ROPES & GRAY LLP
PRUDENTIAL TOWER
800 BOYLSTON STREET
BOSTON, MA 02199-3600
WWW.ROPESGRAY.COM

May 8, 2023

VIA ELECTRONIC FILING

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

Re: Request for Comment on Proposed Rule on Safeguarding Advisory Client Assets; Rel. No. IA-6240; File No. S7-04-23

Dear Ms. Countryman:

Ropes & Gray LLP appreciates the opportunity to provide these comments to the Securities and Exchange Commission (the "Commission") on the above-referenced matter(s). Our firm represents hundreds of asset management firms that are registered with the Commission as investment advisers, including those that advise private equity, credit, real estate, and hedge funds, across a wide range of industries and asset classes, certain of which are also investors in other private funds.

The proposed reforms set forth in the Commission's release titled Safeguarding Advisory Client Assets, Release No. IA-6240 (Feb. 15, 2023) (the "Proposed Rule"),[1] published February 15, 2023, would revise and redesignate the Commission's current rule titled Custody of Funds or Securities of Clients by Investment Advisers, 17 C.F.R. § 275.206(4)-2 (the "Custody Rule").[2] The Proposed Rule would apply directly to most of our investment adviser clients, which would be subject to such a final rule if it were to be enacted as proposed. Given this fact, we write to provide our views on aspects of the Proposed Rule, as practitioners with many years of experience in providing legal counsel to these clients. The comments and opinions expressed herein are not intended to represent individual clients' views but rather Ropes & Gray's perspective complemented by the broad input from our clients.

---

1 Safeguarding Advisory Client Assets, Release No. IA-6240 (Feb. 15, 2023), https://www.sec.gov/rules/proposed/2023/ia-6240.pdf. (hereinafter, "Safeguarding Rule Release").

2 Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. IA-2176, 68 Fed. Reg. 56,692 (Sept. 25, 2003), https://www.sec.gov/rules/final/ia-2176.htm.

The Proposed Rule, if enacted, would represent the first changes to the Custody Rule since the adoption of its 2009 amendments.[3] These changes are significant and would lead to serious repercussions for the investment advisory, custodial, and accounting industries. The Proposed Rule's requirements would fundamentally disrupt a range of transactions and cause a number of parties to incur significant costs that the Commission does not account for in its economic analysis.

In addition to these overarching issues with the Proposed Rule, we believe that certain portions of the Proposed Rule should be revised to ensure that the Commission's goals are best accomplished and that costs and disruptions to existing practices, which have served clients of registered investment advisers well, are minimized. We discuss these concerns throughout the remainder of this letter.

1. The Commission Should Remove the "Possession or Control" Requirement

The Commission should not institute the "possession and control" requirement, as it would cause significant issues, if not impossibilities, for a range of assets that are not publicly traded. The Commission, in implementing this requirement, would be asking advisers to completely uproot the ways in which they currently maintain and protect these types of assets for the benefit of their clients – while the Commission has cited (and we know of) no instance in which those current processes have proven to be inappropriate or insufficient to protect such client assets.

The Proposed Rule would allow institutions to serve as qualified custodians only if they have "possession or control" of client assets pursuant to a written agreement between the qualified custodian and the adviser.[4] This requirement would effectively prohibit advisers with custody over client assets for purposes of the Proposed Rule from investing in a broad range of assets, including loans, privately offered securities,[5] and derivatives,[6] or alternatively would impose substantial new costs on advisers and/or their clients in connection with investing in such assets. The industry and investors would be disadvantaged by this change.

Specifically, many assets are currently evidenced by agreements between parties other than qualified custodians, such as partnership or limited liability company agreements, subscription documents, loan documents, swap contracts, and International Swaps and Derivatives Association agreements. There is no reasonable way for custodians to insert themselves into such arrangements in a manner that

---

[3] Custody of Funds or Securities of Clients by Investment Advisers, SEC Release No. IA-2968 (Dec. 30, 2009), https://www.sec.gov/rules/final/2009/ia-2968.pdf.
[4] Proposed Rule 223-1(a)(1).
[5] Of note, a significant number of privately offered securities, as they are considered in the industry, will not technically meet the requirements of the "privately offered securities" exception under the Proposed Rule (primarily because they can be transferred without the consent of the issuer or its shareholders). As such, simply relying on that exception in the interest of maintaining the possession and control requirement would not sufficiently address the issues we discuss herein.
[6] For a fuller discussion of derivatives, please see our firm's companion letter for commentary regarding aspects of the Proposed Rule that would impact derivatives and commodities assets. *See* Comment Letter of Leigh Fraser of Ropes & Gray LLP (May 8, 2023).

