May 9, 2023

Via Electronic Mail: rule-comments@sec.gov

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

Re: Safeguarding Advisory Client Assets Proposal; File No. S7-04-23; Release No. IA-6240

Dear Ms. Countryman,

We, Innocap Investment Management Inc., and our United State-domiciled subsidiary, HedgeMark Advisors, LLC, are managed account platform providers to institutional investors — including governmental and corporate pensions, foundations, and endowments — which invest in the U.S. capital markets in order to meet to the long-term needs of their beneficiaries, which include millions of Americans.

We support the Commission's efforts to protect the interests of investors in the US capital markets. Indeed, this is also our objective. However, we believe that the proposed rulemaking (the "Proposed Rule") would compromise the managed account mechanism that institutional investors commonly employ to achieve customized solutions that meet their specific goals and protect their interests. Specifically, we believe that expanding the definition of custody to include discretionary trading authority and imposing compliance with the Proposed Rule on private fund advisers ("Managers") for assets managed on a managed account platform would undermine the independent governance structures established by managed account platforms to better protect investors. Therefore, we suggest that any rulemaking should exclude Managers when they serve as investment advisers to private fund vehicles or other portfolios through an independent managed account platform.

In its request for comment, the Commission asked whether Managers already take precautions with respect to accounts for which they only have discretionary authority, and more generally, whether there are any other arrangements where the concerns sought to be addressed by the Proposed Rule are not applicable and therefore should be excluded. In this comment letter, we answer the Commission's questions in the context of dedicated managed accounts.

Background:

Since the 2008 financial crisis and the Madoff ponzi scheme discovery, the managed account industry has emerged as the industry's solution to the control imbalance and lack of transparency common in the hedge fund space. However, the term "managed account" can have different meanings. In a "dedicated managed account" platform, an investor's hedge fund portfolios are placed in a separate vehicle, controlled by that investor. The investor's allocation of assets to each particular Manager is made by purchasing equity interests in the vehicle, or in a segregated cell within the vehicle, so that the assets and liabilities associated with one Manager's trading strategy are isolated from the assets and liabilities associated with another Manager's trading strategy. Each such vehicle or cell is referred to as a "dedicated managed account" or "DMA". In addition to their use by pension plans, endowments and foundations, asset manager investors are also increasingly using DMAs to create fund-of-funds or sub-advised products and to design bespoke solutions for their clients.

DMAs differ fundamentally from conventional hedge fund structures as well as from "fund-of-one" structures. In a conventional hedge fund structure, the Manager sponsors the formation of the fund vehicle and controls all aspects of the investment vehicle. The investor has no control over the investment vehicle and usually only has the right to redeem according to a set redemption schedule. The Manager handles the fund's portfolio trading and day-to-day operations. The Manager's duties and responsibilities are set out in an investment management agreement (an "IMA") or, in some cases, in a limited partnership agreement, between the Manager and the legal entity formed by the Manager to house the assets. The terms of these agreements are typically dictated by the Manager and not negotiated with investors (who invest post-launch after the governing agreements are executed).[1] In what is commonly referred to as a "fund-of-one" structure, an institutional investor may also seek to limit co-investor risk by requesting that the Manager form a separate vehicle to be solely owned by the institutional investor. In such case, the governing documents may be subject to some negotiation between the investor and the Manager; however, the Manager typically remains in control of day-to-day operations and oversight of service providers such as the fund administrator and auditor, and the investor's transparency into such operations as well as the fund's holdings is limited.

For institutional investors (whether pension plans, foundations, endowments or asset managers), investing in hedge fund strategies through a DMA provides important investor protections when compared to the alternative of investing directly into a Manager's commingled fund, including:

- **Independent Governance and Oversight** – The governing body of the DMA is installed by the investor, or its managed account provider, instead of by the Manager. As a result, the governing body is not conflicted in its allegiance to the investor or influenced by a broader commercial relationship with the Manager.

- **Asset Control** – Assets are held in custodial accounts set up by the investor (with the assistance of its managed account provider) in the DMA's name and only limited and revocable trading authority is conferred on the Manager. The Manager has no authority to move cash or assets out of any account (custody, brokerage or otherwise) held in the name of the DMA or to change the beneficial ownership of the DMA's assets. In addition, the Manager has no authority to unilaterally obstruct the investor's access to its assets with "lock-ups", "gates" or other liquidity constraints commonly used in hedge funds. **Of particular relevance to the Proposed Rule, DMA assets are subject to valuation and audit processes independent of the Manager**, allowing the investor to apply valuation methodologies that are consistent with those used at its enterprise level and leaving the Manager with no responsibility for retaining the DMA's auditor or managing the audit process.

