INVESTMENT ADVISER ASSOCIATION

October 30, 2023

Via Electronic Filing

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

Re: Safeguarding Advisory Client Assets; Reopening of Comment Period (SEC Rel. No. IA-6384; File No. S7-04-23)

Dear Ms. Countryman:

The Investment Adviser Association (**IAA**)[1] appreciates that the Commission has reopened[2] the comment period for the Safeguarding Advisory Client Assets proposal[3] in light of the adoption of the private fund adviser audit rule.[4] As we have previously commented to the Commission,[5] the IAA and our members strongly support the safeguarding of client assets and have long called for making the current custody regulatory framework under the Investment Advisers Act of 1940 (**Advisers Act**) more workable and effective in achieving the Commission's important investor protection goals.

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

[2] *Safeguarding Advisory Client Assets; Reopening of Comment Period*, 88 Fed. Reg. 59818 (Aug. 30, 2023), available at https://www.govinfo.gov/content/pkg/FR-2023-08-30/pdf/2023-18667.pdf.

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

[4] Rule 206(4)-10 under the Advisers Act (**Private Fund Audit Rule**). *See Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, 88 Fed. Reg. 63206 (Sept. 14, 2023), available at https://www.govinfo.gov/content/pkg/FR-2023-09-14/pdf/2023-18660.pdf.

[5] *See Letter from the IAA to the Commission re: Safeguarding Advisory Client Assets* (May 8, 2023), available at https://investmentadviser.org/resources/iaa-letter-to-sec-on-safeguarding-advisory-client-assets-proposal/ (**Initial Safeguarding Letter**).

These supplemental comments (**Supplemental Comments**) incorporate, and in some cases expand upon or clarify, the significant concerns with the Safeguarding Proposal that we raised in our Initial Safeguarding Letter, and we again strongly urge the Commission to make the changes we recommended in that letter. We make several additional recommendations in these Supplemental Comments to specifically address our concerns with the Private Fund Audit Rule and improve the proposed audit provision under the Safeguarding Proposal (**Proposed Audit Provision**) in light of that rule.

Executive Summary

We make the following recommendations to improve the Proposed Audit Provision:

- **Allow qualified opinions in limited circumstances and provide an opportunity to cure under the Proposed Audit Provision and the Private Fund Audit Rule.**
- **Eliminate liquidating audits in certain circumstances.**
- **Permit sampling for asset verification.**
- **Retain the surprise examination approach as an alternative to the audit approach and permit a non-control adviser to take reasonable steps to cause an audit where the audit approach is elected.**
- **Clarify that a U.S. GAAS opinion is not required for certain non-U.S. entity financial statements.**
- **Do not require written agreements between advisers and auditors regarding audit-related notifications.**

We also make the following recommendations to expand upon our Initial Safeguarding Letter:

- **Preserve relief for loan syndicate account statements.**
- **Exclude all assets subject to CFTC jurisdiction.**

Discussion

The Private Fund Audit Rule will require an SEC-registered investment adviser to obtain an annual financial statement audit of each private fund that it advises, directly or indirectly, that complies with the audit provision of the current Custody Rule.[6] The Custody Rule requires that these audits be performed by an independent public accountant that meets certain standards of

[6] Rule 206(4)-2 under the Advisers Act (**Custody Rule**).

independence and is registered with and subject to regular inspection by the Public Company Accounting Oversight Board (**PCAOB**), and that the statements be prepared in accordance with U.S. Generally Accepted Accounting Principles (**GAAP**). The Custody Rule also requires that the adviser cause the delivery of audited financial statements to investors. We address the concerns with the Proposed Audit Provision that we discussed in our Initial Safeguarding Letter in light of the Private Fund Audit Rule.

A. Allow Qualified Opinions in Limited Circumstances and Provide an Opportunity to Cure Under the Proposed Audit Provision and the Private Fund Audit Rule

Under the current Custody Rule, audited financial statements must be prepared in accordance with GAAP and audited in accordance with U.S. Generally Accepted Auditing Standards (**GAAS**). Financial statements do not meet these requirements if the auditor cannot give an unqualified opinion. Therefore, a fund that delivers to investors financial statements that have received a qualified opinion will have failed to deliver required audited financial statements under the Custody Rule, even where the qualification is unrelated to the verification of assets or has been cured.