would result in such custodians having "possession or control" of such assets within the meaning of the Proposed Rule, nor can we imagine a willingness on custodians' part to do so. Qualified custodians cannot in any material way maintain actual possession or control over these assets consistent with the Proposed Rule, because they would not have the right to control the transfer of the assets underlying those agreements even if they held instruments memorializing such assets. For example, when a private equity fund acquires a portfolio company, it typically does so through various structuring vehicles, often becoming a member of a limited liability company or a limited partner in a partnership (among other things). The ownership of these interests is reflected by the governing documents of the applicable entity, such as a limited liability company agreement or a partnership agreement, as well as on the books and records of the issuer itself. The governing documents themselves do not give a holder "legal standing" (for instance, merely possessing a limited liability company agreement does not make the holder of such document a "member" of the limited liability company). These instruments are merely indicative of the arrangement and governance of the members and the company.

In order for custodians to actually have "possession and control" of these assets, the way in which such assets are owned and transferred would have to change entirely. Even if it were possible to consider what the Commission is proposing – a proposition that would require the industry and its custodians to completely rework their prior processes that have functioned well to date – it is not practical do so. A custodian would need to become a signatory to a portfolio company merger agreement with rights regarding the transfer of assets in order to obtain "possession and control." Even if a counterparty and/or custodian would agree to such terms, it introduces complexities that would result in significant inefficiencies that would harm investors. Alternatively, while an adviser potentially could introduce custodians into such arrangements by providing custodians the legal rights to such assets through, for example, bearer instruments (e.g., stock certificates). Assuming the relevant company would even agree to issue such a security, such a change to a bearer instrument would lead to significantly more risk to investors than the theoretical risk of adviser personnel absconding with clients' assets that the Proposed Rule seeks to reduce, as well as introducing many operational inefficiencies.

This alternative would be detrimental to investors and the industry. Unlike an agreement between two parties with an underlying interest in such assets (and not to mention, in the adviser's case, a fiduciary duty to protect them), bearer instruments by their nature lend themselves to misappropriation or loss, as possession is all that is required to be entitled to the assets evidenced by that agreement. This is not the case with the agreements described above, as being in possession of one of these agreements does not entitle any individual or entity to any of the assets thereunder.

In our experience, custodial involvement with bearer-like instruments have also tended to increase the difficulty of transacting. For example, an adviser client of ours was unable to hold a closing on a weekend, as a private share certificate was required to be transferred to give effect to the transaction, and the custodian could not retrieve the necessary certificate in time given the custodian's operating

hours. Additionally, the pledging of portfolio company interests for financing is integral to the operation of the private equity buyout industry. The Proposed Rule would require custodians to be involved in the pledging of these interests by signing and being parties to the agreements underpinning these transactions. The proposed requirements regarding "possession and control" would undercut and hinder a practice that is beneficial to investors (by facilitating efficient financing of portfolio company investments), and standard within the industry.[7]

Despite all of these issues, the Commission cites no instances, and we are unaware of any, in which an adviser or its employees have absconded with these types of client assets. In an attempt to mitigate this theoretical and as-yet-eventuated risk, the Commission proposes to disrupt the way in which many assets are currently custodied and expose them to greater risk of appropriation. Given that this is the case, we would recommend that the Commission not include the "possession or control" requirement in any final rule.

2. <u>The Proposed Rule's Requirements on the Segregation of Client Assets Preclude Certain Market Practices</u>

The Proposed Rule would require that client assets over which an adviser has custody be segregated from the adviser's assets and that an adviser obtain reasonable assurances that a custodian holding client assets will segregate the client's assets from its own. These provisions would necessitate significant changes to certain existing custodial practices, with no clear corresponding benefit. We agree with the Commission's indication that the Proposed Rule should permit advisers to commingle client assets and non-client assets and that the *Madison Capital Funding, Inc.* ("*Madison Capital*") no-action letter should be generally rescinded.[8] However, we would recommend that advisers who may have proprietary capital in loans should still be able to rely on the *Madison Capital* no-action letter for affiliated administrative agents holding loan proceeds (as the account would hold both adviser and client assets).

