May 8, 2023

VIA SEC COMMENT SUBMISSION PORTAL

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

Re: ***Safeguarding Advisory Client Assets (File Number S7-04-23)***

Dear Ms. Countryman:

The National Society of Compliance Professionals ("NSCP")[1] submits this letter in response to the United States Securities and Exchange Commission's (the "Commission") request for comments on the proposed amendments and redesign of rule 206(4)-2 under the Investment Advisers Act of 1940 relating to how investment advisers safeguard client assets (the "Proposed Amendments"). Our members have a wide array of responsibilities at registered investment advisers, so we have direct insight into compliance implications of new and redesigned SEC rules from varying perspectives. Consequently, the NSCP is well positioned to comment on the Proposed Amendments, and through a working group, has sought the views of both its members who are compliance professionals with investment advisers, and members who are associated with service providers to investment advisers.

While the NSCP strongly supports the Commission's efforts to protect investors, we nevertheless have significant concerns about the practical manner in which certain elements of the Proposed Amendments could be implemented. These concerns include linguistic ambiguity and lack of clarity in the Proposed Amendments, the imposition of obligations beyond the scope of general compliance functions, and potential regulatory overlap. Our views, comments, and suggested modifications on the Proposed Amendments are discussed below.

1. **Certain elements of the Proposed Amendments are overly broad in scope and impractical to implement without modification or further clarification.**

   The Proposed Amendments seek to "extend the rule's coverage beyond client 'funds and securities' to client 'assets' so as to include additional investments held in a client's account." We are concerned that this extension of scope to include assets that have not been traditionally custodied will create significant

[1] NSCP is a nonprofit, membership organization with approximately 2,000 members and is dedicated to serving and supporting the compliance professional in the financial services industry in both the U.S. and Canada. To our knowledge, NSCP is the largest organization of securities industry professionals in the United States and Canada devoted exclusively to compliance. In light of NSCP's focus on compliance and compliance professionals, our comments will be limited to concerns that impact compliance programs and/or compliance professionals.

implementation challenges for compliance professionals. The Proposed Amendments greatly expand the scope of the kinds of assets subject to the custody rule, but do not include a commensurate expansion of the types of qualified custodians, or alternative methods of custodying the wide variety of assets advisers' clients are invested in. With respect to assets that advisers have not historically been required to be held at a qualified custodian, (e.g., agreement-based assets, collectibles, and real estate), we believe it may be difficult for compliance professionals to implement or oversee these elements of the Proposed Rule without the risk of not doing "enough" to satisfy the Commission's expectation or doing "too much" and incurring unnecessary expenditures.

More specifically, although the Proposed Amendments extend the types of investments subject to custody-related requirements, the Proposing Release acknowledges [at page 127] that certain physical assets and certain privately offered securities may not be able to be maintained with a qualified custodian. The Proposed Amendments include a potential exception to Section (a) when an adviser has custody of physical assets or privately offered securities, provided several conditions are satisfied. If adopted as written, the Proposed Amendments may require judgment about principals that are generally outside core compliance functions.

A. *Determinations called for in the Proposed Amendments would be easily second guessed without additional clarifications.*

i. The Proposed Rule does not require client assets that are privately offered securities or physical assets to be custodied with qualified custodians or comply with the other elements of Section (a) if, among other things, the adviser "reasonably determine[s] and document[s] in writing, that ownership cannot be recorded and maintained (book-entry, digital, or otherwise) in a manner in which a qualified custodian can maintain possession or control of such assets."

   The Proposing Release acknowledges [at page 128] that "the current market for custodial services of privately offered securities is fairly thin." It also expresses the Commission's understanding that "although some custodians will custody these securities by holding them in nominee form, many do not custody them." From this we understand that today an adviser could reasonably determine that ownership of such securities cannot be recorded and maintained in which a qualified custodian can maintain possession or control of such assets.

