May 8, 2023

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

Re: **File Number S7-04-23; Release No. IA-6240; Safeguarding Advisory Client Assets (the "Proposal")**[1]

Dear Ms. Countryman:

The Asset Management Group of the Securities Industry and Financial Markets Association ("SIFMA AMG")[2] appreciates the opportunity to provide comments to the Securities and Exchange Commission (the "Commission") on the proposed new rule for safeguarding advisory client assets.

SIFMA AMG supports the Commission's principal aim of preventing loss, misuse, and misappropriation of client assets. SIFMA AMG also supports revisiting, re-assessing, and updating investment adviser regulatory requirements for custody and safeguarding. As fiduciaries, our members share the Commission's mission to ensure that client assets are protected from misappropriation and misuse. Our experience with markets and operational logistics informs our perspectives on the Proposal. As discussed below, our members have serious concerns about the breadth and consequences of the Proposal and urge the Commission to exercise caution in moving forward.

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[1] Safeguarding Advisory Client Assets, SEC Release No. IA-6240 (Mar. 9, 2023) (Proposal).

[2] SIFMA AMG brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms whose combined assets under management exceed $45 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds. For more information, visit http://www.sifma.org/amg For more information, visit http://www.sifma.org/amg. SIFMA AMG appreciates the assistance of Jay Baris, Kenny Terrero, Chuck Daly and Victoria Anglin of Sidley Austin LLP in the preparation of this response.

Overview

The Proposal, if adopted, would amend and redesignate current Rule 206(4)-2 of the Investment Advisers Act of 1940, as amended to new Rule 223-1 entitled "safeguarding client assets" and impose a wide range of new requirements on registered investment advisers. We are concerned that the critical aspects of the Proposal are impossible, infeasible, or would adversely impact investors. The Commission's assessment of the Proposal's impact on markets underestimates the adverse impact on market participants (especially our members' clients) and efficient markets.

Ultimately, if not significantly revised, the Proposal could (i) result in higher costs to clients of registered investment advisers, (ii) diminish the availability of instruments and strategies for those clients, (iii) subject client assets to greater risk of investment loss by limiting the ability to hedge, (iv) create inefficiencies in market practices for custody services, (v) result in fewer custodians for clients to choose from, and (vi) adversely impact capital markets.

We believe that the Commission can accomplish its regulatory and policy objectives without a material overhaul of existing market practices and the introduction of regulatory mandates for private business arrangements. The Proposal should not be adopted as proposed and should be revised, refocused and tailored to address the Commission's specific areas of concern without mandating a one-size-fits-all solution to all market participants and instruments.

We write representing SIFMA AMG's registered investment adviser members. The Proposal, if adopted, would impose direct regulatory and operational requirements on investment advisers. Among other things, the Proposal would require advisers to negotiate with custodians, prime brokers, and other market participants. The positions of advisers and these parties may diverge as regulatory liability, operational burdens, contractual obligations, and relationships with clients are involved.

The Proposal's impact would extend broadly to a wide range of market participants. Accordingly, SIFMA is separately commenting on the Proposal from the perspective of its custodial constituents, registered investment advisers and other sell-side constituents.[3] SIFMA AMG agrees with and supports the observations and comments set forth in SIFMA's Letter.

Executive Summary

I. Disrupting Well Functioning Markets and Practices is Unwarranted.

In the absence of systemic issues with custodial practices or misappropriation of client assets, the Proposal upends well-established and generally well-functioning industry practices. The Proposal establishes requirements that are impossible or infeasible to meet for instruments such as private securities and derivatives. Investors will be adversely impacted by the Proposal's consequences.

[3] *See* SIFMA, Comment Letter on the Safeguarding Proposal (May 8, 2023) ("SIFMA Letter").

II. Obtaining Contractual Assurances from Qualified Custodians and Injecting Advisers into Contractual Relationships Between Clients and Their Custodians Is Practically Inefficient and Unworkable.

Advisers face significant practical challenges in obtaining written assurances from custodians, especially when assurances impact the contractual relationship between a client and its chosen custodian.

III. Congressional Authority Does Not Contemplate Overhauling Traditional Concepts of Adviser Custody.

The Proposal represents an unwarranted expansion of historically understood concepts of investment adviser custody. Congress never contemplated that providing discretionary investment advice implies control over a client's account and assets or that the Commission should seek to indirectly regulate custodians through investment adviser obligations.

IV. The Cost-Benefit Analysis Does Not Fully Contemplate Initial and Ongoing Costs.

The Commission's cost-benefit analysis grossly underestimates the costs of initial and ongoing compliance to investors, markets, and market participants.

V. Implementation Periods Must Be Extended.

The scale of contracts and agreements between all market participants that would require re-negotiating is substantial and will take significant labor and time to address.

Discussion

I. Disrupting Well Functioning Markets and Practices Is Unwarranted

A. Reform Efforts Should be Tailored to Actual Shortcomings

The Proposal, if adopted, would upend a custodial system that has proven to successfully protect, with limited exception, client assets from loss, theft, misuse, misappropriation, and adviser insolvency. In its aim to further enhance asset protection and address purported concerns with respect to the safekeeping of certain client assets, including digital assets, the Commission failed to adequately consider the detrimental and systemic impact the Proposal will have on well-functioning trading and custodial systems.

We disagree with the Proposal's suggestion that current custodial practices, at least with respect to traditional asset classes, fail to adequately protect client assets. Instances of adviser theft, fraud, or misappropriation of client assets are exceedingly rare. The Proposal fails to articulate a structural problem with existing custodial protections that warrant the proposed systemic overhaul of the custody rule.

The Commission appears to be attempting to address specific concerns related to aspects of certain assets (*e.g.*, current forms of digital assets) and has proposed to expand the scope of custody to include these and future unidentified asset types. In an attempt to address a narrow issue and to future proof the scope of the rule, the Proposal forces all assets into a one-size-fits-all framework which by necessity must be drawn very broadly in order to extend protections to assets which are not currently or adequately covered by the custody rule.

In other words, because certain asset classes do not align easily with the existing rule, all asset types are being forced into a new protocol. While there may be space for marginal benefit for some asset classes, the Proposal simultaneously creates market impediments and inefficiencies and creates new barriers to capital formation and well-functioning markets. Investors will be adversely impacted by losing access to instruments and strategies, changes to the services available from custodians and increased costs, and diminished choice of custodian service providers.

The Proposal's requirements would impair existing business practices and inhibit advisers' ability to provide services to their clients. At a minimum, these hurdles would:

- materially adversely affect standard prime brokerage and banking services,
- prevent or deter the trading of certain instruments due to the "possession or control" and "segregation" requirements,
- result in qualified custodians charging higher fees, exiting the custodial business or limiting the services they provide, and
- establish a complex, inefficient and unworkable framework for third party verification of private securities and physical assets.