Additionally, the Commission has requested comments on circumstances in which advisers' services would require them to commingle client assets and non-client assets.[9] We believe that any eventual rule should allow such commingling. For example, the Proposed Rule should allow an adviser to hold a percentage of the proceeds from the sale or merger of a portfolio company owned by one or more private equity funds and other non-clients for a limited period. It may not be practical or even possible for advisers to segregate client assets and non-client assets immediately in this circumstance. The Commission has likewise acknowledged the existence and need for commingling of assets in circumstances such as credit transactions that are structured as loan syndicates. These transactions typically require the commingling of the assets of the syndicate members or participants into a single

[7] Similar issues arise for other non-publicly traded securities mentioned above, including loans and derivatives.
[8] *See* Madison Capital Funding, Inc., SEC No-Action Letter (Dec. 20, 2018).
[9] Safeguarding Rule Release, at 171.

administrative account, often with the adviser's assets as well, if the adviser is participating as a lender.

Another aspect of this portion of the Proposed Rule would require qualified custodians to maintain clients' assets in accounts that are shielded from their creditors. Accordingly, the Proposed Rule would in effect be overriding U.S. banking and bankruptcy laws as financial institutions, by law, may not be able to hold deposits that will not be exposed to their creditors. The Commission does not provide sufficient explanation as to how this requirement of the Proposed Rule would square with the reality of the existing insolvency regime applicable to federally insured banks and savings associations. Under the Proposed Rule, advisory clients would receive priority over other general depositors in the event of a bank's insolvency. In a similar vein, the Commission's proposal that foreign financial institutions would be subject to the same requirement would amount to the superseding of financial regulation in many other countries. We recommend that the Commission reconsider this aspect of the Proposed Rule as well.

3. The Proposed Rule's Requirements for Written Agreements and Reasonable Assurances Are Untenable in Practice, and the Commission Has Not Appropriately Considered the Economic Analysis Related to Them

We request that the Commission decline to enact the requirements related to written agreements with custodians and reasonable assurances. If enacted, advisers will face significant challenges in entering into and revising custody agreements that meet the requirements for written agreements and reasonable assurances. As an initial matter, the Proposed Rule would place investment advisers in the challenging position of requesting that the custodians currently holding client assets cooperate in renegotiating thousands of custodial agreements and complying with providing reasonable assurances while the custodians have no legal obligations to do so, such that the investment advisers will have limited, if any, leverage in their attempts to comply with the requirements. These requirements will disrupt existing custodial arrangements.

The implementation of the written agreements that the Commission describes is not "plug and play." Each of these agreements will be novel, and there will be significant negotiation needed with each custodian. They will require custodians to agree to changes to their standard of liability and level of authority, among other things, and therefore significant negotiation will be necessary. Issues of liability and authority are central to contract negotiations. Given that these are not merely technical amendments, they will take considerable negotiation to incorporate into custodial agreements. In our conversations with our investment adviser clients related to the Proposed Rule, we have learned that it is not uncommon for a single adviser to have clients that use dozens, if not hundreds, of custodians. Advisers with separately managed account ("SMA") clients may face even greater difficulties in negotiating these agreements, as each SMA client will typically have its own custodial relationships.

Therefore, we believe the estimates in the Proposed Rule release of one hour of work from the custodian's assistant general counsel and five hours from a paralegal are wholly unrealistic given the significant changes required. The Commission has estimated that there would be an initial cost to each adviser of $3,152 to draft and finalize these written agreements. For reference, in our experience, the Commission's rule titled Investment Adviser Marketing, 17 C.F.R. § 275 and § 279 (May 4, 2022) (the "Marketing Rule")[10] contains requirements around placement agent agreements that have caused advisers to spend substantial time and tens of thousands of dollars each to negotiate those agreements. Similarly, the Commission's rule titled Custody of Investment Company Assets Outside the United States, 17 C.F.R. § 270,[11] specifically rules 17f-5 and 17f-7 therein, contains a general framework for how advisers and custodians may maintain their assets with a foreign securities depository. Advisers have encountered many difficulties in negotiating actual contractual provisions with custodians to comply with this general framework. The Proposed Rule's specific framework will be even more difficult for advisers to implement. We anticipate that the complexity and breadth of these arrangements will be significantly greater. The estimates that the Commission offers also do not account for the fact that other parties over which the Commission does not have jurisdiction, namely the custodians, will effectively be forced to bear significant costs to assist advisers in complying with such a rule.

