and circumstances, regardless of: (i) whether the custodian agrees to any QC Requirements; (ii) whether the adviser is aware that the custody agreement grants broader authority than the advisory contract; or (iii) the degree to which the adviser may have been involved in the client's selection of the custodian.[35]

[31] Proposed Rule 223-1(a)(1)(i)(D).

[32] *See Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority*, Division of Investment Management Guidance Update No. 2017-01, available at https://www.sec.gov/investment/im-guidance-2017-01.pdf (**Inadvertent Custody Guidance**).

[33] We understand that some custodians' systems are set up to include a check on the adviser's authority but that this is not common across custodians.

[34] Proposal at 14704.

[35] To the extent that an adviser is involved in the client's selection of custodian, whether through a recommendation or otherwise, the adviser's internal controls should be reasonably designed to ensure appropriate due diligence of the

We are also concerned that the QC Requirements attempt to solve a problem that exists solely because the Inadvertent Custody Guidance mistakenly overlooked the importance of existing protections to address an adviser's authority with respect to client assets, which is determined solely by its agreement with its clients. Custodians are not, and should not be, the arbiters of whether an adviser's activities on behalf of clients are duly authorized. Rather, a host of other safeguards exist for this purpose, including the adviser's fiduciary duties, the disclosures advisers make to clients, the recordkeeping rule, and the Commission's own examination and enforcement authorities. The Commission's enforcement record illustrates that these requirements have proven effective, allowing the Commission to pursue bad conduct where it arises. Accordingly, we do not believe the Commission should further enshrine the concept of inadvertent custody with the proposed rule changes.[36]

Nevertheless, if the Commission does move in this direction, we believe that the staff's Custody Rule FAQ II.11 strikes a better balance in addressing the risk the Commission is seeking to prevent, although even this FAQ does not address the fundamental flaw in the concept of inadvertent custody discussed above.[37] We ask that the Commission consider retaining this staff guidance. To underscore this request, we reiterate and reemphasize the comments that we have previously submitted to the staff on the Inadvertent Custody Guidance.[38] Moreover, we believe that even where an adviser is aware that the custody agreement grants broader authority than the advisory contract, any risk, which as discussed above is minimal, could be addressed through an internal controls approach, which we discuss as an alternative to the Proposal above.

custodian relative to the adviser's involvement in the selection thereof. For a discussion of our views on a principles- and risk-based approach to due diligence, see the Supplemental Outsourcing Letter.

[36] Our view that advisers should not be deemed to have custody when their advisory contracts limit their authority is grounded in the current, and proposed, definition of "custody" as "holding, directly or indirectly, client funds or securities [as proposed, assets], or having any authority to obtain possession of them." Investment advisers do not have "authority to obtain possession" of client assets in violation of the terms of their advisory contracts and would not view themselves as obtaining that authority pursuant to a custody agreement to which they are not a party "when the exercise of authority under that Custody Agreement would violate the investment adviser's [advisory contract]." *See* Letter to Dalia Blass, then Director, Division of Investment Management and Peter B. Driscoll, then Director, Office of Compliance Inspections and Examinations, *Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority*, Division of Investment Management Guidance Update No. 2017-01, from SIFMA AMG and the IAA (Mar. 7, 2018), available at https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/publications/SIFMA_AMG_IAA_Letter_to_SEC_Re_February_2017_Guidance_on_Custody.pdf (**Inadvertent Custody Letter**).

[37] *See Staff Responses to Questions about the Custody Rule*, available at https://www.sec.gov/divisions/investment/custody_faq_030510.htm (**Custody Rule FAQs**) (FAQ II.11 states that an adviser that does not have a copy of a client's custody agreement, and does not know or have reason to know whether the custody agreement would give the adviser custody of client assets, would not have custody of client assets if such custody agreement were the sole basis for custody). We are not aware of an enforcement action, since the Inadvertent Custody Guidance was issued, involving a qualified custodian where an adviser exceeded its level of authority under a custody agreement.

[38] *See* the Inadvertent Custody Letter.

3. Address the inconsistency between the Proposal's qualified custodian account segregation requirements and custodial practice.

A traditional custody agreement establishes: (i) a securities account that is segregated from the liabilities of the custodian and of other clients; and (ii) a cash account that is not held in trust or segregated from the custodian's proprietary assets. These arrangements appear to be inconsistent with the plain language in subparagraph (a)(1)(ii)(D) of the Proposed Rule, which requires the adviser to obtain reasonable assurances that: "The qualified custodian will clearly identify the client's assets as such, hold them in a custodial account, and will segregate all client assets from the qualified custodian's proprietary assets and liabilities…." The Commission should directly address the treatment of cash held in deposit accounts at a custodian in the final rule or in the adopting release to avoid confusion and the need for staff interpretations in advance of or after the final rule's compliance date that could render a vast number of existing custody accounts non-compliant with the final rule, requiring multiple rounds of engagement with qualified custodians. The Commission should also ensure that, in any final rule, it has addressed variations in business models across types of custodians because bank custodians perform their functions differently from, for example, FCMs.[39]

4. Appropriately scope the application of the QC Requirements based on the type of client.

The potential for risks of the type that the Proposal seeks to address through the QC Requirements vary greatly depending on, among other things, the type of advisory client. For example, certain clients already benefit from protections under other regulatory schemes that address these potential risks. The current Custody Rule has long recognized this, excepting from its scope registered investment companies. If the Commission determines to move forward with the QC Requirements, we recommend that it provide exceptions under the following circumstances.

Institutional investors. Institutional investors, which perform ongoing due diligence on, select, and monitor their own custodians, are sophisticated consumers of custody services. There is no evidence to suggest that institutional investors need advisers to intervene in their contractual relationships with custodians.

Non-U.S. accounts that are subject to safeguarding protections under non-U.S. law. The Commission could also reduce burdens on advisers without sacrificing investor protection by excepting non-U.S. pooled investment vehicles and other non-U.S. clients that are subject to

[39] In addition, we understand from our members that it is increasingly problematic for complex financial institutions to have a qualified custodian maintain certain types of assets in a separate account for each client under that client's name. This is a growing problem, for example, for certain advisers that participate in loan syndications and are deemed to have custody of a cash account. We understand that the Loan Syndications and Trading Association (**LSTA**) will be submitting comments on the Proposal and generally support its description and discussion of collateralized loan obligations (**CLOs**) as well as managed accounts and private funds that hold syndicated loan interests.

safeguarding protections under non-U.S. law from the safeguarding rule altogether, which we discuss in Section VIII.A. At a minimum, however, we recommend that they be excepted from the QC Requirements. These accounts would largely be captured under the Proposed Rule solely because the adviser exercises discretion. These types of accounts are already subject to specific safeguarding requirements under other regulatory regimes and subjecting them to these requirements is unnecessary and duplicative. The European Undertakings for Collective Investment in Transferable Securities (**UCITS**) regime, for example, requires that each UCITS engage a single depositary responsible for keeping the assets of the UCITS safe, monitoring cash movements, and ensuring that the UCITS manager performs certain key functions.[40]

5. Give advisers options regarding account statements.

The Proposed Rule would require the written agreement to provide that the qualified custodian will send account statements, at least quarterly, to the client and the adviser, identifying the amount of each client asset in the custodial account at the end of the period as well as all transactions in the account during that period, including the payment of advisory fees.[41] Advisers already have access to the information they need to review client accounts through electronic feeds in their portfolio accounting systems or custodians' online portals, however, and we thus do not believe that they need to receive all account statements.

We recommend that the Commission give advisers the option of satisfying the account statements provision by either: (i) receiving all account statements directly from custodians, as proposed; or (ii) having a reasonable basis after due inquiry for believing that the qualified custodian maintaining an advisory client's assets sends account statements directly to the client, as required under the current Custody Rule. In our view, the due inquiry method achieves the Commission's goals as effectively as the proposed approach, and some advisers prefer that method because it would reduce the volume of account statements – which advisers do not need for purposes of monitoring a client's account – retained on their systems solely to comply with this requirement.

We also request confirmation in the adopting release that account statements may be delivered electronically from qualified custodians to clients and advisers. In connection with this element of the Proposed Rule, we ask that the Commission staff amend its current guidance on account statements delivery[42] to no longer require evidence that the delivery is received by the client, such as an email return-receipt or other confirmation that the information was accessed. Electronic delivery is reliable and well-established, and maintaining email return-receipts is cumbersome. Client consent opting in to electronic delivery should be sufficient, absent a red flag such as an email bounce-back notification.

[40] Directive 2014/91/EU of 23 July 2014.

[41] Proposed Rule 223-1(a)(1)(i)(B). There is an exception if the adviser is relying on the audit provision.

[42] *See* Custody Rule FAQ IV.1.

6. Leverage existing reports instead of requiring internal control reports.

The Proposed Rule would require the written agreement to provide that the qualified custodian, at least annually, will obtain and provide to the adviser a written internal control report that includes an opinion of an independent public accountant as to whether controls have been placed in operation as of a specific date, are suitably designed, and are operating effectively to meet control objectives relating to custodial services (including the safeguarding of the client assets held by that qualified custodian during the year).[43]

We are concerned that the Proposal does not sufficiently consider, or provide adequate evidence regarding, the costs and challenges of obtaining internal control reports that are broad enough to satisfy the Proposed Rule across each type of qualified custodian. Internal control reports are expensive, and it is unclear who would bear these increased costs or that the reports would provide sufficient benefit, compared with the status quo, to justify this requirement. We also are concerned, as we discuss above, that an adviser's ability to comply with the Proposed Rule would depend on the actions of the custodian. If a qualified custodian were to be delayed or fail to obtain or provide an internal control report, an adviser may be forced, at great expense and on an uncertain timeline, to replace the custodian. The Proposal does not sufficiently acknowledge or address the costs of this potential disruption or adequately articulate a need for this control report requirement that would justify the potential harm. Accordingly, we recommend instead that the Commission reassess this requirement and explore leveraging reports that may already be available from qualified custodians (*e.g.*, SOC 1 Reports, ISO 27001 internal auditor certifications).

7. Tailor requirements relating to liens and other claims on client assets to address specific concerns in a more direct and targeted manner.

The Proposed Rule would require an adviser to obtain reasonable assurances in writing from the qualified custodian that the qualified custodian will not subject client assets to any right, charge, security interest, lien, or claim in favor of the qualified custodian or its related persons or creditors, except to the extent agreed to or authorized in writing by the client.[44] This requirement appears to be aimed at certain crypto assets that have been found by the courts to be property of the debtors' bankruptcy estates, and holders of such accounts to be unsecured creditors.

To the extent that the Commission's concerns relate to crypto assets, it should not extend a broad and ill-fitting requirement to the safeguarding of all assets, but instead focus on and target any new requirements to the Commission's specific concerns with safeguarding crypto assets.

[43] Proposed Rule 223-1(a)(1)(i)(C).

[44] *See* Proposed Rule 223-1(a)(1)(ii)(E).

8. Permit advisers to follow an internal controls approach regarding due diligence of custodians.

The Proposal states that, "[t]he requirements that an adviser obtain reasonable assurances from qualified custodians also will require due diligence and periodic monitoring by the adviser."[45] We oppose this diligence and monitoring requirement because it is vague, open-ended, and would reduce the ability of advisers to appropriately calibrate any oversight based on their judgment of risk. If the Commission retains requirements related to reasonable assurances, we reiterate the recommendation we make in our Supplemental Outsourcing Letter with respect to "covered functions" under that proposal that advisers be permitted to follow a risk-based approach to due diligence and include a reasonableness standard relating to the adviser's performance of its due diligence. Similarly, advisers should be permitted to tailor their monitoring to their particular facts and circumstances.

In determining how much due diligence an adviser should perform to verify a custodian's implementation of any required reasonable assurances, the adviser should be permitted to reasonably conclude, based on its risk assessment, that it would not need to check each version of the custodian's account application for the required provisions or obtain annual certifications from each custodian.

III. DEFINITION OF CUSTODY: ACTIVITIES AND ASSETS

A. The Definition of Custody Should Not Include Discretionary Authority

The Commission is proposing to amend the definition of custody to explicitly include discretionary authority. Custody would include "[a]ny arrangement (including, but not limited to a general power of attorney *or discretionary authority*) under which you are authorized or permitted to withdraw or transfer beneficial ownership of client assets upon your instruction" [emphasis added].[46] However, both the Commission and its staff have recognized on numerous occasions that the limited authority to direct custodians in connection with securities settlements does not introduce the same nature or magnitude of misappropriation or loss risk that arises from actual or constructive possession of client assets. The Commission therefore has historically and appropriately never intended to treat discretionary authority as conferring custody on advisers, and it should not change course now. The Proposal's approach would be a major departure from the regulatory treatment of, and market practices regarding, discretionary advice that have worked well since 2003. It would impose the expense and burden of the Proposed Rule on the more than 90 percent of SEC-registered investment advisers that exercise discretion.[47] We are very concerned that this proposed expansion of the breadth of the definition of custody would

[45] Proposal at 14746.

[46] Proposed Rule 223-1(d)(3)(ii).

[47] As noted above, according to the Proposal, 92.0 percent of advisers (13,944 out of 15,160 SEC-registered advisers) currently report having discretionary authority and would be subject to the Proposed Rule. Proposal at 14762.

make trading on behalf of clients impracticable for many advisers through the additional and unnecessary burdens of the Proposed Rule. We therefore urge the Commission to reconsider this aspect of the Proposal and preserve the exception from having custody for trading pursuant to discretionary authority.