B. Proposed Asset Segregation and Rehypothecation Restrictions Would Degrade Effective Prime Brokerage and Collateral Management Practices

The Proposal requires that an adviser obtain assurances that the qualified custodian will "clearly identify and segregate client assets from the custodian's assets and liabilities." The requirement to establish segregated accounts ignores practical realities of prime brokerage and banking and will functionally eliminate a qualified custodian's ability to rehypothecate. Rehypothecation is the right of a secured party to lend, pledge, sell, assign, invest, use, commingle or otherwise dispose of collateral, usually cash or securities, posted by a counterparty under a trading agreement. Rehypothecation is necessary for efficiently functioning markets, enhancing the collateral's underlying market liquidity and promoting the efficient distribution of assets.

The practice of rehypothecation and the Proposal's conception of client asset segregation are antithetical. Where a client has agreed to permit a broker-dealer to rehypothecate securities pursuant to the client's margin agreement, these securities will be included among shares in the

"free box," essentially a non-segregated pool of assets that a broker-dealer may access based on its funding needs and delivery obligations.[4] Notably, because securities are fungible, it is generally not possible to determine which client's securities are being used for rehypothecation at any given time. This right to rehypothecate helps support the broker's ability to lend shares to support short positions of its clients, among other things.

Without the ability to rehypothecate, it is anticipated that broker-dealers will be forced to materially reduce the amount of liquidity available to advisers and their clients. In this way, the Proposal amounts to an indirect restriction on the leverage of margin stock. It is worth noting that various other regulatory regimes already provide comprehensive customer protections in the event of broker-dealer insolvency.[5] Finally, the cost of prime brokerage will increase if broker-dealers are unable to rehypothecate client assets. This cost will ultimately be borne by clients.

In addition to frustrating existing brokerage practices, the segregation requirement is inconsistent with current methods of cash maintenance in regular bank accounts. The Proposal would require a qualified custodian bank or savings association to segregate cash "in an account designed to protect such assets from creditors of the bank in the event of the insolvency or failure of the bank." The Proposal further states that "the account terms should identify clearly that the account is distinguishable from a general deposit account" so that client assets are protected "from creditors of the bank or savings association in the event of the(ir) insolvency or failure."

While assets held in a custodial account are explicitly excluded from the bank's balance sheet, this is not the case for deposit accounts, where cash is held as a liability of the bank and therefore available for use by the bank in the ordinary course of its business activities. This treatment of cash is well-disclosed and understood by market participants, including by advisers and other custodial clients, and the resulting credit risk is managed in the same way as any other credit relationship. In addition, clients also have a number of tools available to manage this deposit risk, including the use of "cash sweep" vehicles to reduce cash left on deposit while maximizing investment returns. Segregating cash into bankruptcy remote accounts as the Proposal requires can be expected to severely limit custodial services available to registered investment advisers and their clients.

We note that the Proposal's segregation requirement will create similar operational and compliance challenges with respect to certain sweep accounts, escrow accounts, and loan servicing accounts where client assets may be necessarily comingled with related party money. The Proposal eliminates the current custody rule requirement to maintain accounts that contain only clients' funds and securities which alleviates certain compliance challenges when client and non-client assets are commingled for administrative convenience and efficiency purposes (*e.g.*, the circumstances addressed in the Commission's no-action letter to Madison Capital Funding,

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[4] A U.S. regulated broker dealer is required under Rule 15c3-3 to maintain fully paid or excess margin securities in a good control location and is permitted to rehypothecate securities that collateralize a customer's margin debit balance up to 140% of the customer's adjusted margin debit balance.

[5] *See* 17 CFR 240.15c3 3(a); 12 CFR 221 (Regulation U); 12 CFR 220.1 (Regulation T); FINRA Rule 4210; 15 U.S.C. §§ 78aaa et seq. (SIPA).

Inc.)[6] However, while we appreciate the Commission's attempt to incorporate the flexibility of the Madison Capital No-Action Letter into the Proposal, the requirement to segregate assets of clients from those of the adviser (and its related persons) would negate the benefit provided by the ability to commingle client and non-client assets.

In sum, the segregation requirement may marginally add to client asset protection in certain scenarios, but is very likely to cause fundamental problems with a vital market function. This will negatively impact the ability of advisers to provide advisory services without the impairment of those services, additional costs to advisory clients, or both. We urge the Commission to consider the broader effect of the Proposal on banking and prime brokerage and to avoid adversely impacting the investors the Proposal seeks to protect.

C. The Proposed Verification Requirements for Privately Offered Securities, Physical Assets and Securities Unable to Be Maintained with a Qualified Custodian Are Impractical.

The scope of the proposed exception in Rule 223-1(b)(2), which would only be available for client assets that are "privately offered securities or physical assets," ignores the expansion of safeguarding requirements under the Proposal to cover all client assets, including many assets that cannot feasibly be maintained with a qualified custodian (*e.g.*, certain derivatives, loans, and other contract-based instruments). The Proposal's failure to make the exception in proposed Rule 223-1(b)(2) available for such assets would force advisers to cease trading those assets for their advisory clients, thereby limiting the access of such clients to investments in relevant asset classes.

In addition, the conditions of proposed Rule 223-1(b)(2) render the exception to the qualified custodian requirement wholly impracticable with respect to many traditional asset classes. The Proposal would require that advisers engage independent accountants to promptly verify any transaction involving an asset that cannot be custodied. As we have outlined, this would apply to numerous assets and instruments. We do not believe that this would be practical. While we believe that the entire Proposal should be reconsidered, if the Commission adopts the rule, we encourage the Commission to reject individual transaction verification. It is unclear what additional protection, if any, the significant burden of independent verification for every purchase, sale, or other transfer of beneficial ownership will offer to clients.

In particular, proposed Rule 223-1(b)(2)(iii) would impose a shadow asset verification requirement that will be costly, inefficient and in many instances impossible to comply with given the timeframe for the verification and notification requirements. For example, assuming that the exception is appropriately amended to cover client assets such as derivatives, loans and any contract-based instrument, the documentation an auditor would need to conduct the required verification is unlikely to be available for days or months, certainly not within the significantly shorter timeframe envisioned by the Commission.

[6] Madison Capital Funding, Inc., SEC Staff No-Action Letter (Dec. 20, 2018) ("Madison Capital No-Action Letter").

As discussed further below, this requirement would raise several practical challenges.

- Considering the extremely short time frames the Proposal contemplates, costs would increase for independent auditors to continually staff their business lines assuming a transaction could be submitted at any time.

- It will be challenging for an independent party to evaluate each change of ownership in the trade flow process for certain complex instruments.

- It is unclear that independent parties would have the ability to obtain and evaluate all the terms and documentation necessary to perform their function within a short time frame.

- Independent parties currently have no audit standards or criteria to conduct a transaction-based verification.

The independent verification requirement could be triggered in such volume that it would be impractical and prohibitively expensive for an adviser to rely on Rule 223-1(b)(2). The tight timeframes will require the independent accounting/audit firm to maintain full-time readiness just in case a trade is executed that requires validation. Maintaining staffing that may or may not be needed presents a more significant cost than planning for a routine financial statement audit or custody examination. Perhaps this may be operationally feasible – albeit still potentially prohibitively costly – for very infrequent trades, but the Proposal sweeps in many other instruments that are traded in significant volume on a daily basis across the financial services landscape.

