December 27, 2018

Via Electronic Filing

Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

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

Dear Mr. Fields:

The Investment Adviser Association[1] appreciates the opportunity to provide comments on the SEC's List of Rules to be reviewed for their impact on small entities, pursuant to Section 610 of the Regulatory Flexibility Act (**RFA**).[2] We strongly support the Commission's retrospective review of regulations governing investment advisers, both as to their impact on smaller advisers and more broadly.

As a threshold matter, we again urge the Commission to redefine "small business" or "small organization" for purposes of treatment as a "small entity" under the RFA in order to more realistically assess the impact of its regulations on smaller investment advisers.[3] We also urge the Commission to tailor its regulations more appropriately for smaller advisers.

Our specific comments relate to Rule 206(4)-2 under the Advisers Act (**Custody Rule**), which was included in the List of Rules to be reviewed.[4] We fully support the important investor

[1] The IAA is a not-for-profit association dedicated to advancing the interests of SEC-registered investment advisers. The IAA's more than 650 member firms manage more than $25 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 our website: www.investmentadviser.org.

[2] *See* List of Rules to be Reviewed Pursuant to the Regulatory Flexibility Act, SEC Rel. Nos. 33-10576; 34-84640; 39-2523; IA-5067; IC-33298 (Nov. 21, 2018), 83 Fed. Reg. 60791 (Nov. 27, 2018) (**List of Rules**).

[3] *See* Rule 0-7 under the Investment Advisers Act of 1940 (**Advisers Act**). *See* Letter from Karen L. Barr, President and Chief Executive Officer, Investment Adviser Association, to The Honorable Walter J. Clayton, U.S. Securities and Exchange Commission (May 10, 2017), *available at* https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/publications/170510cmnt.pdf.

[4] Custody of Funds or Securities of Clients by Investment Advisers, 17 CFR 275.206(4)-2.

protection goals of the Custody Rule. However, we believe that the regulatory framework under the Custody Rule is overly complex, unduly burdensome, and has caused unnecessary confusion. While we address the Commission's consideration of the Custody Rule in the context of the RFA, we also take this opportunity to press the Commission again to comprehensively review the Custody Rule, which in our view could be made significantly more efficient and effective in achieving the Commission's investor protection goals. We commend the Commission for adding amendments to the Custody Rule to the Long-Term Actions portion of the Commission's regulatory agenda. We intend to engage with the staff actively and comment in-depth when the Commission proposes amendments to the Custody Rule. In the meantime, we provide the following high-level comments:

- In evaluating the economic impact of the Custody Rule on small entities, the Commission should assess the burdens imposed on smaller advisers by the surprise exam requirement, as it promised to do in adopting rule revisions in 2009.
- The Custody Rule has a significant economic impact on and unnecessarily burdens investment advisers of all sizes.
- The Commission should consider a comprehensive overhaul of the Custody Rule that focuses the rule on risks presented by actual physical custody and should address other genuine risks to client assets through other more appropriate and better tailored rules, including existing rules.

I. The Commission Should Update the Definition of "Small Business" or "Small Organization" to Provide Alternative Methods Under Which an Investment Adviser May Qualify as a Small Entity

Unfortunately, the current asset-based definition of small business or small organization makes the Commission's analysis of the economic impact of its regulations on smaller investment advisers under the RFA virtually meaningless. Rule 0-7 under the Advisers Act defines "small business" or "small organization" as including an investment adviser that has less than $25 million in assets under management (**AUM**).[5] Given that the threshold to be eligible for SEC registration is $100 million in regulatory AUM (with limited exceptions), few SEC-registered investment advisers are deemed to be "small" for purposes of the RFA – even though the vast majority of SEC-registered investment advisers are small businesses by any logical measure. As of April 2018, 56.8 percent (7,147) of SEC-registered investment advisers reported on Form ADV that they employ 10 or fewer non-clerical employees, and 87.5 percent (11,011)

[5] 17 CFR 275.0-7(a)(1) (defining an investment adviser as a small entity for purposes of the Advisers Act and the Regulatory Flexibility Act if it: (i) has assets under management having a total value of less than $25 million; (ii) did not have total assets of $5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had total assets of $5 million or more on the last day of its most recent fiscal year).

reported employing 50 or fewer individuals.[6] In fact, the median number of non-clerical employees of all SEC-registered advisers is nine.[7]

These advisers have been significantly burdened by "one-size-fits-all" regulations – and related staff guidance and OCIE expectations – the impacts of which – both in isolation and cumulatively – effectively require substantial fixed investments in infrastructure, technology, personnel, and systems relating to documentation, monitoring, operations, custody, business continuity planning, cybersecurity, and more. It is thus critically important to utilize a more meaningful metric beyond AUM, which alone does not accurately reflect the nature of an adviser's business. Because regulatory compliance depends on financial and human resources, using an AUM-based test risks missing the true burdens of regulation on advisers, most of which are quintessential small businesses.