   Recommendation: To address uncertainty about whether market changes are sufficient to require a different determination in the future, we suggest that the Section (b)(2)(i) of the Proposed Rule be deemed as satisfied by a determination that such custodial services are not generally available on reasonable terms.

ii. The Proposed Rule requires an adviser to make various determinations about custodial practices. In particular, Section (a)(1)(ii)(A) would require that an adviser form a reasonable belief that the qualified custodian "will exercise due care in accordance with reasonable commercial standards in discharging its duty as custodian and will implement appropriate measures to safeguard client assets against theft, misuse, misappropriation or other similar types of loss." Similarly, the adviser would be required by Sections (a)(1)(ii)(D) to form a reasonable belief that the qualified custodian "will clearly identify the client's assets as such, hold them in a custodial account, and will segregate all client assets from the qualified custodian's proprietary assets and liabilities."

Determinations about "reasonable commercial standards" of custodians, "appropriate measures" for a custodian to safeguard assets, and effective "identification" and "segregation" of client assets, are not matters generally within the knowledge and experience of adviser personnel, including CCOs.

Recommendation: We suggest that the Proposed Rule be modified to provide that representations from a qualified custodian of compliance with the elements of Section (a)(1)(ii)(A) – (E) constitutes the requisite" reasonable assurance" unless the adviser has actual knowledge that a material element of the representation is not true.

B. Selection of the qualified custodian by the client.

The Proposed Amendments appear to assume that the adviser (and not the client) has full control over the selection of the qualified custodian, which is not always the case. Certain assets require special care and a level of expert knowledge that could be outside the expertise of a compliance professional (e.g., proper safeguarding and storage of art or fine wine) and the client may be better positioned to select a qualified custodian for the asset.

Recommendation: We suggest that the Proposed Rule be modified to include an exception for instances in which the qualified custodian is identified by the client.

Absent modification or clarifying, actionable instructions or standards from the Commission, we believe that application of the Proposed Rule's requirement that an adviser make certain determinations with respect to custodying certain assets would be difficult, uncertain, and sometimes impractical for compliance professionals to implement.

2. Elements of the Proposed Amendments that are linguistically ambiguous and suggested modifications to the proposed definition of custody.

The proposed definition of custody includes "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". With respect to discretionary authority, we are concerned that the language defining custody is being interpreted differently by investment advisory firms and compliance professionals.

Within our working group and reflected in public commentary letters, the terminology *"withdraw or transfer beneficial ownership"* resulted in varying interpretations, by compliance professionals, as to when discretionary authority would trigger application of the proposed safeguarding rule. Some compliance professionals believe the safeguarding rule would be triggered by general discretionary authority, not including limited trading discretion; and some compliance professionals believe the safeguarding rule would be triggered by any discretionary authority, including limited trading discretion.

Notwithstanding the difference in interpretation as to when discretionary authority would trigger the proposed safeguarding rule, we believe that the proposed definition of custody should not include discretionary trading arrangements where the adviser's authority is limited to the purchase and sale of securities or other asset classes within a client's account(s). We believe that the proposal should generally

retain the current practice, as shaped by years of Commission examinations, which treats a client account held at a qualified custodian in which an adviser has discretionary trading authority only as not giving rise to custody over client assets.

Furthermore, the Proposal Release and Fact Sheet contain minimal information with respect to investment advisory fee deduction arrangements. We are concerned that the proposed definition of custody may subject investment advisory fee deduction arrangements to application of the safeguarding rule. Fee deduction arrangements are a standard industry practice, governed by a written agreement, and we believe that this practice should not be included in the proposed definition of custody. Alternatively, the exemption for fee deduction could be expanded to include not only the verification requirement, but also the written agreement and reasonable assumption requirements.

Moreover, we are concerned that pooled employer-sponsored retirement plans such as 401k plans, would be subject to the safeguarding rule by either the discretion or fee deduction elements of the proposal, which may be an unintentional consequence. 401k plans have a custodian, recordkeeper, third-party administrator and other service providers such as an auditor for plans with 100+ participants. Given the safeguards already in place for 401k plans, these pooled employer-sponsored retirement plans should not be subject to the Proposed Amendments as it would put firms and compliance programs in a position to comply with a rule that does not work for 401k plans.

Recommendation: While we appreciate that the Proposed Amendments allow for an exception from the surprise examination requirement for discretionary trading authority and fee deduction, we urge the Commission to modify the proposed definition of custody to explicitly exclude discretionary trading authority and fee deduction.

3. Elements of the Proposed Amendments that establish obligations beyond general compliance functions and suggested modifications to the internal control report requirement.

