May 8, 2023

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

RE: File No. S7-04-23

Dear Ms. Countryman:

We appreciate the opportunity to comment on the US Securities and Exchange Commission's rule proposal, *Safeguarding Advisory Client Assets* (the Proposal).[1] We are pleased to provide our perspectives, which are informed by our interactions with registered investment advisers and qualified custodians and our role in the capital markets. Appropriate safeguarding of investor and client assets is the bedrock of the integrity of our capital markets. The safeguarding of assets held or accessed by financial professionals is critical to the trust built with investors and a significant responsibility of investment advisers, particularly in meeting their fiduciary duty to their clients. Overall, we believe that the proposed requirements would further the protection of investor assets and enhance confidence in markets.

We support the Commission's goals to strengthen and clarify the protections on safeguarding investor assets in light of changing technology, advisory products and services, and custodial practices. We believe the Proposal maintains the core purpose of protecting client assets from loss, misuse, theft, or misappropriation by, and the insolvency or financial challenges of, the investment adviser and qualified custodians. In addition, we support the SEC's belief that audits, attest examination engagements, and evaluations of internal controls provide substantial protections to investors and their assets.

It is our view, however, that certain of the proposed requirements may be too prescriptive, potentially adding unnecessary costs without commensurate benefits to investors. We are concerned that certain aspects of the Proposal may require examination or audit procedures in excess of those required to support a reasonable assurance opinion concerning material misstatement or losses, resulting in potentially disproportionate costs for less risky or immaterial investment positions. We recommend that the final rule continue to allow for a risk-based approach so that independent public accountants may tailor the nature, timing, and extent of their examination or audit procedures to appropriately address the assessed risk of safeguarding of assets as well as material misstatement. This would also allow procedures to evolve upon the development of innovative asset types, which is one of the Proposal's stated objectives.

We offer commentary on these and other matters that may be of interest to the Commission below.

Expanding the definition of assets

The Proposal seeks to expand the definition of assets from "funds and securities" to "funds, securities, and other positions held in the client's account." We understand that this change is intended to, among other things, capture digital (e.g., cryptocurrencies) and physical asset classes (e.g., real estate, precious metals, and physical commodities). The Proposal would also capture a holding that may not be necessarily recorded as an "asset" under US GAAP or other accounting standard (e.g., a negative cash balance, short

[1] See Proposed Rule, *Safeguarding Advisory Client Assets*.

position, or written option). We support expansion of the definition of assets for the purposes of the Proposal.

We note that auditors are able to perform audit procedures over safeguarding of all types of assets and examination procedures on assets within the scope of the current rule. Digital assets, however, are usually similar to bearer assets in that whoever has access to the private key for a digital asset has the ability to claim ownership of the digital asset. Therefore, access to and management of the private key are critical to safeguarding digital assets. This would include safeguarding practices over the full private key lifecycle, including key generation, access management, segregation of duties, key backups, and other practices to prevent misappropriation or loss of assets. The current custodial environment for digital assets, which includes custody solutions such as exchanges and other entities outside of traditional custodians, is not yet fully developed and is the subject of significant regulatory enforcement activity. The current regulatory regime over custody does not address these unique characteristics and risks of digital assets. We suggest that the Commission seek further input from market participants as to whether more specific guidance with respect to the requirements for an entity to be considered a qualified custodian as defined by the Proposal would be beneficial so that proper safeguards and effective avenues for verification procedures are put in place.

Expansion of the audit exception

We support expanding the audit exception from limited partnerships, limited liability companies, and other types of pooled investment vehicles to other entities whose financial statements can be audited. We believe that the expansion of the audit exception to additional types of client investments managed by investment advisers furthers the Proposal's goal of enhancing the safeguarding of client assets.