Any eventual rule should, at a minimum, provide for the grandfathering of existing agreements, as amending existing custody agreements to be compliant with such a rule would likely lead to situations in which investment advisers struggle to negotiate with custodians, or in certain cases need to find new custodians, even if that is not to the benefit of its clients and investors, where custodians are unwilling to cooperate. A grandfathering provision would at least allow assets that are currently adequately protected by their existing custodial agreements to remain under continuous protection.

A one-year transition period is also unworkable as it will take considerable time for each adviser to negotiate or renegotiate agreements with each of their custodians, particularly given that custodians will be inundated with requests to renegotiate agreements with advisers and their clients, all while having no legal obligation to do so.

Furthermore, the Proposed Rule imposes an improper and untenable obligation for advisers to oversee their custodians. Prescribing requirements that go beyond safeguarding client assets but rather mandate that advisers effectively become compliance overseers of their custodians and accountants is a fundamental change to the dynamics between these parties. There are also practical issues with placing investment advisers in such supervisory roles. History demonstrates that when a custodian fails, it tends to do so rapidly and not necessarily in ways that investment advisers could have anticipated or acted to forestall. Advisers are not well positioned to do the level of diligence that would actually be necessary to ensure that financial institutions do not have compliance issues.

[10] Investor Adviser Marketing, Release No. IA-5653 (Dec. 22, 2020), https://www.sec.gov/rules/final/2020/ia-5653.pdf.

[11] Custody of Investment Company Assets Outside the United States, Release Nos. IC-24424, IS-1221 (Jan. 5, 2000), https://www.sec.gov/rules/final/ic-24424.htm.

Qualified custodians, by definition, are themselves regulated entities. Under the Proposed Rule, registered investment advisers would be forced to assume quasi-regulatory oversight with respect to qualified custodians. This should be a core function of the Commission and other financial regulators.

As with the agreements, the Commission has estimated that the cost to initially comply with this aspect of the Proposed Rule will be $1,970 per custodial agreement and the annual costs of compliance to be only $394 per custodial agreement, which we believe is a vast underestimation. We expect that the costs would be much greater, particularly in light of the breadth of the ongoing beliefs that the Proposed Rule would require advisers to maintain. For instance, advisers would have to maintain an ongoing belief that the custodian is properly safeguarding the custodied assets pursuant to the written agreement. Beyond the operational difficulties of this task, it is costly to either add such an ongoing oversight obligation to an internal compliance team's burden or otherwise engage an outside provider, such as a compliance consultant, to complete the task. For all of these reasons and others, we do not believe that the Commission should enact these requirements or, if it should do so, we believe that it strongly consider revisions to the Proposed Rule to account for the issues described.

4. The Proposed Rule's Surprise Examination Requirement Is Impractical Given Relationships Between Advisers and Their Accountants

We would likewise recommend that the Commission reconsider its proposed revision to the surprise examination requirement. The Proposed Rule would require advisers to maintain a "reasonable belief" that any written agreement between an adviser and its accountant performing a surprise examination mandated by the Proposed Rule is being implemented.[12] This requirement is untenable in the context of how advisers' relationships with accounting firms function. The "reasonable belief" requirement is starkly different from the Custody Rule's surprise examination requirement, which does not expressly require an adviser to have a reasonable belief about the implementation of the written agreement between the adviser and the accountant, even though it mandates a written agreement. Given the relationship between advisers and their accountants, it may not be possible for advisers to look into the daily operations of their accountants to maintain such an ongoing "reasonable belief." If enacted with this requirement, the Proposed Rule should provide a method for how an adviser can demonstrate that it is maintaining a "reasonable belief" that the written agreement between the adviser and its accountant performing the surprise examination is being implemented. For example, advisers should be able to comply with the requirements of maintaining a "reasonable belief" by obtaining a quarterly or annual certification that the accounting firm is in compliance.