We strongly disagree with the fundamental premise of the Proposal that having discretionary authority should give an adviser custody for the policy purposes expressed in the Proposal. The adviser's sole authority to "withdraw" (or under the Proposed Rule, "transfer") client assets pursuant to its discretionary authority is to direct the custodian to settle authorized trades. *Discretionary authority does not authorize the adviser to effect or direct any other withdrawal or transfer of client funds.*[48] Discretionary authority thus does not generate the types of risks the current or proposed rules are designed to address (*i.e.*, risk of loss, theft, misappropriation, or being subject to the financial reverses or insolvency of an adviser). To the contrary, more than 20 years of experience with the scope of the definition of custody (including the longstanding exception for authorized trading) under the current Custody Rule have demonstrated the opposite: discretionary authority in itself does not create meaningful custody risks.

As the Proposal itself notes, the Commission in 2003 stated that an adviser's authority to issue instructions to a broker-dealer or a custodian to effect or settle trades (*i.e.*, authorized trading) does not constitute custody and expressly recognized that the risk of misappropriation or unauthorized withdrawal in those circumstances is minimal.[49] The Commission cannot and does not cite any examples or evidence that would warrant reaching a different conclusion, and we are not aware of advisers abusing their discretionary authority to misappropriate client assets. Rather, the Proposal explains that the Commission's shift is based on theoretical concerns that advisers "could" use discretionary authority to misdirect client assets. Moreover, the Proposal's economic and cost-benefit analyses merely repeat the Commission's theory and do not provide any data or quantitative analysis of the purported "benefits" of this shift that would come from eliminating these theoretical risks.

In addition, we believe that there is no indication that Congress intended Section 223 of the Advisers Act to expand the definition of *custody*, let alone to expand it to cover discretionary trading authority.[50] The Proposal does not show evidence, examples, or anything more than theoretical concerns that discretionary authority presents risks that are in any way proportionate to the vast new burdens and expenses that the Proposed Rule would impose on advisers

[48] This type of discretion is directly addressed in the SLOA IAA No-Action Letter (defined below), the conditions of which would be codified in subparagraph (b)(7) of the safeguarding rule. *See Investment Adviser Association*, SEC Staff No-Action Letter (Feb. 21, 2017), available at https://www.sec.gov/divisions/investment/noaction/2017/investment-adviser-association-022117-206-4.htm (**SLOA IAA No-Action Letter**).

[49] Proposal at 14680.

[50] We also question the value to the Commission staff's risk assessment if all advisers with discretionary trading authority would be deemed to have custody of client assets.

considered to have custody of client assets merely because they have discretionary authority. Thus, the hurdle for expanding the definition of custody in this way is high, and the Proposal does not come close to meeting it. For all of these reasons, the IAA strongly urges the Commission not to expand the definition of custody to include discretionary authority.

1. Custody should not turn on whether assets settle on a DVP or a non-DVP basis.

Discretionary authority should not be treated as custody regardless of the method of trade settlement, *i.e.*, DVP or non-DVP. While the Proposed Rule would include an exception from the surprise examination requirement for client assets if the adviser's sole basis for having custody is that it uses discretionary authority to trade in securities that settle DVP,[51] this extremely large number of advisers would nonetheless have to comply with the QC Requirements and the other provisions of the Proposal. As we discuss above, compliance with these requirements will be far more difficult and burdensome than the Commission seems to believe, particularly for smaller advisers. These operational hurdles and expenses are in no way proportionate to the theoretical risks that the Proposal claims derive from DVP trading authority.

An even greater lack of proportionality is inherent in the Proposal's application to non-DVP transactions since it would impose the operational burdens, diversion of resources, and other costs of surprise examinations on any adviser that engages in non-DVP settled transactions, as well as the other provisions of the Proposed Rule. It would thus be especially difficult and expensive for advisers with discretion to trade in asset classes that do not settle on a DVP basis.

The Commission has not made a persuasive case for treating either DVP or non-DVP discretionary trading as custody, or for treating them categorically differently. The absence of an explicit limitation in the current Custody Rule text for certain types of trading authority along with statements in the 2003 Adopting Release – which were not changed in the subsequent and most recent amendments to the Custody Rule finalized in 2009 – underscore that the authorized trading exception in the current Custody Rule was never intended to be limited to DVP settlement.[52] We believe that that is still the right policy and that the Commission should not treat these methods of settlement differently now.

We address the treatment of, and safeguards relating to, transactions that settle on a non-DVP basis in more detail in a 2021 letter to the Commission and refer the Commission to the Non-DVP Letter for that discussion.[53] Our analysis demonstrates that there is no rational basis grounded in experience for distinguishing misappropriation risks arising from DVP-settled and

[51] Proposed Rule 223-1(b)(8).

[52] *Custody of Funds or Securities of Clients by Investment Advisers*, 68 Fed. Reg. 56692, 56693 (Oct. 1, 2003), available at https://www.sec.gov/rules/final/ia-2176.pdf (**2003 Adopting Release**).

[53] *See* Letter to the Commission, *Engaging on Non-DVP Custodial Practices*, from the IAA, SIFMA AMG, and the LSTA (May 13, 2021), available at https://investmentadviser.org/resources/engaging-on-non-dvp-custodial-practices/ (**Non-DVP Letter**).

non-DVP-settled transactions. In the Proposal, the Commission nevertheless avers that there is a reduced risk that the adviser could misappropriate the assets, and reduced risk of theft of the asset, when the transaction settles on a DVP basis. We do not agree. Non-DVP settlement does not pose a significantly greater risk of misappropriation or loss of client assets than DVP settlement, and assessment of these risks, therefore, should not turn on settlement method.

The Proposed Rule echoes interpretive positions advanced by the staff in recent years that are at odds with the current Custody Rule. We disagree with the staff's reading that the authorized trading exception is or should be limited to DVP, and we believe that the language in the 2003 Adopting Release is clear on its face and consistent with market practice and thus represents the appropriate policy judgment.[54] We ask that the Commission also consider that, while mutual funds are subject to strict requirements with respect to securities and similar investments held in the custody of the fund, including that the investments be held by a custodian that meets certain conditions, under these requirements "securities in transit in connection with the sale, exchange, redemption, maturity or conversion […] or other transactions necessary or appropriate in the ordinary course of business relating to the management of securities" are excepted from this custody requirement.[55] We do not see any rational basis for the Commission to generally except settlement activities from the custody requirements applicable to registered funds, but now propose to extend the full requirements of the Proposed Rule to advisers that direct non-DVP settlements, and most of the requirements to advisers that direct only DVP settlements.

Moreover, the Commission offers no rational basis for distinguishing misappropriation risks arising from DVP and non-DVP transactions. The Proposal states, in relevant part:

[54] The Proposal asserts that including discretionary authority as custody "would rectify any unintended consequences of our prior interpretive position" then cites to note 10 of the 2003 Adopting Release. As the Non-DVP Letter explains, we do not believe the broad exclusion of trading authority from the scope of custody was inadvertent. Thousands of investment advisers for two decades have operated on that basis, engaging in many types of authorized trading, regardless of method of settlement, without loss of client assets. We understand the Proposal (as well as the staff's 2019 letter to the IAA soliciting comments on non-DVP custodial practices) as confirmation that any change to this critically important interpretive matter should only be made through formal rulemaking with appropriate notice and comment, such as this one, if finalized. Accordingly, we were surprised to see, at the end of footnote 37 of the Proposal, the following statement: "Absent this narrowly drawn exception for 'delivery versus payment' transactions, authorized trading comes within the definition of custody." The intent of this sentence is unclear because the Proposal includes no discussion of its significance or purpose. We assume, however, that the Commission and staff do not view this dicta as formal guidance effectuating an immediate change in the widely-understood position under the current Custody Rule stated by the Commission in the 2003 Adopting Release. The Commission and staff are clearly on notice concerning the broad reliance of advisers on the 2003 position but have included no acknowledgement of the impact that would result if such an interpretive change were to be made *post hoc* and have not offered a cost-benefit analysis, requested comment on the statement, or included the statement in rule text or even a final Commission action. While the purpose of the statement in footnote 37 is unclear, we are confident that the Commission would not seek to effectuate a major change to a policy about which there has been much commentary by means of a single sentence in one of the 690 footnotes to a proposing release.

[55] Rule 17f-2(c) under the Investment Company Act of 1940 (**Investment Company Act**).

> This "delivery versus payment" arrangement minimizes the risk that an investment adviser could withdraw or misappropriate the assets in its client's custodial account. In our view, DVP transactions reduce the risk that the seller of an asset could deliver the asset but not receive payment or that the buyer of an asset could make payment but not receive delivery of the asset.[56]

This passage, in turn, cites to a 1992 report by the Bank of International Settlements (the **BIS Report**) that describes DVP transactions in detail.[57] The BIS Report cites several risks that can be mitigated through DVP transactions, including credit risk, replacement cost risk, principal risk, and liquidity risk, all arising from a potential counterparty default, as well as systemic risk arising from institutions exposed to the transactional risks. The BIS Report does not address DVP settlement as a protection against unauthorized withdrawal or misappropriation by agents or others. By all accounts, DVP settlement reduces counterparty risk, but the Commission has not cited any account by which it reduces misappropriation risk, which is the nominal goal of the Proposed Rule.

Most advisers with discretionary authority over client assets (regardless of settlement method) currently have safeguards in place – such as limiting access to accounts, implementing and monitoring authorized signatory lists, and requiring additional approvals for larger or unusual transactions – that effectively limit the risks to clients of loss, misuse, theft, and – in particular – misappropriation. With appropriate safeguards in place, which may differ depending on the type of transaction, non-DVP settlement processes are not inherently less reliable than DVP settlement, and do not pose a significantly greater risk of misappropriation or loss of client assets from an adviser's insolvency or financial reverses than DVP settlement. As we have previously shared with the Commission,[58] non-DVP settlement standards and processes routinely and reliably result in full, on-time delivery of securities and corresponding payments, without evidence of increased opportunity for misappropriation.

Consequently, we believe a better approach to address the various risks introduced in the settlement process for different securities in different markets is to require that advisers implement an internal controls approach reasonably designed to safeguard client assets. We believe that all transactions, including those in assets that settle on a non-DVP basis, generally *should* be subject to policies, procedures, controls, and risk management protocols that are effectively designed to prevent loss and misappropriation. Because of the evolution of industry practices since the Commission adopted the current definition of custody in 2003 and in response

[56] Proposal at 14680.

[57] Proposal at n.73.

[58] *See* the Non-DVP Letter.

to these reforms, such policies and controls are already prevalent and effective.[59]

A requirement to establish a robust internal controls approach for both DVP and non-DVP settlement would be better tailored to the risks that are relevant to settlement of these transactions, more flexible to address the actual risks introduced by different instruments and different markets, and thus more effective than pulling both DVP and non-DVP transactions into the scope of custody. Critically, these controls would help safeguard client assets from a wide range of transactional and settlement risks, including the risks discussed in the BIS Report, that cannot be addressed through the one-size-fits-all, prescriptive proposed requirements.

For all these reasons, we urge the Commission to exclude all discretionary authority from the definition of custody.

B. The Proposed Rule Should Be Calibrated to the Actual Safeguarding Risks That an Asset Presents Because It Would Otherwise Impede Investment Without Meaningfully Improving Investor Protection

The Proposal would expand the scope of assets covered by the current Custody Rule beyond funds and securities by defining "assets" as "funds, securities, or other positions held in a client's account."[60] As discussed, the IAA shares the Commission's goal of protecting client assets from misappropriation or loss. We are concerned, however, that this expansion would interact with existing regulatory regimes, market practices, and essential characteristics of many assets in ways that will make investing in these assets difficult or infeasible for many advisers and their clients, including for *bona fide* hedging.

For example, consider how the Proposal would apply to futures, swaps, and other regulated derivatives, which the Proposal would treat as assets subject to the Proposed Rule. However, futures and swaps are not "assets" in the sense that the Proposal would treat them. Rather, they are bilateral contracts between two parties or a set of two contracts, most of which interpose a regulatorily-mandated clearinghouse as a party to each counterparty contract. Futures and cleared swaps contracts generally are evidenced in account statements. Over-the-counter swaps are documented by an ISDA Master Agreement and a confirmation evidencing the terms of a specific contract. There is no practical way for a qualified custodian to maintain possession or control of such contracts, and it is a category error to apply the current Custody Rule framework, which is designed for securities, to such contracts. The client assets in question in

[59] *See, e.g.*, Appendix to the Inadvertent Custody Letter. Other aspects of an internal controls approach could include, if appropriate to the circumstances, for example, the designation of specifically authorized employees to approve transfers of assets, a maker-checker process in which individuals from different reporting lines are required to authorize a transaction, specific Chief Compliance Officer responsibility to periodically review and verify controls over asset transfers and fee deductions, periodic reconciliations with banks, representations from clients regarding assets in the account, and other controls that are tailored to the adviser's business.

[60] Proposed Rule 223-1(d)(1).

derivatives contracts are the funds or securities posted to the FCM or swap dealer as collateral.[61] While FCMs would be considered qualified custodians under the Proposal (with some limitations), an adviser using futures would be required to negotiate agreements with each FCM to which the adviser posted client assets as collateral and obtain assurances from each such FCM that would comply with the Proposed Rule. Moreover, since many swap dealers do not meet the definition of "qualified custodian," the Proposed Rule would *de facto* require that all advisers entering into swaps for clients negotiate triparty custody and control agreements with such swap dealers and their clients' qualified custodians. The burden of negotiating these agreements with large financial institutions and then administering the triparty collateral regime would effectively put swaps investments out of reach for many advisers, particularly smaller advisers.