Some instruments experience changes of beneficial ownership multiple times during the course of a transaction, sometimes within a span of seconds. The Proposal seems to suggest that these interim beneficial ownership transfers would themselves require asset verification. Trades in certain commodities can occur in short time frames in different markets across the world and require highly specialized technical and engineering capabilities to verify.

On top of the volume and timing issues, there are serious questions as to whether the accounting and audit industry has the capacity to provide the necessary verification services[7] or whether, given normal transaction flow, independent verifiers would even be able to obtain timely documentation necessary to perform the verification in conjunction with a rapidly evolving transaction. The Proposal does not adequately consider these practical impediments to implementing the independent verification requirement.

The Proposal also does not fully address the standards or criteria required by the accounting/audit firms that would be required to conduct the reviews. Well-established audit

[7] A number of large accounting firms we have engaged with, and our members have engaged with have confirmed that there is no current staffing model for this large undertaking.

standards currently look at existing holdings as of a particular date, but the Proposal does not outline audit steps or questions to be asked and answered in a transactional context.

D. The Proposal's "Possession or Control" Requirement Would Limit or Eliminate Client Investment in Derivatives and Physical Assets.

The Proposal's requirement for a custodian to exercise "possession or control" does not fit well with a wide range of instruments commonly traded by registered investment advisers. Many instruments have trading, settlement and ownership conventions that differ from listed equities with tickers or cash instruments with CUSIPs. While the financial services industry might be diligent and creative, we are skeptical that the challenges are solvable in light of the Proposal's regulatory parameters.

For illustration, we highlight several asset classes that would be challenged to comply with the Proposal's requirements.[8]

- Contract-based instruments, including
  - repurchase agreements and reverse repurchase agreements
  - loans, commercial mortgages and collateralized loan obligations (CLOs)
  - derivatives, including swaps
- Physical assets, including
  - commodities
  - real estate

If the Commission determines to move forward with the Proposal, we recommend a high level of deference to the existing regulatory and control structures that give market participants comfort about the identity of instruments and their ownership for these asset types. If the Proposal is adopted, the Commission should strongly consider principles-based exceptions to carve-out instruments with established regulatory and control structures (*e.g.*, loans, repos, bi-lateral derivatives, real estate (and other physical assets), etc.) from the audit verification requirement. Without practical exceptions such as these, the Proposal will likely cause certain investments to be unavailable to advisory clients based on the lack of compliant alternatives for advisers; a significant and negative impact to end investors.

[8] This list of asset classes and following discussion are intended to demonstrate just a few of the many instances where the Proposal would profoundly impact current markets. In addition to these more "traditional" asset classes, the Proposal would have a profound impact on digital assets and virtual currency. With respect to digital assets, the Proposal effectively grants custodians a de facto veto over the availability of new crypto assets (*i.e.*, if there are no custodians willing to host to wallet, then it would be impossible for registered investment advisers to trade in these products on behalf of their clients while maintaining compliance with the custody rule). This de facto veto will undoubtedly chill the development of emerging asset classes.

Contract-based Instruments

As a general matter, non-bearer and contract-based instruments face similar challenges under the Proposal. Today, most qualified custodians do not offer custodial services for these instruments, and if they do offer these services in the future, it could be very costly for clients. Unlike custody of cash or securities, which are commonly subject to rehypothecation and provide the custodian with economic upside, loan documents, mortgages, trade claim forms, etc. are generally seen by custodians as a nuisance to safekeep. Thus, custodians will likely charge significant custodial fees before they are willing to custody these documents, especially if they are required to indemnify the client against losses caused by the qualified custodian's negligence, recklessness, or willful misconduct. In the event that qualified custodians ultimately choose not to offer custodial services for these documents, proposed Rule 223-1(b)(2) either is unavailable or does not provide a workable exception, as explained above.[9]

In addition to the issues with the Proposal common to contract-based instruments, advisers will encounter additional compliance complications with respect to the following assets:

Repurchase Agreements and Reverse Repurchase Agreements

Current industry practices may not meet the proposed possession or control or segregation requirements. With respect to asset verification, many repurchase trades are overnight. The benefit of requiring ongoing verification for trades that are settled on a daily basis is unclear. Further, as drafted, the exception in Rule 223-1(b)(2) would not be available to repurchase and reverse repurchase agreements, as such agreements are not privately offered securities or physical assets.

Loans and Securitized Products

Without self-custody, collateral for securitized products such as loans practically cannot be held by existing qualified custodians. A handful of custodians, as a matter of professional courtesy, will hold on to loan documentation for their largest adviser clients. However, this is far from a common industry practice. Many custodians do not want to custody loan, mortgage or other such documentation because the cost and liability of doing so is not justified (*i.e.*, it is not a revenue generator). Absent available qualified custodians to hold these assets, under the Proposal, advisers are left to rely on the self-custody exception.

As discussed above, the self-custody exception requires an independent public accountant to "promptly" verify any purchase, sale, or other transfer of beneficial ownership of such asset. This is simply untenable for a large number of asset classes, including loans. In the loan context, it is unclear at best how a verification could be effectuated generally and certainly not on the timeline set forth in the Proposal. Further, as drafted, the exception in Rule 223-1(b)(2) would not be available to loan instruments that are not securities, as such loans are not privately offered securities or physical assets.

[9] See Section I.C.

Derivatives, including Swaps

The Proposal, if adopted, will have a profound and adverse impact on the derivatives market and will require significant changes to market practice and trading arrangements. As a threshold matter, it is unclear how an adviser might establish that a qualified custodian has "possession or control" in the context of derivatives. Moreover, in many cases collateral posted in connection with a derivative transaction is not held in a segregated account except when required by applicable regulation.[10] This practice would be upended by the Proposal. Assuming segregation could be achieved, the Proposal would result in an overhaul of countless trading agreements and ISDAs and may not make sense economically. Moreover, it is unclear what additional asset protection would be garnered by interposing the adviser in ISDA arrangements between clients and ISDA counterparties,[11] or subjecting derivatives contracts to enhanced custodial protections. Derivatives have substantial client asset protections in place already – reporting requirements, the netting of exposures, including the return of collateral – to mitigate risk and eliminate the need to hold collateral in custody as contemplated by the Proposal.