Prompt verification of certain transactions by an independent public accountant

The Proposal introduces a new approach for certain assets that are unable to be maintained at a qualified custodian. It includes an exception that would, among other things, require an adviser to enter into a written agreement with an independent public accountant that would require the independent public accountant to promptly verify purchases, sales, or other transfers of beneficial ownership of investments subject to the exception upon receiving notice of the transaction from the investment adviser. This approach to the custody and safeguarding concept is a significant change from the traditional point-in-time approach to performing attest examination engagements or annual audits. While we understand the objectives of the Commission's proposed approach, we provide further areas for consideration and recommendations for additional clarity with respect to several aspects of this proposed requirement.

We recommend that the Commission define the time period expected by the term "promptly." Recent proposals and final rules impacting investment advisers have recommended or required the reporting of certain market events within 24 to 72 hours of an event occurring.[2] We do not believe that an attest examination engagement as described by the Proposal would be operationally feasible if a similar time period were expected by the Commission. For one, the independent public accountant would need to consider the availability of qualified staff to potentially immediately reassign from one project to another

[2] *See* Proposed Rule, *Cybersecurity for Investment Advisers, Registered Investment Companies, and Business Development Companies. See also, Amendments to Form PF to Require Event Reporting for Large Hedge Fund Advisers and Private Equity Fund Advisers and to Amend Reporting Requirements for Large Private Equity Fund Advisers.*

to "promptly" examine transactions. Or, when there is a high volume of transactions in such assets, a dedicated team may be required to support this real-time need. Another consideration is that written documentation for certain private transactions may take prolonged time to complete, potentially leading to delays in examination. Transactions may also occur across multiple dates in a relatively short period of time. If this is the case, multiple engagements would need to occur for a series of dates. As an alternative, we recommend an attest examination engagement cadence over a monthly or quarterly time frame. Regardless, we believe that the Commission should clarify expectations of promptness.

Other issues also raise questions of operational feasibility. Certain investment strategies, such as investment vehicles with bank loans, collateralized loan obligations, or real estate portfolios, could experience significant activity, even dozens of transactions in a given day, in asset classes that cannot reasonably be held with a qualified custodian. It is also common for multiple clients of an adviser, including private funds, to collectively participate in a single transaction, with varying ownership interests. A single transaction such as this could impact dozens of entities and accounts and multiple clients of an investment adviser. Given the complexity and often extended timeline of transaction activity in private markets, we anticipate that prompt examination could impact an entity that executes a large volume of transactions by requiring the deployment of substantial resources by the investment adviser or its service providers and a retained independent public accountant on an ongoing basis to ensure that the Proposal's requirements are satisfied.

Finally, we recommend that the Commission confirm that this ongoing, prompt examination by independent public accountants would not create auditor independence concerns given the revised approach suggested in the Proposal. To clarify, under the current custody rule, a surprise attest examination engagement or an annual audit of a private fund tests assets at a point in time, whether it be the surprise attest examination engagement date or a fiscal year end. Under the Proposal, if an investment adviser selects the prompt confirmation of transactions as an exception to certain requirements under the Proposal, the frequency and interaction between an independent public accountant and the investment advisers will be significantly higher. Given the complexity of many private investments made by investment advisers, any prompt examination would require the independent public accountant's procedures to begin before the closing of a transaction and the execution of all of the adviser's controls. We acknowledge that management and the independent public accountant will need to manage independence, but the significant interactions and timing of audit procedures may raise independence appearance issues. As a result, it would help for the Commission to confirm that the significant interactions and timing of the audit procedures alone would not create independence concerns.

Verification of all assets for certain exceptions contained in the Proposal

It is our understanding that the Proposal would require an independent public accountant to verify all of the assets not held at a qualified custodian (as opposed to a sample of the assets). This could be accomplished either through the surprise attest examination engagement or the annual audit. We acknowledge that the concept of verification of all investments not held by a qualified custodian as proposed is consistent with similar Commission requirements, such as in the registered investment company space which requires verification by examinations of investments by an independent public accountant. As discussed above, however, we believe that there are certain asset strategies (e.g., real estate portfolios) subject to the Proposal that could have a relatively large number of investments that cannot be held with a qualified custodian and be subject to testing as part of an annual surprise attest examination engagement or annual audit. AS 2310 requires the auditor, in designing the audit procedures to be performed, to obtain more persuasive audit evidence the higher the auditor's assessment of risk. This is in the context of the overarching requirement in paragraph .08 of AS 2310 for the auditor to design and perform audit procedures in a manner that addresses the assessed risk of material misstatements for each

relevant assertion of each significant account and disclosure. As the assessed risk of material misstatement increases, the evidence from substantive procedures that the auditor should obtain also increases.