This additional layer of regulation would be unnecessary and duplicative. FCMs and swap dealers are themselves subject to comprehensive customer safeguards regulation by the Commodity Futures Trading Commission (**CFTC**) and the National Futures Association (**NFA**). Thus, the Commission would be indirectly regulating intermediaries already subject to another regulatory regime, which, at a minimum, would place duplicative burdens on FCMs that they can be expected to resist. We believe that the existing CFTC/NFA customer safeguarding regime is entirely sufficient to protect advisory clients' assets and thus believe that futures and cleared swaps should be excluded entirely from the definition of "assets," as they currently are. However, if the Commission insists on indirectly regulating FCMs and swap dealers, we strongly recommend that the Commission coordinate with the CFTC before determining what these requirements would be.[62]

Similarly, including interests in CLOs in the definition of custody and thereby applying the Proposed Rule's framework to these interests yields similarly conflicting results. As we discuss below in Section V.A, significant elements of the Proposed Rule would be impractical to apply to CLO interests. In particular, the extensive governing documents and internal controls in a CLO structure expressly limit the manager's access to and authority over investor assets and guard against the risk of misappropriation. Thus, we do not believe that expanding the definition of "assets" to include CLO interests is warranted.[63]

These examples suggest that the risks of misappropriation and loss are best thought of as existing on a spectrum, where different asset classes present different risks, depending on the nature of the asset and its legal instruments, market practice, the interposition of third parties

[61] We note that Custody Rule FAQ II.10 appears to assume that collateral posted as margin in connection with swaps is always the property of the client, which would limit swap counterparties that hold margin to parties that are qualified custodians.

[62] In addition to the points we make above, the IAA generally agrees with and supports the points made in the Alternative Investment Management Association (**AIMA**) and the Alternative Credit Council's (**ACC**) joint letter (**AIMA and ACC Joint Letter**) regarding the impact the Proposal would have on practices involving derivatives, commodities, and other assets, and Appendix A of the Investment Company Institute's letter (**ICI Letter**) relating to the treatment of FCMs and the safeguarding of investments in derivatives.

[63] See *supra* n.39.

with interests in protecting the integrity of the assets they issue or sponsor, and the presence of a strong, existing regulatory regime. The Proposal essentially ignores this risk spectrum and takes a one-size-fits-all, binary approach to custody risk. We believe that the Commission should undertake any potential expansion of "assets" that should be covered under the safeguarding rule in a much more cautious and limited manner. However, if the Commission continues forward with an expansive approach toward the definition of "assets" currently included in the Proposed Rule, we believe that focusing the adviser's role in safeguarding client assets on an internal controls approach would more effectively address the spectrum of risks and achieve the Commission's goal of protecting advisory client assets.

Compliance with the Proposed Rule also would be particularly difficult for novel, innovative, or unconventional asset types. One consequence of the proposed definition of assets is that it would include investments – such as crypto assets – while sidestepping the thorny analysis of whether such assets are securities or could even be held by a qualified custodian. While it may be possible to custody certain established crypto assets with a qualified custodian, there is no guarantee that qualified custodians would support all crypto assets, and especially emerging crypto assets for which there is no established trading market. Additionally, as the Proposal notes, crypto assets would be difficult to custody without violating the proposed safeguarding rule.[64] This is because most crypto asset trading platforms would not satisfy the definition of qualified custodian (*e.g.*, a qualified custodian would have difficulty demonstrating exclusive possession or control with respect to crypto assets).

The Commission has not proposed an exception from holding assets with a qualified custodian for crypto assets, as it has for privately offered securities and physical assets. Therefore, the safeguarding rule would effectively impede investment in crypto assets without directly addressing the policy issues relating to those assets. We recommend that the Commission consider addressing risks arising from crypto assets by proposing more targeted requirements that are specific to crypto assets. Regardless of how the Commission proceeds to address risks arising from crypto assets, advisers, of course, retain their duty to fully disclose material risks associated with investment in crypto assets and their duty of care in making investment recommendations.

Accordingly, we believe that it is imperative to ensure that the final rule offers the most protection for client assets while not chilling innovation or impeding the use or development of new and different investment management business models and tools that increase access to the markets and efficiencies in the investment of assets on behalf of investors seeking to build their portfolios using fiduciary investment advisers.

[64] *See* Proposal at 14689.

IV. DEFINITION OF QUALIFIED CUSTODIAN

A. Clarify the Meaning of Possession or Control

The Proposed Rule would require an investment adviser to maintain client assets with a qualified custodian that has possession or control of those assets. "Possession or control" would be defined to mean holding assets such that: (i) the qualified custodian is required to participate in any change in beneficial ownership of those assets; (ii) the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership; *and* (iii) the qualified custodian's involvement is a condition precedent to the change in beneficial ownership.[65]

With the "possession or control" requirement, the Proposal would attempt to fit a square peg into a round hole by extending the custody concept from cash and publicly traded securities to all asset classes. Custodians can exercise control over cash in a deposit account and over publicly traded securities through book entries on the records of a central securities depository. Moreover, certificated securities (now exceedingly rare) and certain categories of physical assets can be held in a custodian's physical possession. But it is the particular characteristics of these assets that allow a custodian to exercise such possession or control. While these characteristics have facilitated key features of the modern custody system, to the benefit of investors, there are large categories of assets that do not have these characteristics, and thus for which possession or control is infeasible or impracticable. Other techniques for possession or control that the Commission seems to believe are available, such as the custodian becoming a party to the agreement, are at scale infeasible.

For example, a custodian cannot exercise possession or control over large categories of assets that are structured as bilateral agreements, such as floating rate and other loans, commercial mortgages, syndicated loans, foreign currency forwards, and (unless the custodian is an FCM or a swap dealer), futures and swaps (both cleared and over the counter). These contracts are not evidenced as book entries in a central depository, nor can they be deposited in demand accounts, and the custodian cannot become a party to the relevant contract (physical custody of the paper contracts does not give a custodian possession or control, as that term is proposed to be defined). It is also not clear how the possession or control definition would apply to CLOs, where the administrative agent effects the transfer of beneficial ownership. The qualified custodian participates in the process, but it is uncertain if it "effectuates" the transaction or its involvement is a "condition precedent."[66]

[65] Proposed Rule 223-1(d)(8).

[66] To that end, the IAA supports and agrees with comments submitted by the LSTA. As we have previously communicated to the Commission staff, the extensive governing documents and internal controls in a CLO structure expressly limit the manager's access to, and authority over, investor assets and guard against the risk of misappropriation.

Similarly, while there are significant categories of assets that a custodian could in theory possess or control through legal title or becoming a party to the contract, these would be impractical and would create unreasonable exposures for the custodian at scale. For example, a custodian could theoretically own the title for custodied real property, but only at the risk of taking on all of the liabilities (*e.g.*, environmental) associated with that property. Custodians could, in theory, become parties to each stock purchase agreement for private company stock and to each subscription or LLC agreement for private fund interests held by their customers, assuming they were permitted to do so under their particular regulatory regimes. But to do so at scale, for every single such investment by every single client of every single adviser subject to the Proposed Rule, would be a massive legal undertaking (not even considering re-papering every existing such contract), and would impose a costly administrative burden on every such private transaction.

Moreover, as the Commission has long recognized through the structure and requirements of the current Custody Rule, the very features of private securities that make them incompatible with traditional custody arrangements also mean that the risk of misappropriation or loss is exceedingly small. For example, falsifying the subscription agreement for a private fund or the purchase agreement for private company stock simply does not afford the wrongdoer the ability to transfer a client's interest in these funds or companies in the same way as fraudulently accessing a client's brokerage or bank account. A key difference is the fact that such a transfer of a privately offered security requires the consent and express action of a third party (the fund manager or the company) that has a powerful interest in protecting the integrity of the securities it issues and has identification processes and transfer restrictions in place for this purpose. The Commission cannot and does not cite a record or history of actual misappropriation or loss of privately offered securities that would necessitate a complete re-engineering of the system for documenting, and changing the legal relationships relating to, private investments. The disproportion between the sheer scale of the task and the minimal, theoretical risks that this provision of the Proposed Rule attempts to address is striking and suggests that the Commission intends to impede private securities investments.

For these reasons, the proposed requirement of "possession or control" is deeply problematic and is emblematic of many of our concerns with the Proposal. In order to address potential policy concerns with a small subset of asset classes, the Commission would apply a custody tool that was developed and only works for a different subset of asset classes, with the likely, if unintended, result being large-scale disruption of otherwise well-functioning investment systems. We urge the Commission to keep the current definition of qualified custodian,[67] with

[67] Qualified custodian means: (i) a bank as defined in section 202(a)(2) of the Advisers Act or a savings association as defined in section 3(b)(1) of the Federal Deposit Insurance Act that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act; (ii) a broker-dealer registered under section 15(b)(1) of the Exchange Act, holding the client assets in customer accounts; (iii) an FCM registered under section 4f(a) of the Commodity Exchange Act, holding the client assets in customer accounts, but only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; and (iv) an FFI that customarily holds financial assets for its

the exception of expanding the definition with respect to FCMs,[68] without the "possession or control" requirement and instead address specific concerns with subsets of assets in a more tailored way in order to avoid unintended consequences for other asset classes. Alternatively, if the Commission determines to keep the proposed requirement of "possession or control," we recommend that it apply only to the narrow set of assets for which it is workable, for example by mirroring the current Customer Protection Rule[69] for broker-dealer custodians or by applying it only where custodians can exercise control over the asset in a deposit account or through book entries on the records of a central depository.

B. Eliminate Certain Conditions in the Definition of Foreign Financial Institution

The Commission is proposing to require that an FFI satisfy seven new conditions to serve as a qualified custodian for client assets under the Proposed Rule.[70] We are concerned that the proposed new conditions for FFIs are unworkable and would impede an adviser's ability to invest in foreign securities and emerging markets.[71] For example, we do not understand how an adviser could determine whether an FFI has "the requisite financial strength to provide due care for client assets" (the fifth condition) on a routine basis. The third condition (that the FFI is "required by law to comply with anti-money laundering and related provisions similar to those of the Bank Secrecy Act and regulations thereunder") is particularly problematic. This condition would require an adviser to evaluate all of the sub-custodians in a custody network, even though they are regulated entities, and the adviser would need to make legal judgments – likely with expensive consultation with U.S. and foreign counsel – as to whether foreign anti-money laundering provisions are deemed similar to those of the Bank Secrecy Act, leading to inconsistency and second guessing.

For foreign assets, a U.S. client typically engages a U.S.-based qualified custodian that, in turn, engages with a non-U.S. sub-custodian for the purpose of holding certain foreign investments. Other times, a non-U.S. client engages a non-U.S. qualified custodian directly. If an adviser were to determine that an FFI did not satisfy the proposed conditions, it is unclear what the adviser (or sub-adviser) can do when the client selected the qualified custodian. Is the adviser expected to refuse to serve a client or to divest a client's foreign assets if it is unable to determine whether an FFI meets the conditions? A potential unintended consequence could be that clients

customers, provided that the FFI keeps the advisory clients' assets in customer accounts segregated from its proprietary assets. *See* Rule 206(4)-2(d)(6) under the Advisers Act.

[68] As requested and for the reasons discussed in the ICI Letter and the AIMA and ACC Joint Letter, *supra* n.62.

[69] *See* Exchange Act Rule 15c3-3, 17 CFR 240.15c3-3 (requiring appropriate measures to protect and preserve customer property held at broker-dealers).

[70] *See* Proposed Rule 223-1(d)(10)(iv).

[71] The IAA generally agrees with the points made in the AIMA and ACC Joint Letter regarding how the Proposal's FFI requirements could prevent advisers from investing in foreign markets, *supra* n.62.

are compelled to execute trades of foreign securities on their own, without the intermediation of the fiduciary adviser managing their assets.

The final rule should not limit the FFIs that can act as qualified custodians, as proposed. At a minimum, we recommend eliminating the third condition (required by law to comply with anti-money laundering and related provisions similar to those of the Bank Secrecy Act and regulations thereunder) and the fifth condition (having the requisite financial strength to provide due care for client assets). The Commission could also permit substituted compliance for foreign custodians whereby the Commission determines the acceptable jurisdictions and does not shift the risk to advisers**.** Finally, we note that Rule 17f-5 under the Investment Company Act establishes a regime for foreign custodians in which a fund's primary global custodian: (i) assesses that the foreign sub-custodian can exercise reasonable care based on local market standards; (ii) obtains contractual safeguards from the sub-custodian; and (iii) monitors the sub-custodian. An appropriately principles-based assessment and monitoring regime would be more effective that the FFI provisions in the Proposed Rule.

V. CERTAIN ASSETS THAT CANNOT BE MAINTAINED WITH A QUALIFIED CUSTODIAN

A. The Conditions for Certain Assets That Cannot be Maintained with a Qualified Custodian Would be Operationally Difficult, Costly, and Ineffective, and Should be Clarified and Modified

The safeguarding rule would impose a number of conditions on investment advisers that manage client assets that cannot be maintained by a qualified custodian.[72] The "exception" for assets that cannot be maintained with a qualified custodian, coupled with the expanded definition of custody, is in fact a mandate for advisers to take certain actions and engage third parties on behalf of clients if they are engaged by clients to exercise discretionary authority with respect to entire asset classes. We have significant concerns that this aspect of the Proposal is unnecessary in many cases, impracticable in others, and would result in considerable costs for investors without corresponding benefits. We also believe that the application of the Proposed Rule to

[72] The conditions are: (i) the adviser reasonably determines and documents in writing that ownership cannot be recorded and maintained (through book-entry, digital record, or otherwise) in a manner in which a qualified custodian can maintain possession, or control transfers of beneficial ownership, of such assets; (ii) the adviser reasonably safeguards the assets from loss, theft, misuse, misappropriation, or the adviser's financial reverses, including the adviser's insolvency; (iii) an independent public accountant, pursuant to a written agreement between the adviser and the accountant, (A) verifies any purchase, sale, or other transfer of beneficial ownership of such assets promptly upon receiving notice from the adviser of any purchase, sale, or other transfer of beneficial ownership of such assets; and (B) notifies the Commission within one business day upon finding any material discrepancies during the course of performing its procedures; (iv) the adviser notifies the independent public accountant engaged to perform the verification of any purchase, sale, or other transfer of beneficial ownership of such assets within one business day; and (v) the existence and ownership of each of the client's privately offered securities or physical assets that is not maintained with a qualified custodian are verified during the annual surprise examination or as part of a financial statement audit. *See* Proposed Rule 223-1(b)(2).

physical assets and other non-securities, including how an adviser could ascertain whether a custodian can maintain possession or control of such assets, is unclear.