[12] Safeguarding Rule Release, at 176.

5. The Privately Offered Securities Exemption Requirements Are Comprehensively Burdensome and Reduce the Exemption's Utility

The Commission should maintain the existing Custody Rule's exception related to privately offered securities. The Proposed Rule would narrow the exception such that advisers could only avail themselves of it if certain conditions are met, including that (1) the adviser reasonably determines and documents in writing that ownership cannot be recorded and maintained in a manner in which a qualified custodian can maintain possession, or control transfers of beneficial ownership of such assets; (2) the adviser reasonably safeguards the assets from loss, theft, misuse, misappropriation, or the adviser's financial reserves, including the adviser's insolvency; (3) an independent public accountant, pursuant to a written agreement between the adviser and the accountant takes certain actions related to verification and notification; (4) the adviser notifies the independent public accountant engaged to perform the verification of any purchase, sale, or other transfer or beneficial ownership of such assets within one business day; and (5) the existence and ownership of each of the client's privately offered securities or physical assets that is not maintained with a qualified custodian are verified during an annual surprise examination or as part of a financial statement audit.[13] The additional requirements imposed by the Proposed Rule will significantly reduce the exemption's utility and create new compliance and operational challenges that are substantially underestimated by the Commission.

Specifically, the Commission has proposed that in order to rely on the exemption, an adviser would be required to make a "reasonable" determination that ownership of the security cannot be recorded and maintained with a qualified custodian.[14] The way that this standard is written, an adviser would not be able to rely on the exception unless the adviser concludes that it is impossible to establish possession and control of a given asset with a qualified custodian. In the case of privately offered (and negotiated) securities, an adviser "could" always, in theory, negotiate terms that would give a qualified custodian possession and control of the asset. However, such agreement would potentially be at great expense, and that would have minimal or even negative impact on the safety of client assets, for the reasons set forth elsewhere in this letter.

The Proposed Rule would also require advisers relying on the exemption to have each transaction promptly "verified" by an independent public accountant, which must then notify the Commission of any material discrepancy.[15] This verification requirement would occupy significant compliance resources, specifically to keep track of accountant notifications within one day of transfer. Similarly, the requirement that each privately offered security not maintained with a qualified custodian be verified as part of a surprise examination or audit is unduly costly and burdensome. The increased demand on the services of independent public accountants from having to perform time-sensitive

---

[13] Safeguarding Rule Release, at 132-33.

[14] Proposed Rule 223-1(b)(2)(i).

[15] Safeguarding Rule Release, at 142.

verifications over a larger universe of assets is likely to result in potential delays causing advisers to be unable to comply with the requirements and significantly increased costs for their services. These verification services are likely to be offered at a prohibitive cost, if made available by accounting firms.

Moreover, we recommend that the Commission should not limit the availability of the exception to securities that are uncertificated. In August 2013, the Commission issued guidance that effectively eliminated the requirement that the securities be uncertificated.[16] In doing so, the Commission accepted the argument that instruments evidencing ownership of non-transferrable interests in privately issued securities present no custodial risks because the clients' "ownership interest in the security is not impacted by the existence (or lack thereof) of the certificate." We urge the Commission to codify that position for the reasons set forth in the guidance.

Given the foregoing and as noted above with respect to the "possession or control" requirement, the Commission is imposing considerable costs and burdens on advisers with the hopes of mitigating a theoretical risk of misappropriation or loss of privately offered securities. In our experience, there are few custodial risks associated with privately offered securities. These assets bear almost no risk of being lost or stolen (as noted above, the Commission cites to no instances of this occurring under the current Custody Rule), yet the advisers to those funds would have to incur significant time and expense to meet new and burdensome requirements.

6. The Proposed Rule's Audit Requirements Are Not Necessary and Are Duplicative for SPVs

The audit provision modifications under the Proposed Rule would disrupt current market practices that have evolved in response to previous Commission guidance related to the use of special purpose vehicles ("SPVs") in effecting various transactions, as well as cause operational challenges that would increase costs that are likely to ultimately be borne by fund investors. If the new rule were adopted as proposed, the Commission would require any SPV through which a client (e.g., a private fund) and one or more unaffiliated investors invest (for instance, institutional co-investors, rollover shareholders, company management, etc.) to be treated as a separate client of the adviser and therefore to be separately audited.