- **Investment and Operational Transparency** – DMA account custodians, brokers and trading counterparties provide reporting directly to the investor's managed account provider, which then produces daily holdings reports, risk analytics, performance attribution analytics and investment guideline compliance monitoring for the investor. Investors may also request additional analyses from the managed account provider, such as ESG scoring and liquidity classifications using methodologies consistent with those used by the investor at its enterprise

[1] Depending on the legal structure and contractual arrangements of the DMA, the managed account provider may also use the label "fund manager" and provide its services pursuant to a management agreement; however the management agreement in such case would be subject to negotiation and input from the underlying DMA client, and the investment management and trading is still conducted by a third-party Manager, allowing for the independent governance and oversight by the managed account provider.

level, making the data more functional.

- **Expense Transparency** – DMA service providers, brokers and trading counterparties are selected by the investor (usually through its managed account platform provider). The Manager has no authority to incur expenses on behalf the DMA or to instruct reimbursement of its own out-of-pocket expenses without prior agreement of the client.

- **Customization** – The DMA structure allows investors to design investment strategies, investment parameters, fee structures, defensive overlays and other commercial attributes that reflect the investor's values and sensitivities (e.g., to promote and enforce environmental or diversity and inclusion objectives or to clearly demonstrate the application of fiduciary and governance models imposed by the client's stakeholders and beneficiaries).

The absence of control and the limited transparency available to investors in conventionally structured private funds means that investors are exposed to significant operational, valuation, fraud and co-investor risk in addition to their assumed investment risk. By moving their hedge fund allocations into a DMA structure (where the investor sponsors formation and so controls the design of the structure and the investor rights), investors have been able to drive meaningful enhancements in the control environment, often over the objections of hedge fund managers. The managed account industry has grown quickly since 2008, accounting for approximately $170 billion (or 5% of all hedge funds assets) in 2020.[2]

Under current Rule 206-4(2) (the "Existing Custody Rule"), Managers providing investment advisory services to DMAs are not usually deemed to have custody due to their inability to move cash or assets in or out of the DMAs' accounts. The IMA between a DMA and a Manager is negotiated at arms-length, with the roles and responsibilities of the Manager narrowly defined. The Manager has the authority to trade the account and must comply with substantial reporting obligations on daily, weekly and monthly basis. Usually, only the managed account provider has the authority to move cash or assets out of the DMA's name and procedures and controls are implemented such that only individuals employed by the managed account provider have the ability to instruct wires, input new outgoing wire destinations and move non-cash assets to or from any custody or trading account. Accordingly, for example, financial institutions holding the DMA accounts perform call backs to individuals employed by the managed account provider (and not the Manager) prior to implementing any instructions to move DMA assets.

If Managers are deemed to have custody under the Proposed Rule, they would need to take on additional, and in some instances duplicative, functions - functions for which they currently (by design) have no involvement. For example, under the current DMA model, the fund administrator liaises directly with the investor and its managed account platform provider in preparing financial statements, and those parties liaise directly with the independent auditor, with little (if any) need for involvement by the Manager. If the Proposed Rule is enacted in its current form, Managers would likely henceforth insist on being involved in these processes. In addition, Managers would likely insist on involvement in the selection of the qualified custodians and the negotiation of all custody agreements and trading documentation, to ensure satisfaction of their new compliance obligations under the Proposed Rule. Typically, in a managed account scenario, the managed account platform (and not the Manager) is responsible for establishing all custody agreements and trading

[2] "Separately Managed Accounts – The Landscape, Recent Developments and Key Considerations for Hedge Fund Managers and Allocators" by Goldman Sachs, December 2020.

documentation. The Manager's participation in these negotiations is currently unnecessary and undesired by any of the participants involved in the relationship, and any such involvement would only serve to disrupt the process of launching DMAs and to further deter Managers away from the DMA structure. It is also probable that Manager participation in these functions will result in increased management fees, without any benefit of increased protection.