The Commission appears to be concerned that if assets that are difficult to custody are not held with a qualified custodian, the adviser could misappropriate or otherwise change beneficial ownership of the assets, and that clients would bear a risk of loss associated with the adviser's insolvency or bankruptcy. As discussed above, the very features of private securities that make them incompatible with traditional custody arrangements also mean that the risk of misappropriation or loss is exceedingly small. In addition, we do not believe that an adviser's insolvency or bankruptcy impacts the ownership of privately offered securities or physical assets that cannot be held by a qualified custodian.[73] Moreover, we believe that the Commission's proposed solution to mitigate these perceived risks – subjecting assets to multiple layers of verification audits – is a one-size-fits-all approach that would be ineffective in most cases, and expensive and burdensome in all cases.

Instead of forcing asset verification in all cases, we believe that the Commission's safeguarding goals would be better achieved by requiring that advisers implement an internal controls approach that is tailored to the specific risks associated with the different types of assets that are not suitable for custody by qualified custodians. We have identified several specific concerns with this element of the Proposed Rule and opportunities for more tailored and effective approaches below.

1. The adviser's reasonable determination condition is vague and unclear.

In order to rely on the exception for assets unable to be maintained with a qualified custodian, an adviser would first be required to reasonably determine, and document in writing, that ownership *cannot* be recorded and maintained by a qualified custodian.

As currently proposed, an adviser would be precluded from relying on this exception for certain privately offered securities that cannot be transferred without the consent of a counterparty (and, as the Commission itself notes, are therefore less susceptible to the risks the Proposed Rule is designed to address) but nevertheless *can* technically be maintained by a qualified custodian.[74] For example, as we note above, ISDA Master Agreements for uncleared swap transactions and other derivatives, private fund subscription documents, mortgage TBA documents, and executed LLC agreements that demonstrate ownership in a privately offered company all technically can be maintained in hard copy by bank trust departments, at great expense to the client; however, this custody arrangement provides no corresponding benefit to

[73] We appreciate that there have been instances of investment advisers and general partners of pooled investment vehicles commingling assets with pooled vehicles, and that the identification of client assets "hopelessly commingled" with adviser assets can be challenging in a bankruptcy proceeding. *See, e.g.*, *In re Hedged-Investments Assoc., Inc.*, 163 B.R. 841 (Bankr. D. Colo. 1994). However, this issue primarily arises from the commingling of funds, securities held at central depositories, and other fungible assets that can be promptly liquidated before entering a bankruptcy estate. Again, the same concern is not present with respect to privately offered securities.

[74] Proposal at 14704-14705.

the client because any scheme to misappropriate the asset would not be dependent on maintaining custody of the physical paper.[75] The primary check on the ability to transfer the asset rests with the issuer or counterparty, not the holder of record.

The determination that an asset is not suitable for custody at a qualified custodian therefore should not be a binary decision based solely on whether the asset *can* or *cannot* physically be maintained by *any* custodian. Instead, the rule should permit an adviser to rely on this exception where it has reasonably determined that an asset either reasonably cannot be custodied by a qualified custodian or that the costs or burdens of maintaining the asset at a qualified custodian introduce limited or no corresponding benefits to clients and are disproportionate to the risk. This determination would be based on certain considerations and the adviser's internal controls approach. As proposed by the Commission and consistent with our recommendations herein, the adviser would still need to "reasonably safeguard the assets" to comply with subparagraph (b)(2)(ii), which would ensure that the Commission's safeguarding goals are addressed.

If the Commission instead elects to retain a bright line rule approach, we request that it provide additional clarity in the adopting release with respect to the substance and frequency of the analysis advisers would be required to undertake to rely on the exception, including examples of custodial market analysis and factors an adviser may consider.[76] This would help advisers demonstrate good faith efforts to meet the reasonable determination.[77]

The Commission notes that an adviser's written documentation would generally contain material facts concerning its understanding of the custodial marketplace and a description of the client asset at issue. It is unclear to what extent, and how frequently, an adviser would be expected to analyze the available custodial market for an asset. For example, how impracticable must it be for a qualified custodian to maintain the asset? Although we agree with the Commission's suggestion that the frequency of the determination will depend on the particular facts and circumstances, we request additional guidance regarding the intended scope of this requirement. In our view, it would be reasonable to expect an adviser to revisit its analysis no more frequently than annually or upon becoming aware of material changes to the custody market. In addition, if the Commission elects to maintain this requirement substantially as proposed, we request that the word "cannot" in the Proposed Rule be qualified as "reasonably cannot." As currently written, the Proposed Rule invites technical violations for advisers that fail to ensure on an absolute basis that no qualified custodian could be identified to custody the asset (*e.g.*, identifying every conceivable

[75] Similar considerations arise in the context of master/feeder structures, where the "asset" held by the feeder fund is interests in the master fund.

[76] The vague nature of this requirement is further exacerbated by the lack of clarity with respect to the definition of "possession or control."

[77] We and our members would be pleased to discuss and help develop this guidance with Commission staff.

custodian that could custody a particular asset type, conducting constant custodial industry monitoring).[78]

The plain language of the Proposed Rule would also require that an adviser place client assets in the possession of a qualified custodian even if the adviser believes that such action would place client assets at risk. For example, if a state-sponsored trust company that is a qualified custodian offers a novel custody solution for maintenance of certain digital assets, investment advisers would only be able to advise on those assets if their clients held the assets through the trust company, notwithstanding that the advisers had identified severe shortcomings in the trust company's controls. Although the Commission's discussion in the Proposal appears to suggest that an adviser would not need to go to such extremes, the plain language of the Proposed Rule is currently inconsistent with that discussion and – at least on its face – places unreasonable and potentially risky obligations on the adviser. The focus of the adviser's reasonable assessment should not be whether an asset *can* be placed with a qualified custodian, but whether it *should*.

2. Notification within one business day to, and prompt verification by, an independent public accountant are highly impractical.

In addition to the reasonable determination requirement, an adviser relying on the exception for assets not maintained at a qualified custodian would be required to: (i) notify an independent public accountant of any purchase, sale, or other transfer of beneficial ownership of such assets within one business day; and (ii) obtain a verification of the transfer from the independent public accountant promptly upon its receipt of the required transfer notice.[79]

In the Proposal, the Commission asserts that the notice "would not be challenging for any adviser to provide to the independent public accountant, especially considering the limited nature of the requirement relative to the more involved aspects of many of the closings related to privately offered securities or physical assets such as the preparation or review of closing memos, confirmation of receipt of funds, execution of signature pages, and many other more time-consuming tasks related to closing for these types of assets."[80] Although this statement may be true for a very narrow universe of fund sponsors (*e.g.*, with respect to a private equity fund that takes control positions in operating companies a handful of times in a given year),[81] the assumption is wholly inaccurate for a much larger universe of advisers that

[78] We appreciate the Commission's reasonableness qualification of the requirement to reach a determination. However, the determination itself, as currently proposed, would be absolute, *i.e.*, no one can custody this asset.

[79] *See* Proposed Rule 223-1(b)(2). The accountant would also be required to notify the Commission by electronic means directed to the Division of Examinations within one business day upon finding any material discrepancies during the course of performing its procedures.

[80] Proposal at 14709.

[81] In addition, the Proposal does not acknowledge that, as part of the notification, the adviser would need to provide the independent public accountant with all the necessary documentation before it could begin its verification

engage in privately offered securities transactions on a substantially more frequent basis. For example, the one-day notification would be required for any separate account, hedge fund, or other pooled vehicle that enters into an uncleared swap or forward transaction, which are frequently used to hedge positions rather than to obtain investment exposure.

It would also reach the large universe of credit and fixed income managers that engage in direct lending transactions and that purchase and sell participation interests in syndicated loans. A credit manager could, for example, take a $30 million position in a loan that it then allocates among a dozen actively managed CLOs, potentially requiring 12 separate notifications and verifications. The manager may also engage in 12 exits from existing positions in those CLOs before allocating the new loan, which would result in an additional 12 required notifications and verifications. If the manager elects instead to reduce exposure to 7 positions in each of the 12 CLOs, the "exits" would then require 84 distinct transactions. A single "trade" could therefore result in nearly 100 notifications and verifications. We understand from our members and market inquiries that many CLO managers engage in thousands of these trades over the course of a single year. These multiplier effects are not limited to the syndicated loan market, and they would be present to some degree for any manager that transacts in privately offered securities and allocates transactions among multiple clients.

As illustrated by these examples (which do not appear to have been contemplated by the Commission in the Proposal), the notification and verification requirements would place an enormous and unwarranted burden on advisers, and they would generate enormous additional costs that could ultimately largely be borne by clients and fund investors. Furthermore, as the verifications must be performed by independent third parties, advisers would have no ability to develop more efficient and cost-effective verification processes. The notification and verification requirements would also require extensive and ongoing coordination among advisers and accountants, and an adviser could involuntarily violate the rule to the extent that it does not receive a prompt response from an accountant.

In addition to the prompt verification requirement, the Proposed Rule would also require advisers relying on the exception to undergo an annual surprise examination or ensure that clients receive annual audits.[82] As the Commission acknowledges in the Proposal, this would "supplement" the verification of transactions promptly after they occur and would operate similarly to an annual "bring down."[83]

We understand that the perceived or potential benefit of duplicative verification is to identify inappropriate or fraudulent transactions promptly (thereby empowering advisers,

process. We do not believe advisers could accomplish this in the Proposal's one-minute per transaction estimate. Proposal at 14766.

[82] *See* Proposed Rule 223-1(b)(2)(v).

[83] Proposal at 14709.

clients, and/or the Commission to take action to unwind a transaction or to recover proceeds), which may afford investors better protection than identifying the same fraud weeks or months later during a surprise verification or year-end audit. However, although this approach appears protective on its face, an adviser seeking to defraud a client could simply elect not to promptly notify the auditor of a fraudulent transaction, and therefore clients gain no additional protective benefit from the risk of misappropriation by advisers arising from this requirement.

If the goal of the Commission is instead to identify or deter potential wrongdoers within an investment adviser (*i.e.*, rogue employees) or third-party fraud or theft, then the notification and verification requirement may have some incremental benefit to help advisers ferret out potential wrongdoers among employees and counterparties. However, the profound burdens and costs of these requirements are not balanced or commensurate with the very limited risk of misappropriation or loss associated with most privately offered securities and physical assets. As noted above, privately offered securities cannot transfer without the consent and involvement of a third party, which in many cases is itself a regulated entity. With respect to physical assets, the most salient risk is not that assets will be misappropriated in the course of a transaction without the adviser’s knowledge, but that assets will be stolen while in the possession of the adviser. In both cases, the notification and verification requirements amount to a superficial stamp of approval that will create a mountainous paper trail and thousands of new assurance jobs, but do little to actually protect investors.

We propose that the Commission should instead: (i) retain the existing surprise examination for auditable securities and the annual audit exception; and (ii) enhance the adviser’s obligation to reasonably safeguard assets from loss, theft, misuse, misappropriation, or the adviser’s financial reverses with an express obligation to adopt and maintain an internal controls approach to achieve this end.

First, unlike transaction-by-transaction verification, surprise verifications and annual audits afford the auditor an opportunity to review transactions in the broader context of a client’s assets and liabilities over time, and thus provide a meaningful opportunity to uncover fraud and material error.

Second, we believe that the best way to address the varied and changing risks associated with private securities transactions and physical assets that cannot be mitigated through audit or involvement by the issuer is to require an internal controls approach that is tailored to the risks present in each relevant asset class. We recognize that investment advisers already have an obligation derived from their duty of care to safeguard clients’ assets. To the extent that the Commission is concerned that some advisers have failed (or will in the future fail) to discharge this duty effectively, the solution should not be to substitute a prescriptive, one-size-fits-all verification regime, but rather to require advisers to develop a thorough and structured principles-based approach to this obligation. This goal could be achieved either through the publication of guidance reminding advisers of their obligations under the Compliance Rule, or by establishing a distinct internal controls approach obligation with respect to privately offered securities and physical assets in the context of the safeguarding rule.

VI. ADVISER SEGREGATION OF CLIENT ASSETS

In addition to obtaining reasonable assurances that the qualified custodian is segregating client assets, the Proposed Rule also would require an adviser itself to segregate client assets from the adviser's and its related persons' assets when the adviser is deemed to have custody, regardless of whether the assets are held by a qualified custodian.[84]

A. The Adviser Segregation Aspect of the Proposal is Not Targeted to Achieve the Commission's Goals

The Commission's primary justification for imposing the requirement that advisers segregate client assets appears to be the protection of client assets from the insolvency and bankruptcy of the adviser. We believe these concerns are unfounded given the fundamental nature and operation of an advisory business. Unlike banks or broker-dealers that hold their customers' assets on their books, and can thus default on obligations to their depositors or customers, advisers do not, and are not permitted to, accept deposits or clear or settle trades.[85]

Like any other business, advisory firms can close or fail. Generally, advisers are wound down in an orderly fashion, and this process does not affect a client's assets because the adviser does not hold those assets. Because the investment advisory industry is large and diverse, when an adviser goes out of business, clients are able to find other advisers that can readily take them on as clients. In contrast to the failure of a broker-dealer, where the account that holds the assets must be transferred to another broker-dealer, advisory clients' accounts held with the custodians engaged by the client do not need to be transferred. Those custodial

[84] The Proposed Rule would require that client assets over which an adviser has custody: (i) be titled or registered in the client's name or otherwise held for the benefit of that client; (ii) not be commingled with the adviser's assets or its related persons' assets; and (iii) not be subject to any right, charge, security interest, lien, or claim of any kind in favor of the adviser, its related persons, or its creditors, except to the extent agreed to or authorized in writing by the client. *See* Proposed Rule 223-1(a)(3).