If an adviser is unable to obtain an audit in accordance with GAAP, or the financial statements have received a qualified opinion, then the adviser may be in violation not only of the current Custody Rule (and the Proposed Audit Provision) but also the Private Fund Audit Rule. In our Initial Safeguarding Letter, we recommended specifying that a qualified opinion from the independent public accountant will not impact an adviser's ability to rely on the "audit approach" under the proposed safeguarding rule[7] where the qualification is unrelated to the verification of assets, or where the qualification is cured within a reasonable period. Because the Commission has eliminated the surprise examination option for private funds in the Private Fund Audit Rule,[8] an issue with a qualified opinion takes on even more importance because there would be no alternative way to satisfy the proposed safeguarding rule.

We urge the Commission to limit the negative impacts of this change by specifying in the final safeguarding rule or clarifying in the adopting release that, notwithstanding the Private Fund Audit Rule, an issue with GAAP or a qualified opinion from the independent public

[7] The audit approach under the current Custody Rule and the proposed safeguarding rule allows an adviser with custody over pooled investment vehicle clients (expanded to "entities" in the proposed safeguarding rule) to elect an audit in lieu of the required surprise examination.

[8] Under the Private Fund Audit Rule, advisers will need to obtain an audit even where it may be more appropriate to opt for a surprise examination instead. For example, a surprise examination may be more cost effective if a fund is planning to liquidate but continues to hold cash and government securities to pay for expenses or as a reserve against contingent liabilities. The surprise examination approach also may be preferable where the adviser to smaller pooled investment vehicles already engages an accountant for a surprise examination of other accounts for which it has custody. We discuss the surprise examination further below.

accountant will not impact an adviser's ability to rely on the Proposed Audit Provision where the qualification is unrelated to the verification of assets.

In addition, if an adviser works in good faith to address a qualified opinion, and the qualification is ultimately cured within a reasonable time[9] after the deadline to distribute audited financial statements, we strongly recommend that the adviser be deemed not to have violated the audit provision.

B. Eliminate Liquidating Audits in Certain Circumstances

Under the current Custody Rule and the Proposed Audit Provision, an adviser is required to have an audit performed promptly upon liquidation and distribute its audited financial statements prepared in accordance with GAAP to all investors promptly after the completion of such audit.[10] As we noted in our Initial Safeguarding Letter, liquidations typically occur when few assets remain in the fund. Liquidation audits are thus very expensive relative to the limited amount and value of assets left in the fund. These audits harm the fund investors by reducing the remaining fund assets for little to no benefit, especially for smaller funds or funds with small, illiquid investments. Sometimes, all that is left in the fund at the time it liquidates is a reserve for the auditing costs, but an audit is nonetheless required.

In light of the Private Fund Audit Rule, we are reiterating our recommendation to eliminate the expensive and, in our view, unnecessary requirement for liquidating audits in certain circumstances under the safeguarding rule, and therefore under the Private Fund Audit Rule.[11] We recommend providing an exception from the liquidating audit requirement in the final

[9] We believe that up to thirty (30) days after the deadline would be a reasonable amount of time for an adviser to cure.

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

[11] For example, sometimes a private fund will liquidate and not make any new investments but will stay open and hold a worthless security in order to collect the proceeds of a class action settlement. In most cases, the asset is likely to be very illiquid and therefore has an even lower risk of being misappropriated.

safeguarding rule or in the adopting release when any of the following alternative approaches are taken:

(i) *De minimis threshold.* The elimination could be conditioned on a *de minimis* threshold (*e.g.*, the value of the fund as of the last annual audit is lower than the cost of the liquidating audit or the liquidating audit costs exceed 10 percent of the remaining value of the fund), and the adviser maintains records of the cost analysis during the period of the liquidation. Adopting a *de minimis* threshold is our preferred approach as it would ensure that the amount of remaining assets is immaterial and that the costs of performing the liquidating audit would exceed the value of the fund's assets and harm rather than benefit the fund shareholders.

(ii) *Specified liquidation period.* Alternatively, to alleviate concerns about a prolonged unaudited period, a liquidating audit could be required if the unaudited period exceeds a specified time period. In the meantime, unaudited financial statements could be delivered to the remaining fund investors on an annual basis from the time that the fund meets the *de minimis* threshold until liquidation.

(iii) *Allow surprise examination.* Another alternative is to retain the surprise examination option for liquidating funds to provide fund investors with appropriate asset verification of fund assets while preserving the value of the fund's remaining assets.