There are generally two components to a client's obligation to post collateral in a derivatives transaction, variation margin and collateral in excess of a client's market exposure. When parties to a derivative transaction agree to custody collateral with a third-party custodian, they typically do so only with respect to any required collateral with a value in excess of the variation margin, and this makes economic sense. Variation margin is posted daily and is calculated based off an estimate (subject to minor adjustments due to rounding and minimum transfer amounts) of what the respective parties will owe each other in the event one of them defaults. By way of example, if a client posts $100 on a Tuesday, this means the client would owe approximately $100 to its dealer if its derivatives transactions were closed out on Tuesday. From the perspective of the dealer, it does not make economic sense that it should act as a qualified custodian and maintain possession or control of this $100. This is money the dealer is owed from the client, and thus it is not money that is at risk of loss to the client. If the client

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[10] Regulators in the U.S., E.U. and other jurisdictions implemented variation and initial margin requirements for uncleared over-the-counter derivatives transactions as part of global regulatory changes following the 2008 financial crisis (the "UMR Rules"). Regulatory initial margin requires in-scope entities to bilaterally post initial margin ("IM") with its dealer counterparties, resulting in a guaranteed pool of margin posted as a matter of regulation. In-scope parties are permitted, but not required, to adopt an IM threshold amount of up to 50 million USD under the U.S. rules. Under the U.S. rules generally, collateral posted as IM must be held by an independent third-party custodian not affiliated with either party. The segregated arrangement improves a client's ability to recover in the event of the dealer's insolvency – the custody account for IM is in such client's name and a security interest in the custody account is granted to the dealer counterparty, but the dealer does not have legal ownership of the IM. If the dealer becomes insolvent, a client should be able to recover the IM directly from the custodian outside any insolvency proceeding. We further note that the Commission's version of the UMR Rules distinguishes itself from those imposed by other regulators in that it does not require parties to use a third-party custodian to hold collateral posted in connection with security-based swaps. To the extent the Commission is concerned about safekeeping of collateral posted in connection with derivatives it could adapt the same requirements for third-party custody that other regulators require under UMR Rules.

[11] It is unclear from the Proposal whether bilateral ISDA agreements would need to be amended. A plain read of the Proposal suggests that ISDA agreements would need to include the adviser, thus requiring advisers to make all of their client ISDAs triparty arrangements.

must require the dealer to maintain possession or control of that $100, the costs of engaging in swaps with that dealer would quickly become prohibitive.

Physical Assets

As a threshold matter, the Proposal does not include a definition of "physical assets." Although the Commission has indicated that whether an asset is a "physical asset" is "often self-evident," we do not believe this to be the case. A significant number of widely traded assets are at least arguably "physical assets" and there are many different mechanisms by which such assets are possessed and controlled, including via contract, digital or paper documents of title, bills of lading, or warehouse receipts, bailments, or through State or Federally regulated service providers. In some cases, these systems of possession and control have existed for centuries. The lack of a clear definition of "physical assets" will inevitably result in different parties taking different views as to whether Rule 223-1(b)(2) applies to a particular type of asset. That is an untenable situation—if special regulatory procedures are to be imposed on long-standing systems that have stood the test of time, those procedures should be carefully vetted through a transparent public rulemaking process that gives industry stakeholders and opportunity to participate. While we understand that commodity futures contracts would not be "physical assets" under the Proposal, the "commodities" that are deliverable under many commodity futures contracts arguably would be physical assets. Many futures contracts include well-established and specific requirements for delivery of the underlying commodity. The applicability of new custody requirements on such assets may conflict with these and other long-standing requirements about how "commodities" are possessed. Moreover, imposing new mandates on how "commodities" are possessed and controlled would encroach on regulatory authority reserved by Congress to the Commodity Futures Trading Commission and regulated futures exchanges.

Further, imposing special regulatory procedures on the possession or control of a particular type of physical asset by a registered investment adviser will be disruptive to persons who are not investment advisers who seek to possess or control such assets. The imposition of new audit and verification requirements would add unnecessary burdens hampering the orderly trading within commodities markets. Thousands of physical commodities trades and real estate transactions are executed daily, often within moments via electronic and telecommunications. Title often shifts instantly between market participants (including between producers, merchandisers, and end users) amidst spot and forward commodity transactions, with delivery at one of the numerous contractual locations in the U.S. For example, requiring independent public accountants to verify the purchase, sale or transfer of physical assets will increase costs and settlement timeframes for the entire market in that physical asset. If such burdens are going to be imposed, these go well beyond the boundaries of the Investment Advisers Act, and that is a decision for Congress to make.

As discussed above, we are not aware of any service providers that currently offer services necessary to comply with the Proposal with respect to all asset classes. This issue is particularly acute in the physical asset space. Independent accounting firms may or may not decide to provide the verification services that would be necessary under the Proposal. Moreover, there is no assurance that these firms currently have or can obtain the expertise or bandwidth to provide such services, often requiring highly technical and engineering capabilities.

Even if they do provide such services, there can be no assurance that the cost of the services will not be exorbitant or prohibitive. These costs will be passed along to advisory clients. Relatedly, inserting public accounting firms into the process by which physical assets are purchased, sold, transferred, or held, will add another step in every process involving physical assets. This will increase the risk of administrative error, fraud, abuse, misuse, etc., at that added step. The mere fact that the intermediary must be "independent" is no assurance that such intermediary will be responsible or competent.

A number of physical assets are regulated pursuant to other Federal statutory frameworks, often with exclusive jurisdiction, or subject to intrastate administrative or common law. The Commission's attempt to regulate "physical assets" would confuse and upset these existing regulatory and legal frameworks. This is outside of the Commission's competence and not contemplated by its organic statutes. The Proposal also would present commodities market participants with conflicting regulatory requirements from different agencies with different goals, creating confusion as to directives with which to comply.

The U.S. energy industry is one example where possession, control, custody, transfer, and shipment of physical assets is already substantially regulated by a complex framework of Federal and State administrative and common law. These include physical assets that are both commodities and physical plant and equipment.

Investors are already protected by other regulations that are outside the Commission's jurisdiction, that are not contemplated in the Commission's organic statutes, and where the Proposal would disrupt existing practices associated with these physical markets. For example, natural gas, electric power, and oil in liquid form are covered by a mix of Federal and State regulations and contract law. Interstate possession, control and transfer is regulated by the Federal Energy Regulatory Commission ("FERC"). State and common law concepts like interpretations of the Uniform Commercial Code and the International Chamber of Commerce Incoterms (*e.g.*, Free on Board title transfer) also regulate the possession, control, and transfer of these assets. These existing measures mitigate and directly address the Commission's concerns about misappropriation.

If "physical assets" are to be subject to the Proposal at all, they should be subject only to the requirement that the investment adviser "reasonably safeguard the assets from loss, theft, misuse, misappropriation, or [its] financial reverses, including [its] insolvency[.]"[12] This would provide the flexibility necessary to adapt to the many different ways in which various physical assets are possessed and controlled.

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

II. Obtaining Contractual Assurances from Qualified Custodians and Injecting Advisers into Contractual Relationships Between Clients and Custodians Is Practically Inefficient and Unworkable.

A. The Requirements to Obtain Written Assurances and Indemnification from the Qualified Custodian Will Be Exceedingly Costly and Challenging at Best, Impossible at Worst.

The Proposal, if adopted, would require advisers to obtain reasonable assurances in writing from the qualified custodian concerning nine enumerated provisions that address safeguarding of client assets, including a requirement that the qualified custodian indemnify the client for losses resulting from the custodian's own negligence.