The Commission has rightfully attempted to address concerns regarding misappropriation, misuse and loss of client assets through the Existing Custody Rule, and many of the provisions of the Proposed Rule will enhance those protections. However, including discretionary trading authority in the definition of "custody" in the context of dedicated managed accounts does not improve these protections because the risk is already mitigated through the insertion of independent service providers, investor retention of governance rights and by limiting the functions of investment advisers through structural mechanisms. In our experience, we believe the DMA structure effectively reduces the opportunity for advisers to misuse, misappropriate or lose client assets without detection because of the substantial controls and supervisory oversight built into the structure. Indeed, rather than enhancing the protection of investors, this element of the Proposed Rules will serve to undermine those existing investor protections and curtail use of the structure, while potentially increasing expenses where dedicated managed accounts are used.

Comment:

The Commission should define "Managed Account Platform" and exclude advisory clients that an investment adviser manages on a Managed Account Platform from compliance with the Custody Rule. Subsection (d)(3)(ii) in the definition of "Custody" should be amended to exclude arrangements for which the Manager solely has discretionary trading authority on a Managed Account Platform.

First, we urge the Commission to adopt a definition of "Managed Account Platform". This definition will be useful for the Proposed Rule as well as for other recent proposals, including the Private Fund Adviser Rule, on which we commented in August 2022, and the recent proposed rule 206(4)-11 regarding outsourcing of certain covered functions. The definition should contemplate an independent platform on which asset owners or asset managers establish their own investment vehicles, retain service providers of their choosing to act for those vehicles, and retain investment advisers to provide discretionary investment advice pursuant to a written investment management agreement that explicitly excludes custody of assets and authority to move any assets, including cash, securities or other assets, in or out of any account in the DMA's name.

Second, in the final rule, Section 223-1(d)(iii) should be amended as follows: "Any arrangement (including, but not limited to a general power of attorney or discretionary authority) under which you are authorized or permitted to withdraw or transfer beneficial ownership of client assets upon your instruction**; provided, however that any such arrangement pursuant to which an investment adviser solely has discretionary trading authority with respect to an advisory client on a Managed Account Platform shall not constitute Custody**; and".

The Commission has already contemplated that certain exceptions from the surprise examination requirement when the adviser's sole reason for having custody is because it has discretionary authority might be necessary and appropriate. By creating an exception from custody in the context of a Managed Account Platform, the Commission would make clear that investment advisers do not have any responsibility for compliance with the Custody Rule with respect to such assets, and would thereby allow managed account platforms to continue to operate consistently with past practice.

Conclusion and Proposal:

Based upon our experience in servicing private fund investors, in the case of managed account platforms, the underlying public policy considerations of the Proposed Rule do not account for the commercial goals of the very investors such rule-making seeks to protect and would be disruptive to managed account platforms, which already strive efficaciously to prevent misuse, misappropriation or loss of client assets by investment advisers. Thus, we believe that explicitly excluding the concept of a Managed Account Platform, which we would define as proposed above, would be a welcome change in any final rule making and we urge the Commission to include such an exclusion. Furthermore, as the Commission writes new proposed rules and finalizes rules that are currently under consideration, we hope that the Commission will consider managed account platforms and take into consideration how investors that invest in the US capital markets through such platforms might be affected by such rulemaking.

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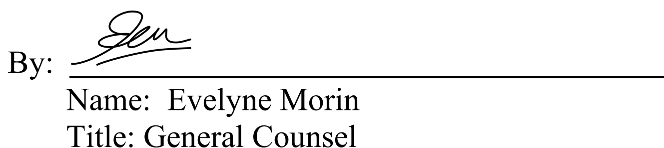
We thank you for your attention to the enhancement of investor protection in the private fund space and look forward to working with you on policies that will serve institutional investors without restricting the ability of sophisticated investors to collaborate with private fund managers to design structures suited to their individual needs and goals. If we can be of any assistance to you in the rulemaking process as you begin to consider impacts on dedicated managed account platforms, we would welcome those conversations with the appropriate teams at the Commission.

Respectfully yours,

INNOCAP INVESTMENT MANAGEMENT INC.



By: ______________________________

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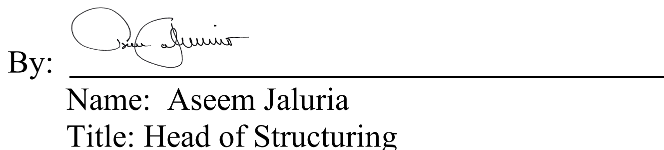
Title: General Counsel

HEDGEMARK ADVISORS, LLC



By: ______________________________

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