[85] This is a fundamental and critical distinction between advisers and banks or broker-dealers, which often act as principals in their dealings with customers or act with respect to their own balance sheet in ways that might put their customers' assets at risk. Regulations are designed accordingly to ensure that a bank or broker-dealer can make good on its obligations with respect to the customer assets that it holds. For example, capital requirements for, and restrictions on, proprietary trading by a bank are designed to protect the bank's safety and soundness and ensure the safety of customer deposits. These regulatory protections prevent or incentivize banks not to take risks with their own balance sheets that would endanger the bank or the banking system. Similarly, capital requirements for broker-dealers help to ensure that they can settle trades and maintain and protect customer assets entrusted to them. They also help to manage the orderly liquidation of a broker-dealer and the transfer of customer assets to another broker-dealer. As discussed above, to the extent that the Commission is concerned with how crypto assets are resolved in bankruptcy, it should target any requirements to those specific concerns.

accounts remain unaffected regardless of whether the adviser stays in business.[86] Thus, while the advisory relationship with the client is impacted, there is no risk to the assets in that client's account. Moreover, advisers are separate and distinct legal entities from their clients, and an adviser's creditors do not have recourse to client assets held in custody by the custodian.

We recognize that these general protections are not necessarily applicable in the narrow case where an adviser holds physical assets such as artwork on behalf of a client, but we believe that these situations are addressed through the safeguarding principles of subparagraph (b)(2) of the Proposed Rule (assets unable to be maintained with a qualified custodian). As a result, the express segregation provisions of subparagraph (a)(3) of the Proposed Rule are duplicative of those protections and would not be additive to the protection of client assets.

B. The Adviser Asset Segregation Requirements Would Lead to Unintended Consequences

The application of the asset segregation requirement would have a number of apparently unintended and problematic consequences for a large group of investment advisers. We have identified several of these consequences and request related clarifications below:

- The asset segregation requirement appears to prohibit arrangements frequently undertaken by various types of clients (including but not limited to private funds) that involve the hypothecation or lending of client assets, even if the client authorizes them. For example, in a prime brokerage arrangement, a client places securities in the custody of a prime broker, authorizes the prime broker to obtain a lien on the assets, and rehypothecates the assets to third parties as a means to finance leverage or short selling. Rehypothecation enables the prime broker and thus the client to borrow at lower rates. Under the Proposed Rule, this common arrangement appears to be prohibited since the rehypothecated assets would no longer be held in the client's name. This prohibition would likely significantly increase the costs of borrowing from prime brokers. The Commission should clarify that these arrangements would not be prohibited so as to preserve current practice.

- Rehypothecation of a security in other contexts would also result in the security no longer being registered in the client's name and would violate the plain language of subparagraph (a)(3)(i) of the Proposed Rule. The Commission partially addresses this issue in the Proposal with respect to securities lending, noting that "[i]n a typical securities lending transaction, the legal title to loaned

[86] The client may of course at any time on its own decide to retain a different custodian or otherwise close its account with the custodian.

securities passes to the borrower for the loan term."[87] While the Commission appears to suggest that securities lending would be permitted under the Proposal (with client authorization), the Proposed Rule text provides that a client's assets at all times would have to be titled or registered in the client's name or otherwise held for the benefit of that client. Consequently, while the client authorization exception would apply to a security interest or lien in a margin account or prime brokerage account, it does not appear to apply to the securities lending or other rehypothecation arrangements that pass legal title of an asset to a borrower. This distinction should be clarified in a manner that preserves current practice.

- We request confirmation in the final rule or the adopting release that the prohibition on commingling assets in subparagraph (a)(3)(ii) of the Proposed Rule would not prohibit an adviser from investing in the same pooled vehicle in which a client invests. We note that the risks that this requirement were designed to address are not present in the context where the adviser's interests are aligned with investors as joint investors in a single investment fund. The rights of investors in the pooled vehicle are determined in accordance with the documents governing the operation of the vehicle, and investors' ownership interests are separately documented on the books of the fund.

- We request confirmation in the final rule or the adopting release that the asset segregation requirement would not prohibit an adviser from owning an interest in an issuer (whether a fund or otherwise) with senior rights to a junior interest held by clients. Although this type of "capital stacking" introduces many conflicts that should be identified and mitigated by the adviser, and subject to client consent, we do not believe it is appropriate to address these conflicts through an expansive application of the safeguarding rule. We appreciate and agree with the Commission's acknowledgement in the Proposal that the prohibition on commingling assets should not preclude traditional operational practices in which client assets are often held in omnibus accounts, including accounts titled in the name of the adviser for the benefit of its clients.[88] The Commission also asks in the Proposal whether the proposed segregation requirements properly align with the contract provisions and reasonable assurance requirements in subparagraph (a) of the Proposed Rule. We believe that in certain markets, the practical need to hold client assets in omnibus accounts, for example to facilitate syndicated loan transactions, may not afford the adviser the opportunity to meet the requirements of subparagraph (a) of the Proposed Rule. For example, in situations where agent banks and other parties may custody assets for a period of time to facilitate transactions, those parties do not have the same type of ongoing relationship with clients that traditional custodial banks have and consequently do not have the

[87] Proposal at 14714.

[88] Proposal at 14695.

same commercial incentives to accommodate the many contractual requirements of subparagraph (a) of the Proposed Rule. To facilitate these situations, advisers should be permitted to make appropriate use of omnibus accounts in the adviser's name, rather than engage third parties or use client accounts as temporary allocation vehicles, as these alternative solutions introduce unnecessary costs and conflicts, respectively.

C. Replace Adviser Asset Segregation Requirement with an Internal Controls Approach

If the Commission elects to retain the adviser asset segregation requirement, we believe it is important to provide the clarifications requested above to preserve certain current market practices and avoid unintended consequences. However, we believe that an internal controls approach would be less disruptive than a prescriptive asset segregation requirement and would also provide superior investor protection. Such an approach could be reasonably designed either to segregate client assets, or, where appropriate, to ensure appropriate client protection with respect to arrangements such as liens, rehypothecation, and securities lending. Although these and other arrangements may technically be viewed as commingling assets, we believe the goal of investor protection is better served through flexible controls rather than rigid prescriptions that in turn require exceptions and carve-outs.

VII. EXCEPTIONS FROM SURPRISE EXAMINATIONS

We appreciate that the Commission is proposing to expand the availability of the annual audit exception to all entities,[89] and to provide additional exceptions[90] to the surprise examination requirement for an adviser that: (i) has custody solely because it has discretionary authority with respect to assets that settle on a DVP basis;[91] or (ii) is acting in accordance with a standing letter of authorization.[92] We offer the following recommendations regarding these exceptions with the goal of making the Proposed Rule more practical and ultimately more effective.

A. Advisers Should Not Be Responsible for Monitoring the Activities of Independent Public Accountants Performing Financial Statement Audits of Client Accounts

As discussed above, the Proposed Rule attempts to regulate indirectly a group of service providers, including independent public accountants, over which the Commission does not have

[89] *See* Proposed Rule 223-1(b)(4).

[90] The Proposed Rule would retain the current exceptions to the surprise examination requirement for advisory fee deductions (*see* Proposed Rule 223-1(b)(3)) and operationally independent related persons (*see* Proposed Rule 223-1(b)(6)).

[91] *See* Proposed Rule 223-1(b)(8).

[92] *See* Proposed Rule 223-1(b)(7).

regulatory jurisdiction. We believe that this type of "backdoor" regulation is both inappropriate, because it imposes regulatory burdens unfairly, and ineffective, because the Commission cannot enforce these requirements directly. If the Commission believes that there are specific risks to investors presented by the activities of independent public accountants, it should address those risks directly, including with the appropriate regulators where the Commission does not have authority.

Surprise examinations. The Commission is proposing to change the surprise examination requirement to require that an adviser reasonably believe the written agreement between the adviser and the accountant has been implemented.[93] This begs the question of why the Commission would impose on advisers the obligation to involve regulated third parties in its provision of investment advice to clients at all if those regulated third parties cannot be trusted to perform the duties required under the rule. The Commission suggests as an example that, after securing a written agreement for the engagement, an adviser should affirmatively confirm that the accountant is able to access the Commission's filing system.[94]

This additional requirement imposes unnecessary burdens on advisers without a showing that there is a harm that needs to be addressed. Advisers that are required to have a surprise examination already enter into written engagement letters with independent public accountants, and the selection of an accountant – like all outsourcing – should and does involve appropriate risk-based due diligence.[95] In order for a surprise examination to be conducted, advisers typically educate the accountant about the firm's operations, provide a list of accounts over which the adviser has custody, generate reports for and provide other support to the accountant, answer questions from clients related to the examination, and participate in a meeting with the accountant at the conclusion of the exam. We therefore question the Commission's rationale for imposing burdensome formal constraints on a process that we understand already functions as intended.[96]

Accountant audit-related notifications. We do not object to a requirement that an independent public accountant performing an annual audit notify the Commission: (i) within one business day of issuing an audit report that contains a modified opinion; and (ii) within four

[93] *See* Proposed Rule 223-1(a)(4).

[94] Proposal at 14717. While advisers should respond to a red flag such as an independent public accountant's failure to conduct a surprise exam, we believe that ensuring the accountant's access to the Commission's filing system is a level of minutiae that should be entrusted to the accountant. If an independent public accountant – which is subject to licensing and education standards and is deemed competent and retained by an adviser to perform a surprise examination – is unable to access the Commission's filing system, it would be capable of determining how to resolve the issue without assistance from the adviser.

[95] *See* the Supplemental Outsourcing Letter.

[96] Should the Commission nevertheless require this written agreement, the rule should not require accountants performing audits under the rule to be registered with or subject to regular inspection by the Public Company Accounting Oversight Board (**PCAOB**). These accountants are very costly to advisers and clients, and not necessary to achieve the Commission's objectives.

business days of resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed. However, we do not believe that an adviser should be the Commission's enforcement agent with respect to annual audits. Unlike a surprise examination arranged by the adviser to satisfy its obligations under the Custody Rule, annual audits are obtained by clients (*e.g.*, private funds) for their own benefit, and a client's interest in an independent relationship with its auditor is frustrated by a separate regulatory requirement for a written agreement between the adviser and the auditor with respect to such audit. It would be disruptive and costly for advisers to negotiate these agreements, and the involvement of advisers in these negotiations – particularly with respect to separately managed account arrangements that are specifically structured to limit an adviser's control – may introduce adviser-related conflicts into an engagement that is otherwise appropriately independent of the adviser's influence.[97]

To the extent that accountants are not complying with their Form ADV-E filing and notification obligations, we ask that the Commission consider working with the Financial Accounting Standards Board (FASB) to strengthen requirements directly on independent public accountants.

B. Annual Audit Provision

1. Codify aspects of the audit provision.

An adviser that obtains an audit at least annually and upon an entity's liquidation under the Proposed Rule would be deemed to have complied with the surprise examination requirement, and would not need to comply with the client notice requirement and the account statement aspect.[98] The Proposal is intended to extend the investor protection benefits of an audit to a larger number of investors, such as pension plans, retirement plans, college saving plans (**529 plans**), and Achieving a Better Life Experience savings accounts (ABLE plans or 529A

[97] This is especially so in light of all the other burdens the Commission proposes to impose on advisers, not only in this Proposal, but in the many other regulatory initiatives that are pending, including the Cybersecurity Risk Proposal, Outsourcing Proposal, Regulation S-P Proposal, and Private Fund Advisers Proposal.

[98] Under the Proposed Rule: (i) the audit must be performed by an independent public accountant that meets the standards of independence described in Rule 2-01 of Regulation S-X that is registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the PCAOB in accordance with its rules; (ii) the audit meets the definition in rule 1-02(d) of Regulation S-X, the professional engagement period of which shall begin and end as indicated in Regulation S-X Rule 2-01(f)(5); (iii) audited financial statements must be prepared in accordance with U.S. Generally Accepted Accounting Principles (**U.S. GAAP**) or, in the case of financial statements of entities organized under non-U.S. law or that have a general partner or other manager with a principal place of business outside the United States, must contain information substantially similar to statements prepared in accordance with U.S. GAAP and material differences with U.S. GAAP must be reconciled; (iv) within 120 days (or 180 days in the case of a fund of funds or 260 days in the case of a fund of funds of funds) of an entity's fiscal year end, the entity's audited financial statements, including any reconciliations to U.S. GAAP or supplementary U.S. GAAP disclosures, as applicable, are distributed to investors in the entity (or their independent representatives); and (v) pursuant to a written agreement between the auditor and the adviser or the entity, the auditor notifies the Commission upon certain events. *See* Proposed Rule 223-1(b)(4).

accounts). Although we appreciate the expanded availability of the exception from "pooled investment vehicle" clients to "entities," we do not expect many entities to be able to utilize the exception. Although the exception would allow an adviser to rely on an audit obtained by an entity (*e.g.*, a benefit plan), the exception is only available if that audit is obtained by the entity in a manner that meets all the enumerated requirements for such audits in subparagraph (b)(4) of the Proposed Rule (entities subject to annual audit).