C. Permit Sampling for Asset Verification

Under the Safeguarding Proposal, any purchase, sale, or other transfer of beneficial ownership of any privately offered securities or physical assets that are unable to be maintained with a qualified custodian must be promptly verified by an independent public accountant pursuant to paragraph (b)(2) of the proposed rule. In addition, each such asset must be verified during the annual independent verification conducted pursuant to paragraph (a)(4) of the proposed rule (*i.e.*, the surprise examination) or as part of a financial statement audit performed pursuant to paragraph (b)(4) of the proposed rule. The proposed rule would not allow a sampling method for any of these accountant verifications, which is current market practice for both surprise examinations and annual audits.[12]

Instead of requiring 100% asset verification for all client assets not maintained with a qualified custodian, we believe that the Commission's safeguarding goals can be achieved by continuing to permit the longstanding practice of sampling for surprise examinations and audits, and permitting sampling for asset verification, should the Commission retain that requirement despite our strong opposition. According to the Commission's guidance to independent public accountants on the independent verification and internal control report, "For a *sample* of client accounts, the accountant should obtain records of the purchases, sales, contributions,

[12] *See* proposed rule 223-1(b)(2)(v).

withdrawals and any other debits or credits to each selected client's account occurring since the date of the last examination."[13] (emphasis added)

The Commission expresses its concern in the Safeguarding Proposal that assets that cannot be maintained with a qualified custodian "may not be included in the sample of assets subject to verification procedures during a surprise examination or meet the materiality threshold for verification during a financial statement audit."[14] However, we understand that sampling is an accepted standard from an accounting and GAAS perspective and we believe that sampling is the more reasonable and practical approach for all types of accountant verifications. The Commission could condition sampling on the independent public accountant's conducting a risk assessment in order to select the sample.

D. Retain the Surprise Examination Approach as an Alternative to the Audit Approach and Permit a Non-Control Adviser to Take Reasonable Steps to Cause an Audit Where the Audit Approach is Elected

For the reasons expressed above, we believe that the Commission should retain surprise examinations as an alternative approach to the audit approach for all relevant asset classes where the adviser determines that a surprise examination would be preferable, for example when it would be more cost effective or where the adviser to smaller funds already arranges to have a surprise examination of other accounts. We recommend that the Commission reconsider the Private Fund Audit Rule in this regard.

We support the exception adopted by the Commission in the Private Fund Audit Rule "for funds and advisers not in a control relationship. Specifically, for a fund that the adviser does not control and that is neither controlled by nor under common control with the adviser (*e.g.*, an adviser to a fund of funds may select an unaffiliated sub-adviser to implement a portion of the underlying investment strategy), the adviser only needs to take all reasonable steps to cause the fund to undergo an audit that meets these elements."[15]

We agree that some advisers may not have requisite control over a private fund to cause its financial statements to undergo an audit. For similar reasons, we ask that the Commission apply this exception to surprise examinations and audits relating to all asset classes that may rely on the surprise examination approach or the audit approach under the safeguarding rule. For a fund or entity that the adviser does not control and that is neither controlled by nor under common control with the adviser, we recommend that the Commission confirm that the adviser only needs to take all reasonable steps to cause the fund or entity to undergo a surprise examination or audit. For the same reasons, we recommend that the Commission extend this

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[13] *See Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*, 75 Fed. Reg. 1492 (Jan. 11, 2010) (**Auditor Guidance**), available at https://www.govinfo.gov/content/pkg/FR-2010-01-11/pdf/2010-19.pdf.

[14] Safeguarding Proposal at 14705.

[15] Private Fund Audit Rule adopting release at 63250-63251.

exception to the prompt asset verification as well, should the Commission retain that requirement.

E. Clarify that a U.S. GAAS Opinion is not Required for Certain Non-U.S. Entity Financial Statements

In our Initial Safeguarding Letter, we supported codifying current staff guidance permitting the use of financial statements for non-U.S. entities that are not prepared in accordance with U.S. GAAP, provided that with respect to pooled vehicle audits, they: (i) contain information substantially similar to statements prepared in accordance with U.S. GAAP; (ii) material differences with U.S. GAAP are reconciled; and (iii) the reconciliation is distributed to U.S. clients along with the financial statements.

We further recommend in these Supplemental Comments that the Commission clarify in the final safeguarding rule's adopting release that, with respect to non-U.S. advisers to non-U.S. entities with a U.S. sub-adviser, a U.S. GAAS opinion is not required if the entity does not have U.S. investors. Preparing these financial statements in accordance with U.S. GAAS would not provide value to the non-U.S. investors but would be burdensome and costly for the fund.[16] Further, the U.S. sub-adviser would generally only provide investment advice to the adviser and play little to no part in the coordination with the PCAOB-supervised independent public accountant to secure the U.S. GAAS opinion. Finally, it would also risk delays in providing the non-U.S. GAAS audited financial statements opinion to non-U.S. investors due to translation and other coordination issues. We believe that the distribution of an entity's audited financial statements in accordance with an applicable local accounting standard (*e.g.*, the International Standards on Auditing) within 120 days is appropriately and sufficiently protective of non-U.S. investors.