As discussed further below, this change of course raises several challenges for advisers:

- The Proposal would expand the scope of an adviser's fiduciary duty beyond investment advice.
- Advisers are unlikely to be able to compel custodians to amend contract terms and provide written assurances.
- Custodians could alter the services they provide which could limit the services an adviser is able to provide to a client.
- Advisers providing investment advice may not have the skill set to perform effective oversight of a custodian selected by the client.
- Significant time and labor would be required to negotiate the high volume of contracts and assurances the Proposal contemplates.

At present, not all custodians are able or willing to provide services to all clients, instruments, and strategies. If the Proposal is adopted, custodians will re-evaluate the services they are able or willing to provide in light of the assurances required by the Proposal. Adding complexity and changing the legal liability terms for custodians can only result in higher costs and more limited services to clients. It is likely that clients will have fewer options for service at higher cost which is not a desirable outcome. Alternatively, clients may have to engage multiple custodians in order to cover all the asset types in which they wish to invest through the help of an adviser, which will require additional time, money and resources of the clients.

Moreover, we believe it is unlikely that all custodians will adopt standard terms of engagement for all advisers. Terms can vary depending on client, adviser, instrument and/or strategy. There could be a wide range of custodians with different terms of service, requiring the adviser to actively monitor and limit the instruments available to different clients with different custodians.

We believe that written assurances could require a bespoke negotiation which will take time and resources to negotiate. The cost of this requirement will be borne by the client that either must wait to receive services or move to a different adviser that may not be their desired provider.

Well-established business and market operations concerning numerous existing contractual relationships would be upended. Even assuming that custodians were willing and able to amend existing agreements or provide a new separate, written document to include the terms required under the Proposal, it would be immensely time intensive and costly for advisers to re-negotiate each prime brokerage, custodial and any other trading agreement that they have in place, some spanning decades.[13]

Even if custodians ultimately adopt a more uniform approach to terms of engagement, given the time and complexity involved in getting such agreements in place, this requirement may also have the unintended effect of consolidating the number of custodians utilized by separate account clients to a select few (*e.g.*, the ones who already have agreements in place with the advisers they would consider using). This could likely lead to clients losing negotiating leverage with custodians as well as increasing the risk to their assets by having industry assets being held by only a handful of custodians.

In addition to the issues and challenges identified with obtaining written assurances from unaffiliated third party custodians, the Proposal would also require these same written assurances from affiliated custodians. Negotiating against and conducting due diligence of a related entity could pose inherent challenges with respect to an adviser's fiduciary duty of loyalty and may even rise to a prohibited transaction under ERISA. If the Proposal is adopted, advisers would effectively be required to validate the client-custodian contract and then supervise the performance of the custodian.

B. The Prescriptive Contractual Assurance and Indemnity Requirements Expects the Adviser to Perform Functions Beyond Providing Investment Advice.

The Proposal's requirement that advisers obtain written agreements and assurances inappropriately inserts advisers into the client-custodian contractual relationship.

It is common practice in some business models that separate account clients independently select their qualified custodians and directly contract their services. While advisers in those cases have investment discretion, they have no involvement in the identification, selection, and retaining of the client's custodian. Advisers are hired to select investments that are best suited for their client's objectives, not their ability to negotiate custody contracts for their clients or oversee the performance of a client's custodian.

[13] *See* Section IV.

As a practical matter, an adviser that is not involved in a client's selection and retention of their custodian because the adviser has no privity of contract and no negotiating position in relation to the custodian. Expecting the adviser to perform a role of negotiating business terms with custodians and overseeing custodian services is an expansion of what is expected of any adviser providing investment advice. The Proposal incorrectly asserts that the custodian relationship is inherently part of the adviser's fiduciary duty based on the Commission's 2019 fiduciary interpretation.[14] The fiduciary interpretation makes no such statements and is not solid ground for such an assertion.

The Proposal attempts to deputize the adviser to validate contract terms between two parties over which the Commission has no regulatory authority. An adviser providing investment advice to separate account clients has no legal authority to negotiate or accept contract terms on their behalf with the custodian. Correspondingly, an adviser without privity of contract has no legal authority to negotiate or accept contract terms on the custodian's behalf for services provided to the adviser's separate account clients.

Because a written agreement of reasonable assurance must be in place before an adviser can provide services, a new separate account client desiring to utilize a custodian of their choice must wait to determine whether the adviser has such an agreement in place. If not, the inception of the account must be delayed until the adviser is able to work with the custodian to agree on written terms or the client must look elsewhere and engage a different adviser. Similarly, if a client changes custodian, the adviser will be unable to continue providing services until/unless an arrangement is agreed with the client's new custodian.

In addition, the Proposal envisions the adviser taking on an ongoing oversight role of custodial services. This oversight function is particularly problematic where an adviser is not involved in the client's selection and retention of their custodian is only providing investment advisory services. Custody services are not the same as advisory services and mandating an adviser to perform an oversight function for a service provider selected by the client puts the adviser in a position it did not seek. The adviser would likely need to incur additional costs to build and maintain a custody oversight function. Playing that role also puts the adviser in the inappropriate position of evaluating the client's selected service provider and developing a view about the quality of service but with no legal or contractual authority to take action.

It is not clear how the adviser would handle a good faith difference of opinion regarding the quality of custodial services or accuracy of assurances provided. It would be an untenable result to require the adviser to resign over custodial services when the client is ultimately the party determining whether their service provider is satisfactory. It would also be an unsound result to hold the adviser accountable under a regulatory standard of conduct for services performed under a contract between two third parties and not involving the adviser.

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[14] *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. at 33,669 (Jun. 12, 2019), https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12208.pdf.

If, in the event the custodian has an operational or service issue, it is unclear whether the Proposal would hold the adviser responsible for not preventing or identifying the issue. If the Commission determines to adopt the Proposal, we request that the Proposal and adopting release acknowledge the limits of the adviser's role with respect to regulatory liability and custodian operations.

The pragmatic questions that the Proposal would cause are not easily resolvable with recommendations to improve the Proposal. The nature of the framework envisioned by the Proposal makes these issues unavoidable and difficult to remedy with minor refinements.

C. The Proposal's Practical and Legal Impediments for Foreign Financial Institutions, Custodians and Sub-custodians Are Significant.

The Proposal would upend the existing custody system that utilizes foreign financial institutions ("FFIs") custodian and sub-custodian arrangements to access markets that would otherwise be unreachable.

FFIs allow advisers access to global markets. FFIs usually serve as custodians or sub-custodians and allow advisers to invest in local securities and instruments that would otherwise be unavailable to their clients. The proposed requirements for FFIs could make investing in certain foreign markets difficult or impossible. Specifically, we are concerned with the requirements that custodians must (1) be subject to judgements that originate in the United States; (2) operate within a country that has similar anti-money laundering laws as the United States; and (3) keep client assets segregated. The Proposal's requirements on FFIs are likely to result in extraterritoriality issues. Specifically, it is unclear at best whether accounts that are custodied by foreign qualified custodians or affiliated sub-custodians could be both compliant with the Proposal and the applicable banking, bankruptcy, accounting and exchange laws of the country where the FFI is located.