The Proposed Amendments include a requirement that the qualified custodian will obtain and provide a written internal control report to the investment adviser. If the amendment is adopted as proposed, on an annual basis, we believe this element could result in firm or regulatory expectations that the firm's compliance staff review and approve the sufficiency of such reports, thereby creating an additional compliance responsibility. Compliance professionals are likely to be given the difficult task of obtaining and evaluating the internal control reports for all the adviser's qualified custodians, or at a minimum, compliance professionals may be held responsible for the annual assessment of adequacy and enforcement of related policies and procedures.

The Proposal Release states [at page 100] "Consistent with an adviser's fiduciary duty, an adviser should review the report for control exceptions and take appropriate action where necessary." We are concerned that a rigorous review of the internal control reports may require access to confidential information and a detailed understanding of the internal operations of qualified custodians, which may place unrealistic expectations and burdens on compliance professionals. This element could raise the unwarranted expectation that the investment adviser or compliance professional analyze the report and act on that analysis, however, the individual may not have the expertise to effectively analyze the report. Additionally, other than switching custodians, which is expensive and disruptive for clients, the individual will not have authority or control over the qualified custodian.

Furthermore, although the Proposed Rule does allow for some flexibility in the type of internal control report provided, we are concerned that successful implementation by a compliance professional is dependent on the qualified custodian's ability and willingness to satisfy the requirements and objectives of the rule. The Proposal Release acknowledges [at page 101] "that not all qualified custodians obtain internal control reports". Footnote 195 of the Proposal Release illustrates the dependency on the qualified custodian to obtain and provide an internal control report that sufficiently satisfies the required objectives. Generally, footnote 195 states that a SOC 1 Type 2 Report "would be sufficient to satisfy the requirements of the internal control report", but a SOC 1 Type 1 Report, "would not satisfy the requirements of the internal control report because it does not test operation effectiveness of the controls." This example highlights the reliance that investment advisers would have to place on the qualified custodian to obtain and provide an internal control report that would be deemed acceptable by the Commission. Additionally, qualified custodians may be inundated with requests from numerous individual compliance professionals all seeking to obtain the same internal control report, which could delay delivery of the report by the qualified custodian.

Moreover, we believe that weaknesses in internal control reports would be better addressed by the appropriate regulator of the qualified custodian. The Commission exercises direct regulatory authority with respect to a significant portion of the entities that provide custodial services (i.e., registered broker-dealers). FINRA similarly exercises authority over substantial elements of broker-dealer custodial practices. To the extent the internal controls at broker-dealers or other entities providing custodial services need strengthening, we suggest that the Commission work directly with the appropriate regulator(s) to address the weaknesses.

Overall, we are skeptical that this element of the Proposed Amendments would materially enhance investor protection considering the potential difficulty in obtaining internal control reports, the confidential nature of the reports, and the level of expertise needed to complete a meaningful analysis of the reports. We believe the Proposed Rule would further stress already scarce investment adviser compliance resources and mandate formality that would not meaningfully reduce the risk of inadequate performance by a qualified custodian.

Recommendation: We suggest that the Commission eliminate the requirement for qualified custodians to provide the internal control report to an investment adviser. Alternatively, and still dependent on qualified custodians, the Commission could modify the Proposed Rule to require an opinion of an independent public accountant regarding the adequacy of the qualified custodian's controls or take on the regulation and evaluation of qualified custodians itself.

4. Suggested modification to eliminate duplicative regulatory effort.

The Proposed Release solicits [at page 29] comments whether "there particular types of assets held in a client's advisory account that should or should not be subject to the proposed rule". We believe there is an

opportunity to eliminate duplicative regulatory effort for assets under the jurisdiction of another non-banking federal regulator. Overlapping regulations can result in varied regulatory interpretations and requirements, which may expose a firm and its compliance professional to potential liability.

Recommendation: We suggest that the Commission establish an exemptive provision for assets under the jurisdiction of another non-banking federal regulator (e.g., an adviser acting as a CTA with the CFTC).

5. Conclusion

As a compliance group in the securities industry, we strongly support the Commission's efforts to protect investors, however, without further clarification and modification we believe that certain elements of the Proposed Amendments would prove challenging for compliance professionals to implement or oversee. Accordingly, if the Commission adopts the Proposed Amendments, we urge the Commission to implement requests into the final rules.

Sincerely,

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