F. Do Not Require Written Agreements with Auditors Regarding Audit-Related Notifications

The proposed rule would require an adviser to enter into a written agreement with the independent public accountant performing the audit requiring the accountant to notify the Commission (i) within one business day upon issuing an audit report to the entity that contains a modified opinion and (ii) within four business days of resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed.[17]

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[16] The fund's governing documents would generally permit this type of regulatory obligation to be charged to the fund.

[17] *See* proposed rule 223-1(b)(2). The Commission considered but did not adopt the notification requirement as part of the Private Fund Audit Rule. The one business day notice is the same as the notification requirement for material discrepancies found during a surprise examination under the Custody Rule.

As we stated in our Initial Safeguarding Letter, we do not object to a requirement that an independent public accountant performing an annual audit provide these notifications to the Commission. However, we believe that mandating this written agreement with advisers would impose unnecessary burdens on advisers and is unnecessary; indeed, overkill. We also do not believe that it is appropriate for the Commission to require a contract between an adviser and an independent public accountant for an audit because the audited entity – not the adviser – typically is a party to an audit engagement agreement and has an independent relationship with the independent public accountant. This is an important distinction from a surprise examination, in which an adviser is a party to an engagement agreement with an independent public accountant to satisfy the adviser's obligations under the Custody Rule.

The Commission has already imposed well-established obligations for advisers and accountants though the current Custody Rule and the Auditor Guidance in connection with the current surprise examination requirements. The Commission should continue to adopt such Auditor Guidance in connection with any new or revised safeguarding or custody rule to explain the obligations of both parties rather than impose a prescriptive requirement to engage in a separate written agreement under the rule.

We understand that there may be situations in which an adviser is already a party to an audit engagement letter with an independent public accountant. Should the Commission determine to require a written agreement between an adviser and an independent public accountant with respect to audit-related notifications notwithstanding our recommendation to the contrary, we ask that the Commission clarify in the safeguarding rule's adopting release that, where an adviser is already a party to an audit engagement letter, the new required language may be incorporated into the existing engagement letter.

G. Preserve Relief for Loan Syndicate Account Statements

In connection with the new safeguarding rule, the staff in the Division of Investment Management is reviewing certain of its no-action letters and other staff statements addressing the application of the Custody Rule to determine whether any such letters, statements, or portions thereof, should be withdrawn in connection with any adoption of the Safeguarding Proposal. For example, in 2018, the Commission staff issued a no-action letter under which an adviser that acts as administrative agent for a loan syndicate that is comprised, at least in part, of its advisory clients, can commingle advisory clients' loan syndication holdings in an agency account with third-party assets.[18] We understand that the staff is reviewing the Madison Capital no-action letter in light of the Safeguarding Proposal's asset segregation requirements. If the staff determines to withdraw the letter, we ask that the Commission retain the no-action letter's relief from the requirement that the custodian of the agency account send loan syndicate account statements at least quarterly in accordance with subparagraph (a)(3) of the Custody Rule to

[18] *Madison Capital Funding LLC*, SEC Staff No-Action Letter (Dec. 20, 2018), available at https://www.sec.gov/investment/madison-capital-funding-122018-206-4. The letter is subject to 11 conditions. The letter specifically states that third parties may rely on the letter to the extent their circumstances are similar.

advisory clients that do not qualify for the exception under subparagraph (a)(4) of the Custody Rule. This relief is relied upon by certain advisers such as managers of private credit strategies to fulfill their loan servicing responsibilities and should be retained in any new safeguarding rule.

H. Exclude All Assets Subject to CFTC Jurisdiction

In our Initial Safeguarding Letter, we stated that we believe that the existing CFTC/NFA customer safeguarding regime is entirely sufficient to protect advisory clients' assets, namely futures and cleared swaps, that are subject to CFTC jurisdiction. With respect to such advisory client investments, we are clarifying our initial recommendation to request that the Commission entirely exclude all CFTC-regulated assets (*e.g.*, derivatives, including futures and swaps), whether cleared or uncleared, from the definition of "assets" under the proposed safeguarding rule, as they currently are under the Custody Rule. The Commission should recognize the existing regulatory regime that applies to these instruments and should not move forward until analyzing the duplication, overlap, or conflict between the proposed safeguarding framework and the CFTC custodial framework that currently protects investors' assets.

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

Respectfully,

/s/ Gail C. Bernstein

Gail C. Bernstein
General Counsel

/s/ Laura L. Grossman

Laura L. Grossman
Associate General Counsel

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