A benefit plan is unlikely to, for example, insert an obligation into its engagement letter with an auditor that the auditor will notify the Commission within one business day if the audit report contains a modified opinion. Where a third-party entity has elected to obtain an audit and controls that audit, the enumerated requirements for audits under the exception are not necessary to reasonably ensure the reliability of the audit. In addition, to reduce potential burdens imposed on clients, the Commission should clarify that an adviser may rely on a client's representation that it has obtained an audit rather than obtaining a copy of the audit itself from the client.

We support permitting the use of financial statements for non-U.S. entities that are not prepared in accordance with U.S. GAAP, provided that with respect to pooled vehicle audits, they contain information substantially similar to statements prepared in accordance with U.S. GAAP, material differences with U.S. GAAP are reconciled, and the reconciliation is distributed to U.S. clients along with the financial statements. This would codify current staff guidance.[99] We also support requiring audited financial statements of an entity to be distributed to all the entity's investors within 120 days (or 180 days in the case of a fund of funds or 260 days in the case of a fund of funds of funds) as proposed.[100] However, we do not believe that these requirements should be applied to audits of separate accounts, which do not introduce differential access to information between fund sponsors and investors that these requirements appear designed to address. Finally, we support the Commission's position in the Proposal that an adviser's failure to deliver audited financial statements in the specified timeframe due to unforeseen circumstances would not provide a basis for enforcement action so long as the adviser reasonably believed that the audited financial statements would be distributed by the applicable deadline. We request that the Commission incorporate this position into the final rule or restate it in the adopting release.

2. Make the audit approach for pooled investment vehicles easier to use.

Under the current Custody Rule, audited financial statements must be prepared in accordance with U.S. GAAP and audited in accordance with U.S. Generally Accepted Auditing Standards. Financial statements do not meet these requirements if the auditor cannot give an unqualified opinion. Therefore, a fund that delivers to investors financial statements that have received a qualified opinion will have failed to deliver required audited financial statements under the audit approach. This is the case regardless of whether the reasons for the qualification are related to the verification of client assets or any other aspect of the advisory services

[99] Custody Rule FAQ VI.5.

[100] Proposal, Question 220.

provided by the adviser to the client. The receipt of any qualified opinion can therefore force an adviser to a private fund or any other client that anticipated the delivery of a timely, unqualified audit into non-compliance with the Proposed Rule. Although the qualification may be cured, an adviser's violation of the rule cannot. Accordingly, we recommend that the Commission specify in the final rule or clarify in the adopting release that a qualified opinion from the independent public accountant will not impact an adviser's ability to rely on the audit exception where the qualification is unrelated to the verification of assets, or where the qualification is cured within a reasonable period.

3. Permit the ownership interest of an adviser's managed client in an SPV that also has third-party investors to be included in the managed client's audit.

To the extent that an adviser utilizes an SPV that is not a pooled investment vehicle sponsored by the adviser to aggregate capital from one or more investors to hold one or more investments, the adviser should not be required to treat the SPV as a separate client. In these cases, the adviser's managed client is co-investing with a third party, and the adviser is not providing advisory services to the SPV. An example of such an arrangement would be a joint venture substantially controlled (typically through majority ownership) by a managed client whereby a third party operates or supports the operation of the SPV in exchange for a minority equity interest. Additionally, an adviser may partner with a development partner in the case of real estate to construct and ultimately sell an asset, in which case the development partner is compensated (generally through equity and carried interest) as part of the economics of the arrangement. The third party does not compensate the adviser or its affiliates.

As a threshold matter, therefore, we do not believe that these SPVs are advisory clients for purposes of the Advisers Act in the first instance because the adviser has not been engaged to control, supervise, or provide investment advice to the SPV. Instead, the SPV functions as a typical operating company. Since we do not believe the adviser should be required to treat the SPV as a client at all, it follows that the adviser should not have to treat the SPV's assets as a separate client for purposes of the Proposed Rule. An additional SPV-level audit would thus be unnecessary.

Ultimately, the purpose of the Proposed Rule (and of the Custody Rule) is to ensure the safeguarding of client assets, which are verified by a client-level audit, in this case of the adviser's managed client. We believe the client's interest in the SPV is adequately protected by the existing client-level audit. On an ongoing basis, the adviser has an incentive to monitor the assets and cash flow of an SPV owned by its managed clients, including those partially owned by a third party, to maintain expected performance and the overall value of the portfolio, and to satisfy client obligations, as it would any client investment. We do not believe there is any supplemental value to auditing an entity owned by the client simply because a third party has a stake in that entity.

Further, even if the incremental volume of additional audits created by such a requirement could be timely performed by auditors (which is highly uncertain), this largely redundant requirement would prohibitively impact net performance of the managed client and impose unexpected and unwarranted costs. Because these costs could exceed the potential benefits, it would also chill an adviser's interest in participating in transactions with third parties that could otherwise benefit its managed clients.[101]

4. Eliminate liquidating audits.

We urge the Commission to eliminate the expensive and, in our view, unnecessary requirement for an audited liquidating financial statement. The elimination could be conditioned on the private fund's offering documents requiring delivery of unaudited financial statements to the remaining investors in the private fund on an annual basis until liquidation. Liquidations typically occur when few assets remain in the fund. Liquidation audits are thus very expensive relative to the limited amount of assets left in the fund. These audits harm the fund investors by reducing the remaining fund assets for little to no benefit. Sometimes, all that is left in the fund at the time it liquidates is a reserve for the auditing costs, but an audit is nonetheless required.[102] Instead of requiring a liquidation audit, the Commission could require that the private fund adviser determine that a reasonable investor would believe that the risks of forgoing the liquidating audit are outweighed by the proportionate cost of the liquidating audit.

C. Do Not Limit the Surprise Examination Exception for Advisers with Discretionary Authority to DVP Settlement

As discussed above in Section III.A, the IAA strongly urges the Commission to preserve the exception from having custody for discretionary authority. If the Commission nonetheless determines to bring discretionary authority in scope of the rule, we recommend that it extend the proposed exception to the surprise examination requirement to both DVP and non-DVP transactions. The exception would apply to client assets that are maintained with a qualified custodian when the sole basis for the application of the rule is an adviser's discretionary authority that is limited to instructing the client's qualified custodian to transact in assets that settle on a DVP or non-DVP basis.

We continue to believe that the authority of an adviser to direct the custodian to participate in securities settlements, whether DVP or non-DVP, introduces less acute

[101] Proposal at 14722. Even if the Commission disagrees with our view, notwithstanding the staff's prior guidance, the outsized burden of an additional audit in circumstances such as we describe (*i.e.*, creation of an SPV where the managed client's partner has a role in the management or operation of the entity or its assets) is unwarranted, and practical adjustments should be made to right-size this obligation. *See Private Funds and Application of the Custody Rule to Special Purpose Vehicles and Escrows*, Division of Investment Management Guidance Update No. 2014-07 (June 2014).

[102] Some advisers seek to protect clients from unwarranted expenses in this scenario by switching to the surprise examination method, which requires no (or a very limited) final surprise examination, because there are no assets to examine other than funds reserved for post-termination expenses. We believe that an undertaking in the private fund's offering documents to deliver unaudited financial statements is appropriately protective given the limited amount of remaining assets.

misappropriation risks than those associated, for example, with fee deduction or standing letters of authorization, both of which are excepted from the surprise examination requirement. Moreover, distinguishing between DVP and non-DVP settlement for purposes of this exception would raise operational challenges. For example, it would raise significant operational challenges for advisers to confirm whether an account only engaged in DVP transactions for an entire year because advisers' current systems are not programmed to identify or monitor for this type of distinction in the settlement process. Advisers would need to re-code their systems or perform tedious manual processes to confirm that there were no non-DVP trades for each account. We therefore recommend excepting advisers from the surprise examination requirement when the adviser has custody solely due to the exercise of investment discretion, without regard to whether client transactions settle on a DVP or non-DVP basis.

D. Standing Letters of Authorization

The Proposed Rule contains an exception from the surprise examination requirement for client assets if the adviser has custody of those assets solely because of a standing letter of authorization (**SLOA**).[103] We greatly appreciate and support the proposed codification of the relief the Commission staff provided regarding SLOAs in the SLOA IAA No-Action Letter.

VIII. OTHER RECOMMENDATIONS

There are several additional revisions that we believe would make the safeguarding rule more workable without reducing investor protections. Some of these would address substantial difficulties under the current Custody Rule while others would alleviate other issues or codify helpful staff interpretations. Our requested revisions are as follows:

- Except certain accounts from the safeguarding rule;
- Except transfers from 529 plans to qualified educational institutions from the definition of custody;
- Except ERISA plans from the definition of custody or deem an adviser to satisfy the safeguarding rule if it is in compliance with ERISA with respect to a retirement plan;

[103] Proposed Rule 223-1(b)(7). The Proposed Rule would define an SLOA as an arrangement among the adviser, the client, and the client's qualified custodian in which the adviser is authorized, in writing, to direct the qualified custodian to transfer assets to a third-party recipient on a specified schedule or from time to time. In such an arrangement, the client's qualified custodian could not be an adviser's related person. Such an authorization would have to include the client's signature, the third-party recipient's name, and either the third party's address or the third party's account number at a custodian to which the transfer should be directed. The authorization also would have to provide that the investment adviser has no ability or authority to designate or change any information about the recipient, including name, address, and account number. Proposal at 14725.

- Require that custodial account numbers be masked in advisers' notices to clients;
- Codify and clarify guidance related to first-person transfers; and
- Modify and codify relief for inadvertently received client assets.

Our recommendations are discussed in more detail below.

A. Except Certain Accounts from the Safeguarding Rule[104]

As noted in Section II.B, we recommend that the Commission except from the safeguarding rule accounts of funds and other non-U.S. clients that are subject to safeguarding protections under non-U.S. law from the safeguarding rule altogether. The Commission's regulatory interests arise only where the adviser or its clients and private fund investors are located in the United States, and do not warrant application of the Proposed Rule. We note that the general anti-fraud provisions of the Advisers Act would still apply and would provide adequate protection to investors in these funds.

B. Except Transfers from 529 Plans to Qualified Educational Institutions from the Definition of Custody

An adviser may manage, advise, and/or service 529 plan accounts for clients. These plans are maintained with a qualified plan provider. When servicing these accounts, an adviser may assist clients directly with account contributions, plan selection, purchases, sales, and withdrawals. Under Section 529 of the Internal Revenue Code, withdrawals from these plans are tax free if they are for qualified expenses and are sent to: (i) the client of record; (ii) the beneficiary of record; or (iii) a qualified educational institution (validated by the plan provider). Assuming that the adviser does not have the ability to change the client's address of record or the beneficiary on the account, then the only reason these accounts would be included under custody is because of the ability to transfer money to a third party. However, that third party is restricted in that it must be a qualified educational institution.

[104] We also recommend clarifying in the final rule text or adopting release that the exception from the safeguarding rule for assets of registered investment companies includes business development companies (**BDCs**) as well. The absence of a reference to BDCs in the text of the current Custody Rule appears to be an oversight. Rule 206(4)-2(b)(5). ("*Registered investment companies.* You are not required to comply with this section with respect to the account of an investment company registered under the Investment Company Act of 1940.") Like registered investment companies, BDCs are subject to the custodial requirements of Section 17(f) of the Investment Company Act. *See* Section 59 of the Investment Company Act. We appreciate that the Commission has proposed to reflect this understanding in revised Item 9 of Form ADV Part 1A. *See* proposed revisions to Item 9.A.(1) ("Do you have custody of client assets (excluding clients that are investment companies registered pursuant to the Investment Company Act of 1940 or business development companies that elect to be regulated as such) either directly or because a related person has custody of client assets in connection with advisory services that you provide to the client").

While the amended custody definition would include any arrangement (including, but not limited to, a general power of attorney or discretionary authority) under which the adviser is authorized or permitted to withdraw or transfer beneficial ownership of client assets upon the adviser's instruction, this type of access does not provide an adviser the ability to hold, directly or indirectly, client assets, or have any authority to obtain possession of them since the adviser has no ability to ever obtain possession of these client assets. We thus request confirmation that qualified distributions from a 529 plan would not be deemed to give the adviser custody.

C. Except ERISA Plans from the Definition of Custody or Deem an Adviser to Satisfy the Safeguarding Rule if It is in Compliance with ERISA with Respect to a Retirement Plan

ERISA-covered employee benefit plans (**plans**) managed by an adviser, or for which an adviser or a related person acts as trustee, should not be in scope of the safeguarding rule because ERISA includes its own stringent requirements relating to custody of the plan. Alternatively, the Commission should deem an adviser to satisfy the safeguarding rule if it is in compliance with ERISA with respect to the plan, to the extent applicable.

Plan assets must be held in a trust set up as a separate legal entity[105] from the adviser and trustee and must be held with an independent custodian. None of these entities are permitted to have legal title to or beneficial ownership of plan assets. If any one of these entities were to become insolvent, there would be no legal effect on the trust, and creditors would have no recourse against its assets.

Advisers that manage plans generally do not have authority to select or contract with plan service providers, such as custodians. Indeed, for a plan's adviser to directly contract with a custodian could violate ERISA and/or the plan documents.[106] The assets of ERISA plans are also subject to additional stringent protective measures that make the safeguarding rule entirely unnecessary.