We recommend that the Commission develop an alternative method for classifying investment advisers as small entities for purposes of the RFA.[8] We believe, for example, that the number of non-clerical employees would be a more realistic and effective measure of which advisers should be considered "small." This measure would more appropriately reflect the potential burdens on smaller advisers. Moreover, the data is readily available in Form ADV and often used in other contexts to define the relative size of companies.[9] We recommend that the Commission use the number of non-clerical employees as a metric for whether an adviser is a small entity for purposes of the RFA.

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[6] *See* 2018 Evolution Revolution, A Profile of the Investment Adviser Profession by IAA and NRS, *available at* https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/resources/Evolution_Revolution_2018_v7.pdf, at 34.

[7] *Id.* at 33.

[8] The IAA thus supports H.R. 6321, the "Investment Adviser Regulatory Flexibility Improvement Act," part of a bi-partisan "JOBS Act 3.0" package of 32 bills. The bill provides that "Not later than the end of the 1-year period beginning on the date of the enactment of this Act, the Securities and Exchange Commission shall revise the definition of a 'small business' or 'small organization' under section 275.0-7 of title 17, Code of Federal Regulations, to provide alternative methods under which a business or organization may qualify as a 'small business' or 'small organization' under such section. In making such revision, the Commission shall consider whether such alternative methods should include a threshold based on the number of non-clerical employees of the business or organization." *See* H.R.6321, Investment Adviser Regulatory Flexibility Improvement Act, *available at* https://www.congress.gov/bill/115th-congress/house-bill/6321/text?q=%7B%22search%22%3A%5B%22hr+6321%22%5D%7D&r=1.

[9] *See* Independent Regulatory Agency Compliance with the Regulatory Flexibility Act, for the Office of Advocacy, United States Small Business Administration (**SBA Study**) (noting, among other things, that the SBA's definition of small business incorporates number of employees), *available at* https://www.sba.gov/sites/default/files/rs410tot.pdf.

II. The Commission Should Tailor its Regulations Better For Smaller Advisers

We urge the Commission to use its discretion to tailor regulations more appropriately for smaller advisers, just as it has in other contexts. For example, public companies that meet the definition of a "smaller reporting company" under Rule 12b-2 of the Securities Exchange Act of 1934 are not required to report certain information, or are permitted to provide scaled disclosure or report information in lieu of some requirements in their periodic reports. Further, a smaller reporting company that qualifies as a "non-accelerated filer" is not required to provide an auditor attestation of management's assessment of internal control over financial reporting and, in contrast to other reporting companies, has more time to file its periodic reports. In addition, the SBA Study identified other independent federal agencies that have differing compliance requirements for small businesses, involving partial exceptions, a choice of alternative methods for compliance, extended compliance timetables, and tiered requirements.[10]

The Commission has substantial data to assist it in tailoring its rules for smaller or different types of advisers. For example, the Commission engaged in this type of analysis when it most recently amended Form ADV, Part 1 to increase the threshold for collecting certain data from $150 million in separately managed account regulatory AUM (as proposed) to $500 million (as adopted). We commend the Commission for this appropriate tailoring of the reporting requirement, which enabled the Commission to collect 95% of the data that it would have collected using the $150 million threshold, while relieving approximately 3,000 advisers from having to report derivatives and borrowings information.[11] The Commission should similarly revisit the impact of other rules as interpreted and enforced, including as related to the Custody Rule (as discussed below) and various aspects of the compliance program rule (Rule 206(4)-7 under the Advisers Act), as well as consider the cumulative cost of compliance for smaller advisers.

III. In Evaluating the Economic Impact of the Custody Rule on Small Entities, the Commission Should Follow Through on its Promise to Assess the Burdens Imposed on Smaller Advisers by the Surprise Exam Requirement

We appreciate the Commission's decision to include the Custody Rule in the List of Rules to be reviewed under the RFA. As we discuss below, the economic impact of the rule on *all* advisers is unnecessarily burdensome. And the surprise examination requirement of the rule is arguably the most burdensome aspect of the rule. Indeed, in the release accompanying the adoption of amendments to the Custody Rule in 2009, the Commission acknowledged concerns regarding the effect of the surprise exam requirement on smaller advisers whose clients' assets

[10] *See* SBA Study at 15-16.

