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Filed Electronically

Mr. Brent J. Fields, Secretary
U.S. Securities and Exchange Commission
100 F. Street, N.E.
Washington, DC 20549

Re: List of Rules to be Reviewed Pursuant to the Regulatory Flexibility Act; Release No. IA-5067, File No. S7-25-18

Dear Mr. Fields:

Pickard Djinis and Pisarri LLP[1] is pleased to submit these comments regarding the Regulatory Flexibility Act agenda the Commission published for comment on November 21, 2018. We are particularly pleased that the Commission is planning to review Rule 206(4)-2 under the Investment Advisers Act of 1940.

This rule, (the "Custody Rule") addresses the custody of the funds and securities of investment advisers' clients. The rule defines "custody" broadly to include both physical possession (actual custody) and various forms of constructive custody that derive from an adviser's ability to obtain access to customer assets. Constructive custody may arise where an adviser is authorized to write checks on a client's account or issue instructions to disburse funds and securities to third parties, as well as where the adviser or its supervised person serves as the general partner of a client who is a limited partnership, the managing member of a client who is a limited liability company, the trustee of a client who is a trust or the executor of a client who is an estate. It even includes situations in which the adviser is authorized to deduct advisory fees directly from a client's account.

The primary safeguard provided by the Custody Rule is a requirement that all customer funds and securities be maintained by one or more qualified custodians in an account in the client's name or in an account containing only client assets in the name of the adviser, acting as agent or trustee for the client. A "qualified custodian" is the kind of financial institution that typically provides custodial services and is regulated and examined with respect to those services. This

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[1] Pickard Djinis and Pisarri LLP is a law firm specializing in securities regulation relating to investment advisers, broker-dealers and service providers thereto. This letter reflects the views of many of our federally registered investment adviser clients.

includes banks, savings associations, broker-dealers and in some cases, futures commission merchants and foreign financial institutions that segregate client assets from proprietary assets.

In addition, advisers must have a reasonable basis, after due inquiry, for believing that the qualified custodians are sending at least quarterly account statements directly to clients or their independent representatives. These statements must identify the amount of funds and each security in the account at the end of the period and set forth all transactions (including adviser-directed deductions) in the account during the period. The twin protections of safekeeping by a qualified custodian and regular, independent reports about account activity serve to prevent an adviser's misappropriation of client assets and allow prompt detection of any misfeasance that might occur.

During the last rewrite of the Custody Rule,[2] the Commission reinstituted a surprise examination element that had been virtually eliminated from the rule during a previous amendment. In this regard, virtually all of the client funds and securities subject to an adviser's actual or constructive custody must be verified by examination at least once during each calendar year by an independent accountant.

Public commenters on the 2009 Custody Rule amendment questioned the need for a surprise exam requirement, especially in cases where client assets are maintained by an independent qualified custodian. While finding the benefits of an exam to be illusory, commenters pointed out that the costs of this requirement would be all too real, especially for smaller advisers. In response to public comment, the Commission carved out two minor exemptions to the surprise exam requirement [3] and said:

> We acknowledge the concerns raised by commenters with respect to the impact of the surprise examination requirement on smaller advisers whose client assets are maintained by an independent qualified custodian. For this reason, we have directed our staff to evaluate the impact of the surprise examination requirement on smaller advisers that have the authority to obtain possession of client funds or securities and whose client asserts are maintained by an independent qualified custodian. We have also asked the staff to evaluate the impact of the surprise exam on these advisers' clients. Following the completion of the first round of surprise examinations of these advisers under the requirements of the amended rule, our staff will conduct a review and provide the Commission with the results of this review along with any recommendations for amendments necessary to improve the effectiveness of the rule as it applies to these advisers, or address unnecessary burdens on them.[4]

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[2] *Custody of Funds or Securities of Clients by Investment Advisers,* Advisers Act Rel. No. 2968 (Dec. 30, 2009), 75 Fed. Reg. 1456 (Jan. 11, 2010) ("2009 Release").

[3] One exemption applies to advisers whose custody derives solely from fee deduction, and the other applies to advisers who have "imputed custody" through one or more operationally independent affiliates.

[4] 2009 Release at 13-14, 75 Fed. Reg. at 1459.

Unfortunately, this assessment appears never to have occurred. Instead, for almost ten years now, investment advisers have spent compliance resources to satisfy a requirement of very questionable utility.

The surprise exam requirement has imposed a large, unanticipated cost as well. Since the 2009 amendment of the Custody Rule took effect, advisers of all sizes and the staff of the Division of Investment Management have spent an inordinate amount of time struggling to find a way to articulate the parameters of the surprise exam requirement.[5] It is time to put an end to this wasteful exercise, and remove the surprise exam requirement where client assets are maintained by an independent qualified custodian.

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We fully support the Commission's plan to address the current flaws in Advisers Act Rule 206(4)-2, and would be happy to supply any additional information you may desire.

Respectfully submitted,

Mari-Anne Pisarri

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cc: The Honorable Jay Clayton, Chairman
The Honorable Robert J. Jackson, Jr.
The Honorable Hester M. Peirce
The Honorable Elad L. Roisman
Dalia Blass, Director, Division of Investment Management

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[5] These efforts include a seemingly endless round of FAQs, no-action letters and other staff guidance to define custody and the circumstances under which a surprise exam is not necessary. *See e.g.* staff FAQs, available at https://www.sec.gov/ divisions/investment/custody_faq_030510.htm; letter from Aaron T. Gilbride, Senior Counsel, Division of Investment Management to Laura L. Grossman, Assistant General Counsel, Investment Advisers Association (February 21, 2017); and IM Guidance Update No. 2017-01 on Inadvertent Custody (February 2017).