In addition to excepting ERISA plans managed by advisers from custody, or deeming them compliant with the safeguarding rule, the Commission should also expand current Custody Rule FAQ XII.1.[107] This relief, in our view, is too narrow as it has the effect of precluding an

[105] Under ERISA, the "employee benefit plan" is a separate (and highly regulated) legal entity. 29 U.S.C. § 1132(d)(1). Congress granted the plan itself the right to have its assets held in trust, 29 U.S.C. § 1103(a), and managed in accordance with ERISA's fiduciary standards. 29 U.S.C. § 1109.

[106] *Kennedy v. Plan Adm'r for DuPont Sav. & Inv. Plan*, 555 U.S. 285, 300 (2009) ("ERISA requires '[e]very employee benefit plan [to] be established and maintained pursuant to a written instrument,' 29 U. S. C. §1102(a)(1), 'specify[ing] the basis on which payments are made to and from the plan,' §1102(b)(4). The plan administrator is obliged to act 'in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of [Title I] and [Title IV] of [ERISA],' §1104(a)(1)(D).").

[107] Custody Rule FAQ XII.1 currently provides that an adviser would not be subject to the safeguarding rule solely due to its related person acting as the trustee of a participant-directed defined contribution plan established for the

adviser's employee from allocating the employee's 401(k) plan to the very fund the employee is involved in managing and, in effect, "eating the employee's own cooking." Selecting registered investment companies advised by the adviser as options for its employees' defined contribution plan does not pose any more risk of misappropriation of client assets than selecting unaffiliated mutual funds. This limitation in the current FAQ also imposes undue expense on plan participants and does not reflect the range of typical structures of plans and existing protections for retirement plan assets under ERISA. We believe that investment options that are sponsored by banks or are registered investment companies include sufficient protections for their assets so that such a limitation is unnecessary.[108] We request that the Commission codify Custody Rule FAQ XII.1 as we recommend that it be expanded.

For similar reasons, we believe that the accounts of clients that are financial institutions regulated as banks or trust companies or that are regulated insurance companies should be excepted from the scope of the Proposed Rule. These accounts are also subject to comprehensive regulatory regimes with robust safeguarding provisions.

D. Require that Custodial Account Numbers Be Masked in Advisers' Notices to Clients

The Proposed Rule would require an investment adviser to notify its client in writing promptly upon opening an account with a qualified custodian on its behalf.[109] The notice would continue to include the qualified custodian's name, address, and the manner in which the investments are maintained. The Proposed Rule would also explicitly require that the notice include the custodial account number to improve the utility of the notice. We recommend that the Commission specify in the adopting release that advisers must mask (*i.e.*, display only part of) the qualified custodian's account number to address security and privacy concerns.

E. Codify and Clarify Guidance Related to First-Person Transfers

Once an adviser determines that a transfer authorized by a client is a first-person transfer, Custody Rule FAQ II.4 describes the circumstances in which that authority would not be deemed custody. We request that the Commission codify this FAQ and confirm in the adopting release that the following situations are first-person transfers that fit within FAQ II.4: (i) the adviser has a reasonable belief that the receiving account is owned by the client, *e.g.*, when the two accounts

benefit of the adviser's employees, provided that neither the adviser nor a related person acts as adviser to the plan or any investment option available under the plan.

[108] In a no-action letter unrelated to the current Custody Rule, the staff expressed the view that a subsidiary of a company providing advice to its parent's own defined benefit plan was not giving advice to "other persons," and thus was not an investment adviser. It follows that an adviser providing advice to its own defined benefit plan does not have an advisory relationship with that plan and thus the proposed safeguarding rule should not apply. *See Lockheed Martin Invest. Mgmt. Co.*, SEC Staff No-Action Letter (June 5, 2006), available at https://www.sec.gov/divisions/investment/noaction/2006/lockheed050506.pdf.

[109] *See* Proposed Rule 223-1(a)(2).

have the same social security or taxpayer identification number or beneficial owner; and (ii) the adviser has a reasonable belief that the beneficiaries of a client trust or the owners of a client's joint account are the same, *e.g.*, when the client provides or the adviser obtains supporting documentation. We also recommend that the staff separately consider setting forth general principles to help clarify what is deemed first person in other situations. For example, scenarios involving joint accounts and trusts are often unclear.[110]

We also support the retention of Custody Rule FAQ II.5.A (an adviser does not have custody if it has authority to instruct the qualified custodian that maintains a client's account to remit the funds or securities from the account to the same client at his or her address of record, and meets the conditions in FAQ II.5.A). Based on our experience, we believe the current conditions set forth in this FAQ are appropriately designed to prevent the custodian from remitting a client's assets other than as a first-person transfer, *i.e.*, to the same client at his or her address of record.

F. Modify and Codify Relief for Inadvertently Received Client Assets

1. Expand relief for forwarding or returning certain assets.

Forwarding tax refunds, settlement proceeds, and stock certificates. The Commission requests comment on the exception from the definition of custody for possession of client assets when the adviser receives them inadvertently and returns them to the sender.[111] We recommend that the Commission codify the current no-action relief permitting advisers to forward to clients funds and securities (under the Proposed Rule, assets) inadvertently received in the case of: (i) tax refunds; (ii) client settlement proceeds from administrators in connection with class action lawsuits; and (iii) stock certificates or dividend checks or evidence of new debt from issuers in connection with class action lawsuits involving bankruptcy or business reorganization.[112] In these circumstances, the failure to forward assets to clients is highly likely to result in a loss to clients.

Returning misdelivered assets to sender. The 2007 IAA No-Action Letter provides an adviser with up to five business days to *forward* the funds or securities to its client in order to avoid application of the current Custody Rule. In addition to codifying this relief in the new safeguarding rule, the Commission should lengthen to up to five business days the amount of time an adviser has to *return* to the sender client assets received by the adviser rather than the current three business days specified in the rule. The different time periods (three business days vs. five business days) are confusing and could lead to foot faults. We do not believe it makes sense to treat forwarding and returning assets with different time periods.

[110] We and our members would be pleased to discuss and help develop this guidance with Commission staff.

[111] Proposal, Question 15.

[112] *See Investment Adviser Association*, SEC Staff No-Action Letter (Sept. 20, 2007), available at https://www.sec.gov/divisions/investment/noaction/2007/iaa092007.pdf (**2007 IAA No-Action Letter**).

Forwarding or returning other types of checks. We also recommend that the Commission permit an adviser to send other types of checks to clients or forward other types of checks to custodians, also within five business days. For example, a client may forward to its adviser a rollover check it has received as a distribution from a retirement plan. The check would be payable to the receiving custodian, clearly marked as FBO client. We understand from our members that many clients are anxious about delivering the check directly to the custodian in case they direct it to the wrong account, and strongly prefer that their adviser send the check to the custodian for them. This situation does not fit squarely under Custody Rule FAQ II.1 or the 2007 IAA No-Action Letter – because these checks are not tax refunds, settlement proceeds, or stock certificates or dividend checks – and the adviser thus may not forward them to the receiving custodian. We have the same concerns in these situations as described above: checks that are returned to the sending custodian or in the case of our example, to the client, might get lost or delivery may be delayed, and the client will be unable to invest the cash for some time and be concerned about what happened to the funds. In addition, checks that are instead sent or returned to the client sometimes, in our members' experience, are confusing for the client, which may not understand their importance or know what to do with them, causing another round of delay, confusion, and risk of loss.

Forwarding assets to related person custodians. In instances where an adviser inadvertently receives assets from a client that were intended for a qualified custodian that is a related person of the adviser, we believe the adviser should be permitted to forward those items to the custodian. Clients are confused and frustrated when an adviser returns assets and instructs the client to send the items to a different contact at the same firm instead. Additional transfers among the various parties, *e.g.*, through the mail, also increase the risk of loss of the assets. With reasonable controls (*e.g.*, the adviser does not take any actions to suggest the client should have sent the assets to the adviser; the adviser represents to the client that the adviser directly forwarded the item(s) to the qualified custodian), the assets will be delivered as intended within the spirit of the rule.

2. Adopt a new safe harbor for forwarding assets other than the four special categories.

Despite advisers' best efforts, some clients mistakenly send securities or checks (assets) that are in the client's or a third party's name to their adviser, which must return them to the client for proper delivery to the client's custodian or the adviser will be deemed to have custody over the assets. This requirement is inconvenient for both the adviser and the client, and it increases the risk that the assets will get lost in the mail or the client will misplace the securities or cash, for example, by treating the letter with which it is returned as "junk mail." The requirement to return assets to clients is designed to discourage advisers from suggesting that clients forward their assets to the adviser, which should not be holding these assets.

We recommend that the Commission adopt a new safe harbor under the safeguarding rule that would permit advisers to forward assets, other than those explicitly permitted, including as we recommend above for rollover or plan distribution checks FBO client, that they receive from a client to the client's custodian subject to three conditions:

1. *Generalized disclosure to all clients*. The adviser explicitly informs all of its clients that assets should be delivered to the custodian and not to the adviser;

2. *Notification to client and forwarding to qualified custodian*. Upon receipt of the assets, the adviser notifies the client immediately (by the end of the day of receipt) that it has inadvertently received the client's assets and forwards them to the qualified custodian within five business days of receipt; and

3. *Specific reminder to a client that sends assets to the adviser*. The adviser, after forwarding client assets, sends the client a reminder that assets should be delivered to the custodian rather than to the adviser.

This safe harbor would cut back on inconvenience and frustration (both for the client and the adviser) when a client mistakenly sends assets to the adviser. We do not believe that this relief would weaken the protections afforded by the safeguarding rule.

IX. RECORDKEEPING

We offer a few recommendations to make the proposed changes to the recordkeeping rule less burdensome for advisers.

First, as discussed above, any account statements received by an adviser from a qualified custodian should be permitted to be maintained electronically.

Second, we recommend that an adviser be permitted to rely on a third party to make and keep the required records.[113]

Third, we ask that the Commission confirm in the adopting release that trade confirmations can be maintained by the adviser's accessing of DTC's archives. Otherwise, it would be burdensome to maintain voluminous trade confirmations.

Fourth, for the reasons discussed in this letter, it would be exceedingly challenging for advisers to: (i) obtain reasonable assurances from a qualified custodian; and (ii) make a reasonable determination that ownership of an asset cannot be recorded and maintained in a manner in which a qualified custodian can maintain possession, or control transfers of beneficial ownership, of such assets. And, therefore, it would be difficult for advisers to create and

[113] This would be consistent with the T+1 Final Rule ("investment advisers may continue to rely on third parties to meet their recordkeeping obligations") and the Supplemental Outsourcing Letter (we recommend that an adviser that relies on a third party to make and/or keep any required books and records adopt and implement policies and procedures reasonably designed to ensure that the third-party service provider performing the recordkeeping function implements adequate internal systems for making and/or keeping these records on behalf of the adviser).

maintain records evidencing compliance with these requirements. In addition, absent guidance or flexibility, an adviser would be required to continually make these determinations on an ongoing basis. If an adviser advises a wide variety of privately offered securities or other assets that are not securities, then this would be unworkable. Recordkeeping obligations with respect to these elements of the Proposed Rule should be based on reasonably designed, risk-appropriate due diligence as determined by the adviser, consistent with our recommendations.

X. FORM ADV

We suggest several changes that would simplify custody-related reporting on Form ADV to reduce complexity and help advisers respond correctly, thus improving the quality of data the Commission receives. These changes would also alleviate unnecessary burdens on advisers.[114]

A. Item 9.A.(2)

The Commission is proposing to modify Item 9.A.(2) to require advisers to report the approximate amount of client assets and number of clients attributable to nine categories of custody (plus a catch-all category). We believe that it would be challenging for advisers to break out each basis for having custody by the approximate amount of assets and number of clients, especially if the definition of custody is expanded to include discretionary authority. We recommend, instead, that reasons for having custody that are lower risk (*e.g.*, having the ability to deduct advisory fees) should be Yes/No questions, without requiring the approximate amount of assets and number of clients. We also suggest allowing advisers to report based either on the number of clients or the number of accounts to retain the flexibility they have today in counting clients for purposes of other Form ADV items.

We also recommend providing a *de minimis* threshold for reporting custodian information for all types of assets (*e.g.*, for each custodian that holds ten percent or more of the adviser's aggregate regulatory assets under management (**RAUM**)). This threshold is the same as the threshold applicable to the information that advisers currently report regarding separately managed accounts.[115] We believe that this threshold would advance the Commission's regulatory goal of identifying and obtaining a more complete picture regarding the custodians maintaining client assets, while appropriately tailoring and limiting the scope of information to be reported since this requirement will, at most, require advisers to identify ten custodians.

In addition, we suggest clarifying that assets that are attributable to the advisory firm because an employee (a related person) has custody of client assets should be reported in Item

[114] Our recommendations are informed by our experience analyzing Form ADV data over more than two decades for our annual Industry Snapshot. In this section, we address custody questions that advisers commonly find confusing, misinterpret, or for which they report identical assets for more than one item.

[115] *See* instructions to Section 5.K.(3) of Schedule D of current Form ADV Part 1 ("Complete a separate Schedule D Section 5.K.(3) for each custodian that holds ten percent or more of your aggregate separately managed account regulatory assets under management.").

9.A.(2) as "Direct Custody by Adviser" and not "Indirect Custody through a Related Person." This has been a confusing distinction, and some advisers may report these assets in both items, causing assets to be double counted.

B. Item 9.F

Although Item 9.F (requiring advisers to report the number of persons acting as qualified custodian) is not included in the Proposal, we ask that the instructions to Item 9.F be supplemented to explain that if an adviser has custody with respect to at least one client account, but does not have custody regarding all of its clients' accounts, the adviser should include only the total number of qualified custodians employed by all advisory clients for which the adviser has custody (by any means, whether acting as qualified custodian or having access or authority, including by virtue of deducting fees directly from the account, or acting as general partner of a limited partnership, etc.). This would formalize the completion reminder that was sent to registrants in 2014, which was issued in response to confusion regarding whether Item 9.F asks how many persons act as qualified custodians for: (i) all advisory clients; or (ii) those advisory clients for which the registrant has custody.