We are concerned that the Proposal does not allow for a risk-based approach to audits or examinations and may add costs that outweigh benefits to investors with respect to certain types of investments. For example, the risks of safeguarding from misappropriation of real estate investments would be very different than those associated with physical commodities, such as the transportability of precious metals not held at a qualified custodian. While we support the Commission's intent to strengthen and clarify certain investor protections for assets not held by a qualified custodian, we believe the final rule should reference a risk-based approach that allows independent public accountants to develop a response that is efficient and effective — tailoring the nature, timing, and extent of their examination or audit procedures to appropriately address the assessed risks of material misstatement relevant to the nature and unique risks of an asset class.

SEC notification of an auditor's resignation, dismissal, or other termination and upon the issuance of a modified audit opinion

We note the proposed requirement for written agreement between the adviser or the adviser's client and the auditor to notify the Commission upon the auditor's resignation, dismissal, or other termination within four business days, or upon issuance of a modified opinion within one business day. We support these added requirements and believe they appropriately serve the intentions of the Proposal.

Clarifying the definition of material discrepancy given new requirements

Like Rule 206(4)-2 under the Advisers Act, the Proposal includes a provision requiring that the auditor notify the Division of Examinations within one business day of a finding of a material discrepancy during the course of an attest examination engagement. The Proposal, however, does not define a "material discrepancy," and we are unaware of a working definition in current guidance. *Interpretive Release No: 2969, Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant To Rule 206(4)-2 Under the Investment Advisers Act of 1940*,[3] (Interpretive Release) that accompanied the custody rule adopting release defined a material discrepancy as a material non-compliance with the provisions of Rules 206(4)-2 (Custody) or 204(b) (Books and Records) under the Advisers Act. In footnote 5 of the Interpretive Release, the staff refers to reporting of non-compliance in AT 601 of the AICPA Attestation Standards, but AT 601 was superseded with the new AICPA attestation guidance for compliance attestation engagements in AT-C Section 315, *Compliance Attestation*.

We regularly complete attest examination engagements and notify the Commission upon finding material discrepancies. We, however, have concerns as to the lack of a definition of material discrepancy, particularly given that the Proposal would require additional deadlines for compliance with the proposed Rule 223-1, along with the expansion of the Rule to new asset classes. We recommend that the Commission clarify whether violations of Proposed Rule 223-1 or Rule 204(b), particularly as they relate to timing and new asset types, would in and of themselves be material discrepancies requiring notification.

Requirements for all qualified custodians to obtain a written internal control report

Rule 223-1(a)(1)(i)(C) requires all qualified custodians to obtain and provide annually to the investment adviser a written internal control report that includes an opinion of an independent public accountant whether controls have been placed in operation as of a specific date, are suitably designed, and are

[3] See Interpretation, *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*.

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). If an investment adviser or its affiliate has custody, the independent public accountant that prepares the internal control report must verify that client assets are reconciled to a custodian other than the investment adviser or related custodian and be subject to regular inspection by the PCAOB. The Proposal states that the internal control report would be expanded to all qualified custodians, not just those affiliated with the investment adviser, and refers to the Interpretive Release; however, it is not clear if the Interpretive Release will be updated to consider alternative investment types not contemplated in 2009. The issued guidance promoted consistency in approach for independent public accounting firms. To promote consistency in application of the new requirements, we request that additional guidance be issued covering the new asset classes included in the Proposal.

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We would be pleased to discuss our comments or answer any specific questions the Commission or its staff may have. Please contact Annette Spicker at annette.p.spicker@pwc.com or Christopher Brabham at christopher.brabham@pwc.com regarding our submission.

Sincerely,

PricewaterhouseCoopers LLP

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