We are also concerned about the supervision of custodian requirement, especially as it relates to FFIs and other custodians and sub-custodians. Global custodians are the entities that usually engage the services of sub-custodians (including FFIs) Moreover, when asset managers engage custodians, the engagement frequently includes the ability of that custodian to sub-custody with any number of affiliates, including foreign affiliates. Sub-custody can be necessary to effect transactions in certain markets and products. It is a-typical for the adviser to have an independent contractual relationship with that sub-custodian or conduct diligence with respect to every affiliated sub-custodian that the primary custodian may use. If the Proposal is adopted, the Commission should strongly consider adding a provision that provides for substituted diligence and reliance on the primary qualified custodian engagement.

In addition, the Proposal presumes a wide selection of available sub-custodians in all countries. In some cases, there are a limited number of service providers. While custodians currently maintain their own diligence and selection process, they cannot ultimately guarantee the performance of a third-party sub-custodian. In the event that a foreign sub-custodian does not meet the Proposal's minimum requirements or the adviser believes may not meet the Commission's expectations for ongoing service, the adviser is unable to make a risk decision or

disclose the facts to the client. The only response available to the adviser to avoid a regulatory violation will be to withdraw from the market. The client will ultimately lose access to the market without having effective input in the matter.

In sum, if the Proposal is adopted and investment advisers are no longer able to access markets through FFIs, clients will no longer have access to the returns and diversification that those markets provide.

III. Congressional Authority Does Not Contemplate Overhauling Traditional Concepts of Adviser Custody.

We understand and appreciate that the Commission has a statutory mandate to issue regulations implementing Section 223.[15] But, Congress did not mandate that the Commission promulgate a regulation as far-reaching as the Proposal. The Commission has the authority to appropriately tailor regulations to the realities of the market as it exists today—a market shaped by a decade of new rules and controls, including those promulgated by banking regulators, CFTC, etc. that have fundamentally changed the conditions in which Section 411 was enacted and the risks it sought to address.

Further still, the Proposal impermissibly encroaches on the primary and exclusive jurisdiction over physical and derivatives commodities markets as regulated by Federal regulators as granted by Congressional statutes. [16] In the derivatives context, the D.C. Circuit held that the Commodity Exchange Act provided the CFTC with exclusive jurisdiction to govern natural gas futures contracts to the exclusion of FERC attempts to enforce manipulation standards regarding such futures.[17] The Commission should not be interfering with the statutorily defined jurisdiction of the CFTC over futures derivatives, which would be contrary to D.C. Circuit precedent.

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[15]"An investment adviser registered under this title shall take such steps to safeguard client assets over which such adviser has custody, including, without limitation, verification of such assets by an independent public accountant, as the Commission may, by rule, prescribe." *See* Section 411 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (15 U.S.C. 80b-18b) ("Dodd-Frank").

[16] *See, e.g.*, Federal Courts have recognized that FERC has exclusive authority to regulate the rates of interstate natural gas and power commodity markets as established with the filed rate doctrine. Such rates, as filed tariffs submitted to FERC, include provisions for the scheduling and title transfer of natural gas and electric power commodities which are subject to FERC's audit and investigation authority. *See further Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 571, 580 (1981) (holding that a state regulator cannot disrupt the exclusive authority of FERC over natural gas rates, and that doing so would "undermine the congressional scheme of uniform rate regulation" as protected by the filed rate doctrine); *see also*, *Nantahala Power and Light Co. v. Thornburg*, 476 U.S. 953, 956 (1986) (explaining that FERC "has exclusive jurisdiction over interstate wholesale power rates").

[17] *See Hunter v. Fed. Energy Regulatory Comm'n*, 711 F.3d 155 (D.C. Cir. 2013) (holding that the CFTC had exclusive jurisdiction over a natural gas futures manipulation scheme, and that FERC lacked such jurisdiction).

A. Expanding the Custody Rule to All Assets Exceeds the Commission's Authority.

The expansion of the custody rule to cover all assets is inconsistent with Congressional intent. From a historical perspective, the phrase "client assets" was used by the Commission in the 2009 custody rule release as a concise reference to the custody rule's actual scope. Specifically, the phrase was used "solely for ease of reference in [the 2009] Release; it does not modify the scope of client funds or securities subject to the rule."[18] Congress parroted the Commission's phrase "client assets" in Dodd-Frank Section 411. Given the Commission's non-substantive use of the phrase "client assets," it is reasonable to conclude that when Congress used the phrase in Section 411, Congress similarly meant client funds or securities, not all assets. In short, "client assets" was never intended to be a substantive term as it is being used in the Proposal. Expanding the scope of the custody rule on that basis is an inappropriate interpretation of Congressional intent.

B. Redefining Custody Is Not Contemplated by Section 223.

We fundamentally disagree that discretionary investment authority is a synonym for custody. The Commission's statutory authority traces to Section 223 of the Investment Advisers Act. Section 223 was added in 2010 by Dodd-Frank Section 411 but there is nothing in the statute that contemplates comprehensively changing the common understanding of what custody means. Historically, an adviser needed to have control or involvement in the client's account beyond providing investment advice to have custody. We believe that Section 223 was a grant of authority to amend and update rules for advisers that have custody, not a grant of authority to expand the concept of custody to include all advisers with investment discretion.

Practically, this will result in drawing an artificial line across client guidelines and instruments available for investment. In many cases, it will limit an adviser's trades to DVP only. If an adviser is deemed to have custody because of non-DVP trading authority, a surprise exam is required. It will be especially challenging for an adviser to engage an auditor to conduct such an exam with respect to its institutional separate account relationships where the adviser has no privity of contract with the custodian and no other involvement with the client's assets. The DVP / non-DVP distinction in the Proposal has no materiality threshold or safe harbor. Thus, advisers with a single non-DVP trade in a client account will trigger the full burdens of the Proposal. Non-DVP instruments may be received into an account without any change of authority for the adviser (corporate actions, workouts, etc.), involuntarily putting the adviser in a position of taking on additional regulatory requirements such as those related to the surprise audit exemption.

We continue to believe that existing protocols are better and less burdensome to address the risks of non-DVP trading. The magnitude of instruments that trade without problems on a daily basis is enormous. Instruments such as derivatives, private placements, bank loans, and

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[18] Custody of Funds or Securities of Clients by Investment Advisers, SEC Release No. IA-2968 (Dec. 30, 2009) (Final Rule), https://www.sec.gov/rules/final/2009/ia-2968.pdf.

foreign securities trade with reliable settlement processes and controls. The Commission Staff requested comment in a letter dated March 12, 2019 on non-DVP custodial practices.[19] A number of comments were submitted, including a joint trades letter between SIFMA AMG, the Investment Adviser Association and the Loan Syndications and Trading Association dated May 13, 2021.[20] True misappropriation is extraordinarily rare and the Proposal's controls would be ignored by bad actors. The Proposal's citation of custody issues in examinations has much more to do with administrative challenges of custody compliance – Form ADV filings, audits, and statements – than actual misappropriation.[21] We applaud the Commission's willingness to update and revise custody rules for investment advisers but reiterate that any cure should be tailored to the illness.