Previously, the SEC guidance titled Private Funds and the Application of the Custody Rule to Special Purpose Vehicle and Escrows, Division of Investment Management Guidance Update No. 2014-07 (June 2014)[17] contemplated that advisers could, based on the relevant facts and circumstances, reasonably make a determination that certain SPVs established through which a fund made an investment were not separate clients of the adviser and were therefore outside the scope of the

[16] *Privately Offered Securities under the Investment Advisers Act Custody Rule*, IM Guidance Update (Aug. 2013).
[17] *Private Funds and the Application of the Custody Rule to Special Purpose Vehicle and Escrows*, IM Guidance Update (June 2014).

Custody Rule. In our experience, advisers have heavily relied on this guidance in determining that SPVs held by a fund are not required to be separately audited.

The change in approach contemplated by the Proposed Rule and proposing release would be particularly problematic (both financially and logistically) for certain advisers that establish hundreds of SPVs in connection with various transactions that would, under the terms of a new rule enacted as proposed, have to be treated as separate clients (and therefore have to be separately audited when unaffiliated third parties invested). Where a fund invests through one of the SPVs, the cost of an SPV audit would be indirectly borne by the fund limited partners. That SPV is already within the scope of the applicable fund's audit. In the event that a fund made each investment through a different SPV, some of which have third-party investors in them, this could result in significant duplicative audit costs without any incremental benefit to such fund investors. These additional audits would largely be protecting institutional co-investors and portfolio company management at the expense of fund investors, as the cost of the SPV audit is an appropriate SPV expense, borne indirectly (at least in part) by fund investors. In effect, fund investors would bear multiple levels of audit fees to audit an SPV twice in order to protect these third party co-investors. Such protection for co-investors or portfolio company management would be incremental at best, as auditors are likely to discover any potential issues with the SPV in their audit of the fund itself.

In our experience, in representing both fund managers and investors, third parties that invest through an SPV do not typically request or negotiate for separate SPV audits in connection with co-investments. Many times, these investors include portfolio company management personnel, who are inherently intimately familiar with the transaction at hand as well as the financial health and stability of the relevant company, and, as such, would see minimal, if any, benefit from receiving audited financial statements from such SPVs. Even where co-investors are third parties, such third parties typically recognize that their interests are effectively protected by virtue of annual fund audits, in conjunction with financial reporting to which such co-investors are entitled.

7. We Would Generally Support a Final Rule That Provides Extensions for Audits at the Beginning and End of Fund Life

Moreover, we would support a modification of the Proposed Rule to allow newly formed entities to perform an audit less frequently than annually, with an audit period of 15 months[18] permitted for the initial fund audit. Otherwise, limited partners would pay for an additional audit covering a stub period during which there is often little activity, when the relevant stub period will eventually be subject to an audit in any event. Similarly, auditing liquidating entities with the frequency currently required by the Proposed Rule risks having a substantial portion of those assets be consumed by those very same audits. Given the foregoing, we would recommend a modification of the Proposed Rule that permits these liquidating entities to have an audit period of 24 months. Moreover, the Proposed Rule should

[18] Safeguarding Rule Release, at 181.

permit an adviser to comply with a longer audit period upon liquidation if the adviser determines that the cost of the audit is unreasonable in light of the remaining assets.[19]

8. Notification of Modified Opinions Is Unnecessary

Furthermore, the requirement that the auditor inform the Commission upon the occurrence of a modified opinion would create operational burdens for advisers. A modified opinion may often be totally unrelated to any practical custody risk, but the Commission would likely follow up and investigate nonetheless and would therefore require additional time and/or other resources of both the Commission and the adviser. We would suggest that the Commission reconsider the addition of this requirement.

***

Again, we thank you for the opportunity to provide these comments. If you have any questions regarding our comments, please feel free to contact Jason Brown at jebrown@ropesgray.com or Joel A. Wattenbarger at joel.wattenbarger@ropesgray.com.

Ropes & Gray LLP

Ropes & Gray LLP

[19] Some advisers will have funds with minimal remaining assets that stay open for many years (e.g., because they hold an illiquid asset that cannot easily be sold) where an audit, even every 24 months, would consume most or all of the remaining assets.