In addition, we request clarification in the Instructions to Form ADV or in Form ADV itself that: (i) if the same qualified custodian is custodian for multiple client accounts for which the adviser has custody (for any reason), that qualified custodian should be counted only once; and (ii) qualified custodians that are affiliates should be counted individually if they are separate legal entities.

XI. TRANSITION PERIOD AND COMPLIANCE DATE

We appreciate that the Commission is proposing staggered implementation periods based on firm size, and we urge the Commission to follow a similar approach in all its rulemakings. Given the scope of work that will be necessary for advisers (and custodians) to implement the Proposal, as described throughout this letter, however, the proposed implementation periods are too short, even with the more tailored changes we recommend.

It will take significant time for advisers to align current practices with the prescriptive regulatory requirements under the Proposed Rule, should the Commission retain these requirements, especially if the final rule also covers discretionary advice. Preparing to comply with the final rule will entail tremendous resources for advisers of all sizes to negotiate new written agreements with qualified custodians and independent public accountants and arrange for asset verification, prepare for new reporting on Form ADV, and draft, update, and implement an internal controls approach to reflect new Commission requirements.

These challenges will be severely exacerbated by the many other anticipated substantive Commission rulemakings that together will demand of advisers greatly increased operational, personnel, and compliance resources. It is imperative for the Commission to take into consideration the cumulative effect of all of these regulations on advisers' operational limitations in determining the compliance date of the new safeguarding rule.

For these reasons, we recommend that the Commission provide a transition period of at least 30 months following the effective date of the final rule for larger advisers, and at least 36 months for smaller advisers.[116] Given the extent of the burdens that will be placed on smaller advisers, we also strongly urge the Commission to increase the threshold for the smaller adviser transition period to $2.5 billion RAUM, or, preferably, to advisers with 100 or fewer employees, or a combination of the two.[117]

XII. ECONOMIC ANALYSIS

A. The Commission's Economic Analysis Severely Underestimates the Costs and Burdens of the Proposal

As discussed throughout this letter, we believe that the economic impact of the Proposal is severely underestimated and will substantially exceed the Commission's figures. For example, the Commission estimates the following:

Prepare the written agreement with the qualified custodian	1 hour[118]
Change the written agreement when the adviser's level of authority changes (approximately once per year)	10 minutes per written agreement[119]
Obtain reasonable assurances in writing from a qualified custodian	15 minutes[120]
Related changes a qualified custodian makes to a custody agreement to reflect the reasonable assurances provided to the adviser	1 hour[121]
Prepare the written agreement with an independent public accountant	1.25 initial hours[122]

[116] We expect implementation of the safeguarding rule to take even more time than implementation of other recent major rulemakings. *See, e.g.*, *Investment Adviser Marketing*, 86 Fed. Reg. 13024 (Mar. 5, 2021), available at https://www.govinfo.gov/content/pkg/FR-2021-03-05/pdf/2020-28868.pdf (providing an 18-month transition period between the effective date of the rule and the compliance date).

[117] For example, at a $2.5 billion threshold, over 95 percent of total RAUM held by nearly 2,700 advisers would be covered by the initial compliance date, while the over 12,000 smaller advisers with the remaining five percent of RAUM would have more time to comply.

[118] Proposal at 14763.

[119] *Id.*

[120] Proposal at 14764.

[121] *Id.*

[122] Proposal at 14766.

Adviser's notice to the accountant of any purchase, sale, or other transfer of beneficial ownership of such assets within one business day	1 minute[123]
Report the new information on Form ADV Part 1	1 additional hour[124]

We strongly disagree with these estimates. As noted throughout our letter, the proposed expansion of the definition of custody to include discretionary authority,[125] coupled with the QC Requirements and asset verification requirements, are arguably the most burdensome aspects of the Proposed Rule and would significantly undermine the Commission's goal of simplifying the rule's application. In our members' experience, it takes substantially more time than one hour to draft, negotiate, review, execute, and implement a brand new legally binding contract and new disclosures. Each of these steps typically involves multiple layers and rounds by both in-house personnel and outside counsel.

We also take issue with the Commission's estimate that each adviser would only enter into approximately four written agreements with qualified custodians. As discussed above, this estimate neglects to consider that an adviser may have several different levels of authority with different clients that use the same custodian, or institutional clients may use several different custodians or only one custodian but multiple advisers. All of these scenarios would necessitate multiple written agreements between each adviser and the custodian. And the largest custodians are parties to a substantial proportion of the hundreds of thousands of custody agreements that would need to be repapered.

For these reasons, the Commission should undertake a more realistic and accurate assessment of the specific costs, burdens, and economic effects that are likely under the Proposal. We believe that such an assessment will demonstrate the disproportionality between the massive scale and expense of the Proposed Rule's requirements and the actual, rather than theoretical, risks that it purports to address.

[123] *Id.*

[124] Proposal at 14772, Table 10.

[125] As noted above, 92.0 percent of SEC-registered advisers currently report having discretionary authority and would be subject to the Proposed Rule. That would be an over 60 percent increase from the 56.7 percent of advisers (13,944 vs. 8,536) that report having custody today. One-third of all SEC-registered advisers would, as a result of the new safeguarding rule, have custody. *See* Proposal at 14738. Such a drastic expansion of the burdens on advisers should not be undertaken without a compelling evidentiary basis, as well as a more realistic assessment of its potential negative impacts, including on investors.

B. Consider Safeguarding in the Context of, and Interplay with, Other Rules and Rule Proposals

The Commission has not considered the interplay of the Proposal with other rule proposals or existing rules, or the cumulative impact of its many regulatory initiatives on advisers. We urge the Commission not to view the proposed safeguarding rule in isolation.

As an initial matter, we note that the current Custody Rule is one part of the robust investor-protective framework of the Advisers Act. Investment advisers, as fiduciaries, understand the paramount importance of protecting client assets from misappropriation. Many of the steps advisers routinely take to minimize misappropriation and related risks to client assets are already built into the Advisers Act and regulations beyond the current Custody Rule. The Commission should thus bear in mind that the current Custody Rule (or new safeguarding rule) is only one of the protections afforded to advisory clients under the Advisers Act, and that other regulations such as the Compliance Rule, the Identity Theft Red Flags Rule,[126] the Regulation S-P Proposal, and Cybersecurity Risk Proposal may better address (or may be more suitable to amend in order to better address) many of the staff's underlying concerns regarding safety of client assets.

The Commission should also address how the Proposal overlaps with the other numerous related regulatory initiatives that are pending, such as the Commission's Outsourcing Proposal, Cybersecurity Risk Proposal, and Private Fund Advisers Proposal, to name just a few. All of these proposed regulations will require advisers to enter into and renegotiate contracts, often with the same parties but with different requirements and implementation deadlines, yet the Commission does not address how these proposals may overlap or interact with one another, or the substantial and unnecessary costs attendant to multiple negotiations with the same parties.[127] Rules interact in myriad ways, and the Commission has neither identified nor provided any guidance on how advisers should address overlapping, duplicative, or even inconsistent requirements. For example, both the Private Fund Advisers Proposal and the Proposal include audit provisions that may be duplicative or inconsistent with one another.

The IAA recently submitted the Supplemental Outsourcing Letter, asking the Commission to make clear, if it adopts a final outsourcing rule, that custodians are outside of the scope of that rule. As discussed in that letter and here, it is the client that contracts directly with the custodian to provide it with custody services, and the adviser has no privity of contract with the custodian with respect to that agreement. The adviser does not retain the custodian to perform a function that is necessary for the adviser to provide its advisory services. But, if some custodians were nevertheless covered by the Outsourcing Proposal, would advisers need two or more separate agreements and two separate sets of obligations with respect to custodians: one addressing outsourcing custody of the client's assets and one addressing protection of client assets? Moreover, would a contract between the adviser and custodian under this Proposal create

[126] 17 CFR Subpart C.

[127] This issue was also raised in the Supplemental Outsourcing Letter.

the privity of contract that would then make all custodians "Service Providers" under the Outsourcing Proposal?[128]

In addition to insufficient attention being given to the interplay of the many rulemakings, there is also no real assessment in any of the recent proposals of the cumulative impacts of the many new requirements on advisers. For example, the rules will all have different implementation dates, so we question whether the Commission could reasonably expect advisers to keep re-opening and renegotiating contracts every time it adopts a new rule. We urge the Commission to explore whether less onerous alternatives could meet its objectives while minimizing the cumulative impacts on advisers.[129]

C. Consider the Significant and Disparate Impact of the Proposal on Smaller Advisers

The Commission, in our view, has not considered the significant and disparate impact of the Proposal on smaller advisers. The Proposal, if adopted, will impose a disproportionately greater burden on smaller advisers. Smaller firms have little to no leverage to negotiate terms with qualified custodians and independent public accountants. As a result of these constraints, the Proposal could create meaningful barriers to entry for new advisers, and increase pressure for industry consolidation, thereby reducing competition and the investment choices available to investors. As discussed above, the Proposal may cause market contraction for custodial services. Fewer custodians may offer their services, driving up costs. Custodians may only take fewer, larger accounts because it is easier to scale their operations, leaving smaller advisers with fewer options. In evaluating the costs of the Proposed Rule, the Commission should consider that many advisers, particularly smaller ones, will not be able to offer certain services, to investors' detriment.

[128] *See* Supplemental Outsourcing Letter for an example of a potential unintended consequence of not considering how issues in different proposals relate to one another.

[129] The IAA urges the Commission to consider regulation holistically and assess the cumulative impact of regulation on investment advisory firms of all sizes, particularly on smaller advisory firms. It is incumbent upon the Commission to conduct robust cost-benefit analyses, not only of each regulatory proposal in isolation, but of their cumulative effects on advisers, their clients, and the financial services landscape more broadly. Executive Order 13563, "Improving Regulation and Regulatory Review," issued in 2011, which is supplemental to and reaffirms the principles in Executive Order 12866, "Regulatory Planning and Review," requires agencies to "tailor [their] regulations to impose the least burden on society, consistent with obtaining regulatory objectives, taking into account, among other things, and to the extent practicable, the **costs of cumulative regulations**." [emphasis added].

There can be no doubt that the costs of compliance – direct and indirect – rise with each regulation and directly impact the resources advisers have to invest in other aspects of their businesses, including the resources available for client-facing efforts. We recognize that as an independent regulatory agency, the Commission is not legally bound by the requirements in Executive Orders 12866 and 13563. However, the Commission has long recognized "that these principles represent accepted standards of good practice in conducting rulemaking proceedings." *See, e.g.*, SEC, Office of the Inspector General, *Rulemaking Process*, Audit No. 347 (July 12, 2002), available at https://www.sec.gov/about/oig/audit/347fin.htm.

Unfortunately, under current federal regulations, the Commission is not required to conduct a realistic analysis of the impact the Proposal would have on smaller advisers,[130] and we believe that the Proposal severely underestimates the costs and burdens that would be imposed on smaller firms. The vast majority of advisers are small businesses[131] and they face unique challenges. Smaller advisers have been significantly burdened by one-size-fits-all regulations – both in isolation and cumulatively – that effectively require substantial fixed investments in infrastructure, personnel, technology more broadly, and systems relating to documentation, contract negotiation, monitoring, operations, custody, business continuity planning, and more.[132]

The IAA has long advocated for the Commission to utilize the data at its disposal and conduct a more realistic assessment of the impact of its rulemaking on this community of advisers and their clients. We have also long called on the Commission to take steps to tailor its rules to minimize this impact, for example through preserving a flexible, principles-based approach, excluding or exempting smaller advisers from requirements where the burdens on those advisers outweigh the benefits, and staggering implementation and compliance dates.[133] As we have discussed, however, we do not believe that the Commission adequately takes into account how its rules are likely to affect smaller advisers nor does it adequately consider alternatives for smaller advisers, and it certainly has not done so in this Proposal.

*   *   *

[130] The current asset-based definition of small business or small organization makes the Commission's analysis of the economic impact of its regulations on smaller investment advisers under the Regulatory Flexibility Act virtually meaningless. Rule 0-7 under the Advisers Act defines "small business" or "small organization" as including an investment adviser that has less than $25 million in assets under management. With few exceptions, advisers are not permitted to register with the Commission unless they have at least $100 million in assets under management.

[131] Of the 14,806 firms in the Industry Snapshot, 88 percent have fewer than 50 non-clerical employees and the median adviser has fewer than 10.

[132] *See* the SEC's Asset Management Advisory Committee's *Final Report and Recommendations for Small Advisers and Funds* (Nov. 3, 2021) (**AMAC Recommendations**), at 4, available at https://www.sec.gov/files/final-recommendations-amac-sec-small-advisers-and-funds-110321.pdf ("[D]espite deploying activities and strategies that typically involve less risk, regulatory compliance expenses, as a percentage of revenue, for these firms tends to be 'outsized' as compared to the small number of large firms.").

[133] *See, e.g.*, Letter to the Commission, *Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies*, from the IAA (Apr. 11, 2022), available at https://investmentadviser.org/resources/comments-on-proposed-cybersecurity-rules-for-advisers/; *see also* AMAC Recommendations.

We appreciate the Commission's consideration of our comments on the proposed Safeguarding Advisory Client Assets rule and stand ready to provide any additional information that may be helpful. Please contact the undersigned at (202) 293-4222 if we can be of further assistance.

Respectfully,

/s/ Gail C. Bernstein

Gail C. Bernstein
General Counsel

/s/ Laura L. Grossman

Laura L. Grossman
Associate General Counsel

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