The Proposal exceeds the scope of Commission authority by imposing requirements on private contracts with custodians, including FFIs, indirectly attempting to regulate market participants that are outside the direct purview of the Commission's mandate. If there are public policy reasons to address the services of custodians, those ought to be raised through the regulators with relevant jurisdiction.

If the Commission decides to proceed, at minimum, we urge recognition of the key distinction between those advisers involved in custodian engagement and instruction and those advisers that only exercise discretionary trading authority. Advisers with no privity of contract with a custodian and/or no ability to take action beyond providing investment advice are in a considerably different position than those who take a more active role with custodians and their services to clients.

IV. The Cost-Benefit Analysis Does Not Fully Contemplate Initial and Ongoing Costs.

Advisers may absorb some of the cost, but direct costs for implementation of the Proposal, negotiation of new agreements and written assurances, renegotiation of existing agreements, engaging additional custodians, conducting additional audits and asset verifications would be borne by clients and fund investors. Although it is difficult to determine a precise cost, the Proposal significantly underestimates the cost of implementation.[22] A number of members

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[19] *See* Engaging on Non-DVP Custodial Practices and Digital Assets: Investment Advisers Act of 1940: Rule 206(4)-2 (Mar. 12, 2019), https://www.sec.gov/investment/non-dvp-and-custody-digital-assets-031219-206.

[20] *See* Engaging on Non-DVP Custodial Practices (May 13, 2021), https://www.sec.gov/files/iaa-sifma-lsta-051321.pdf.

[21] *See* National Exam Program Risk Alert by the Office of Compliance Inspections and Examinations, "Significant Deficiencies Involving Adviser Custody and Safety of Client Assets" (Mar. 4, 2013), https://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf. *See also* "The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers" (Feb. 7, 2017), https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf.

[22] The Proposal's estimates to obtain, prepare and amend written agreements and assurances with custodians are not credible. Suggesting that arrangements of such complexity and significance can be agreed and completed in an hour

indicated that they or their clients have custodial agreements numbered in the hundreds, not including arrangements that they have with FCMs and clearing counterparties that could be impacted by the Proposal. Even if these advisers were able to amend or enter into new agreements in short form or by omnibus agreement with each custodial counterparty, it would take significant time to engage and negotiate with each counterparty.

Beyond implementation expenses, the ongoing cost to engage additional custodians for assets that are currently self-custodied, and to engage auditors for independent verification services could be substantial. Audit firms are not currently organized for transaction-oriented business lines, so it would take time and resources to build out their new capabilities. These costs would result in additional expenses for the additional services and be borne by clients. Moreover, the application of the Proposal could disproportionally burden clients with strategies involving frequent transactions in non-custodied assets versus those doing infrequent transactions, regardless of client account size.

Consistent with its mission, the Commission is required to consider whether an action or prosed rulemaking action will "promote efficiency, competition, and capital formation."[23] In this respect the cost-benefit analysis fails to consider the global, market-wide impact that the Proposal will have on markets and instruments. The economic impact of registered investment adviser clients abandoning certain asset classes and foreign markets would have an impact on efficiency, competition, and capital formation.

We urge the Commission to fully analyze those costs and implications before deciding whether to proceed with the Proposal in any form. We also continue to encourage the Commission to consider the cumulative effects and interconnected nature of the various rulemaking initiatives.

V. The Implementation Period Must Be Extended.

As described above, the Proposal would present a comprehensive overhaul of many existing business arrangements and require construction of new frameworks and workflows. In many instances, compliance with the Proposal would be impossible and in other circumstances,

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or 15 minutes is well short of the realities of a process that will involve in-house counsel, outside counsel, exchanges of drafts, client review, etc. The Proposal also significantly underestimates the volume of written agreements and assurances that would need to be agreed and completed. Clients often have multiple advisers and advisers have multiple clients with multiple custodians. The custodians at the epicenter would have a herculean task to revise existing arrangements and the Proposal does not fully account for the associated burdens.

[23] "Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." *See* Securities Act of 1933, Securities Exchange Act of 1934, Investment Advisers Act of 1940, and Investment Company Act of 1940.

compliance could be prohibitively expensive or limited unless custodians and audit service providers materially expand their service offerings.[24]

Assuming that custodians will acquiesce to market demand for the Proposal's required written assurances and contractual terms, negotiating written arrangements between most advisers and all custodians would be a significant undertaking. With so much change introduced by the Proposal, it will take time to negotiate terms and conditions. The Proposal itself acknowledges the difficulty advisers presently have in amending contracts to reflect their actual authority. Expecting advisers to successfully encourage custodians to agree to substantive contract terms is extremely ambitious. Smaller advisers in particular will likely be in a "take it or leave it" position relative to their custodians. Either way, the changes will require time and legal resources to address. The Commission ought to take into account the following:

- Efforts to change the business terms that custodians maintain with their clients would likely require extensive involvement with clients and overhauls of the existing contracts between clients and custodians.

- Clients may need to change advisers if their custodians are unable or unwilling to support services and/or enter into agreements with the client's adviser of choice.

- Custodians may seek to change economic terms in light of the Commission's mandated terms of service.

- Audit firms would need to build new lines of business with new audit standards to accommodate the transaction reporting and verification requirements.

- Many trading agreements beyond strict custody agreements would be in scope for amendments.

The sheer scale of all advisers re-negotiating contracts and agreements with so many market participants is daunting.

The Proposal suggests a 12 month implementation period for advisers with over $1 billion in regulatory assets under management and 18 months for those with up to $1 billion in regulatory assets under management. At a minimum, we believe that a three year implementation period will be necessary for all advisers to make such significant changes. Larger advisers are likely to have more clients with more instruments and more custodians than smaller advisers. The time required will be largely driven by custodians and third party accountant/audit firms which means the advisers will have limited control over relevant timelines. Given the heavy role parties outside of the advisers' control will have in compliance, we request relief from the Commission if the intended timeframes become infeasible.

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[24] We also note the Commission's pending proposal on outsourcing for investment advisers. A comprehensive analysis of the impact and implementation requirements of this Proposal is infeasible without a final outline and determination of how the custody function and custodians would operate under a final outsourcing rule.

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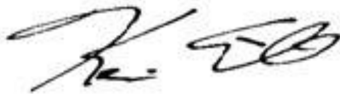
As noted at the outset of these comments, SIFMA AMG supports the Commission's principal aim of preventing loss, misuse, and misappropriation of client assets. SIFMA AMG also supports revisiting, re-assessing, and updating investment adviser regulatory requirements for custody and safeguarding. As fiduciaries, our members share the Commission's mission to ensure that client assets are protected from misappropriation and misuse.

However, our experience with markets and operational logistics informs our perspectives on the Proposal. We have serious concerns about the breadth and consequences of the Proposal and urge the Commission not to adopt the Proposal in its current form. Given the immense impact any mandated change to current custodial practices will have on advisers, their clients, qualified custodians, and the market at large, the Commission should consider withdrawing the Proposal and engaging in a market-wide analysis and discourse that is otherwise infeasible in the constraints of the Proposal and comment period. SIFMA AMG appreciates the opportunity to comment on the proposed rules. If you have any questions or would like to discuss anything in this letter further, we welcome the opportunity to engage with you. Please feel free to contact Kevin Ehrlich (kehrlich@sifma.org) or our counsel at Sidley Austin LLP.

Sincerely,



Kevin Ehrlich
Managing Director, Asset Management Group
Securities Industry and Financial Markets Association

Attached: Appendix

cc: Honorable Gary Gensler, Chair, U.S. Securities and Exchange Commission
Honorable Hester M. Peirce, Commissioner, U.S. Securities and Exchange Commission
Honorable Caroline A. Crenshaw, Commissioner, U.S. Securities and Exchange Commission
Honorable Jaime Lizárraga, Commissioner, U.S. Securities and Exchange Commission
Honorable Mark T. Uyeda, Commissioner, U.S. Securities and Exchange Commission
William Birdthistle, Director, U.S. Securities and Exchange Commission, Division of Investment Management

Appendix

Responses to Specific Commission Questions[25]:

7. Should the proposed rule apply to assets that are treated as liabilities from an accounting perspective?

No. Please see Section I.B.

9. Should the rule apply to when an adviser has discretionary authority over client assets, as proposed? Are there provisions of the proposed rule that should or should not apply to advisers who have custody because they have discretionary authority?

DVP authority acts like a cliff. Advisers with only one trade in a client account will trigger the full burdens of the custody rule. They will need to either embrace the full rule or take measures to prevent trading with discretion on a non-DVP basis. The burdens apply even if the adviser only has non-DVP authority – even if it doesn't use it in the ordinary course, authority means it might at some point in the future. If a trade arises and the adviser has not made preparation to comply with the custody rule, the adviser cannot trade without violating the rule. It must decline to make that trade. It may be feasible for a one-off exception to obtain an instruction from the client, but that imposes a burden on a client and may not be timely enough to execute a trade.

38. Should the rule permit securities depositories, administrators, or other intermediaries to be qualified custodians?

Yes, the Commission should expand the definition of qualified custodians to include administrators, as well as regulated entities such as CFTC registered-swap dealers.

11. When a trade settles in a manner that is not DVP, are there controls that are or couldn't be established in the event one leg of the trade does not complete? If so, how commonly are such controls utilized?

Non-DVP controls are common and have been shared with the Commission in the past. See Link. Delegated advisers should be exempted to avoid duplication if a named adviser is already taking the lead and addressing the requirements.

16. Should we include an exception from the rule for assets for which the adviser provides advice in certain sub-adviser relationships, such as was described in our staff's statements?

Yes.

[25] Question numbers correspond to the numbered question set forth in the Proposal.

123. We are proposing to retain the mutual fund shares exception because, in our experience, this exception has not raised similar types of investor protection concerns that we are seeking to address in this proposal. Do commenters believe that the mutual fund shares exception raises investor protection risks? Should we eliminate the exception for mutual fund shares? To what extent do advisory clients purchase mutual fund shares through qualified custodians such as broker-dealers such that the exception may not be necessary?

We recommend that the Commission maintain this exception and expand it to include Common Investment Funds ("CIFs"). In CIFs, the bank holds title to the fund's assets. When an adviser invests in a CIF on behalf of a client, that client becomes entitled to a participating interest in the fund. This interest is typically recorded by the bank or its service provider. Since no certificate of ownership is issued, neither the custodian nor the adviser would be able to control or possess it. Furthermore, participating interests can be neither pledge nor otherwise be encumbered by a third party. As such, they are safeguarded in a way consistent with the Commission's policy goals.

193. Should the rule require audits to cover a period of 12 months? Would investors derive value from audits that cover periods longer or shorter than 12 months? If so, what time periods, and why?

Flexibility for 15 month audits would help mitigate the cost of audits for newly launched and liquidating funds. Similarly allowing a fund that is in a drawn out liquidation, to rely on longer period audit would be beneficial (Q196).

205. Is the term "entity" the appropriate term to use to describe the audit provision client type, or is there another term we should use? For example, an adviser may manage a separate account for a corporate institutional client that undergoes a financial statement audit for reasons unrelated to the custody rule. Although the financial statements pertain to a much broader universe of transactions than just transactions in the account or the assets the adviser manages for that client, should the adviser be able to rely on this audit to comply with the proposed rule? Would the answer depend on whether the adviser manages a non-entity sleeve of the client corporation's assets or a subsidiary entity?

If an adviser is deemed to have custody because of non-DVP trading authority, a surprise exam is required. This is challenging for institutional separate account relationships where the adviser has no privity of contract and no other involvement with the client's assets. If the Commission proceeds with the Proposal, substituted compliance should be authorized based on the client's GAAP financial statements for their account. To do otherwise would duplicate effort and expense.

267. Should advisers be required to file promptly an other-than-annual-amendment to Form ADV when the information provided in response to certain parts of Item 9 becomes inaccurate?

No. This is an unduly burdensome requirement and require frequent other-than-annual amendments in order to maintain accurate information regarding a scope of authority that changes often but will provide little additional information.

Technical Questions and Clarifications

If the Commission decides to proceed in some form, we request that the Commission consider the following technical and interpretative questions that arose during our analysis of the Proposal:

- How would the Proposal apply to master-feeder structures? For example, do feeder funds need to custody master fund interests/shares?

- Similarly, how would custody work with respect to assets of portfolio/operating companies held within a fund complex? Would the adviser need to look-through the portfolio company and custody those assets, or is custody of the portfolio company interest sufficient?

- Regarding wrap accounts where the sponsors (i.e., the adviser's client) act as custodians, how does the Proposal apply in this context?

- How would the Rule as proposed apply to a registered investment adviser that is hired by another adviser (whether SEC-registered or not) to act as a sub-adviser? Would both advisers (if SEC-registered) have to comply with the Rule, or could the sub-adviser rely on the hiring adviser? If the hiring adviser is not SEC-registered then is the burden on the SEC-registered sub-adviser to comply?

- Is there sufficient consideration for the custodian to enter into a written agreement with the adviser?

- The Proposal does not change how the definition of "qualified custodian" treats FCMs, saying that an FCM is a qualified custodian if it is "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". This was fine while the rule only covered "funds and securities" but now that it covers all assets, this provision as it stands seems to stand for the proposition that an FCM would not be a qualified custodian with respect to commodities (which includes all CFTC regulated swaps). The is likely an oversight but it should be corrected if the Proposal is adopted.

- Can the Commission provide assurance that existing no-action letters addressing the application of the custody rule not specifically identified in the Proposal (Section II.J) will not be withdrawn in connection with adoption of the Proposal? Withdrawal of certain of this guidance[26] would materially and adversely impact market participants.

[26] *See e.g*., CIGNA Capital Advisers, Inc., SEC Staff No-Action Letter (Sept. 30, 1985).