[11] *See* IA Rel. No. 4509 (Aug. 25, 2016) at 17-18; *see also* IAA Letter to SEC on Proposed Amendments to Form ADV and Advisers Act Rules (Aug. 11, 2015), *available at* https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/publications/150811cmnt.pdf.

are maintained by a qualified custodian. The Commission directed the staff to assess the impact on smaller advisers and report its results after the first round of surprise exams.[12] We do not know whether the staff ever conducted such an assessment, but if so, it has not been made public. We urge the Commission to conduct and/or include that assessment as part of its comprehensive review of the Custody Rule, and make it available for public comment.

IV. The Economic Impact of the Custody Rule Unnecessarily Burdens Investment Advisers of All Sizes

The Custody Rule imposes a significant economic burden on advisers of all sizes caused by both lack of clarity about the rule and the rule's essential requirements. The complexity of the Custody Rule, in conjunction with technological changes with respect to how securities are traded and held, is leading to significant confusion on the part of firms that are or may be subject to the rule. For example, counter to a plain English understanding of the word "custody," the rule extends far beyond actual physical custody of client assets to include constructive or technical custody. By using the single term "custody" to cover not only direct physical possession, but also the broader (and vaguer) concepts of imputed possession, access, and legal ownership, it has become difficult to articulate requirements for compliance with the rule in a clear fashion.[13]

This complexity is evidenced by the Commission staff's issuance of nearly 70 FAQs, over a dozen no-action letters, and other guidance under the rule. While staff guidance is often requested by the industry and is helpful, this has resulted in a patchwork of requirements many of which are difficult to decipher, subject to inconsistent and conflicting interpretations, and not always readily apparent from the rule text itself.[14]

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[12] "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 assets 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." *See* Custody of Funds or Securities of Clients by Investment Advisers, SEC Rel. No. IA-2968 (Dec. 30, 2009) at 13-14, *available at* https://www.sec.gov/rules/final/2009/ia-2968.pdf.

[13] The confusion is exacerbated by the rule's use of the term "qualified custodian" – although most advisers have "custody" under the Commission's far-reaching definition, they are not "custodians."

[14] For example, as we have highlighted previously, the Commission staff's February 2017 Guidance Update on inadvertent custody has led to increased, rather than decreased, uncertainty in the industry with respect to the proper scope of the Custody Rule. We have been working with the staff since it issued that guidance. We appreciate the staff's recent FAQs providing clarity on one aspect of that guidance, and we continue to engage with the staff on the other aspect regarding the treatment under the Custody Rule of transactions that settle on a non-DVP basis. *See* IM Guidance Update, *Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority* (Feb. 2017),

The rule's complexity and ambiguity along with its core requirements cause investment advisers to incur significant costs. In 2013, the Government Accountability Office (**GAO**) published a report on its examination of investment advisers' costs of complying with the Custody Rule, as mandated by the Dodd-Frank Act.[15] The GAO Report noted that investment advisers can incur an "array" of costs, both direct and indirect, to comply with the Custody Rule.

According to the GAO Report, initial costs incurred include management and staff hours and consulting or legal fees to interpret and comply with the rule, identify accounts over which the adviser has custody, reprogram systems to code accounts, train staff about surprise examination requirements, and search for and hire an accountant to conduct the examinations. Recurring costs to comply with the rule include internal staff hours to maintain records and prepare required statements and disclosures, including Form ADV.[16]

Two of the more costly requirements associated with the Custody Rule – according to the GAO Report – are surprise examinations and internal control reporting.[17] In addition to incurring the direct cost of the examination or audit, advisers that are subject to these requirements expend staff hours to prepare for and facilitate reviews.[18] These duties include educating the accountant about the firm's operations, generating reports for and providing other support to the accountant, and answering questions from clients related to the examination.

V. The Commission Should Consider a Comprehensive Overhaul of the Custody Rule

We commend the Commission for undertaking a comprehensive review of the Custody Rule as part of its longer term agenda and consistent with its commitment when it implemented the RFA in 1981 to "conduct a broader review . . . with a view to identifying those rules in need of modification or even rescission."[19] As technology and communications evolve, it is important

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available at https://www.sec.gov/investment/im-guidance-2017-01.pdf. Currently, the industry remains in limbo with respect to the proper application of the Custody Rule to these transactions.

[15] *See* United States Government Accountability Office, Report to Congressional Committees, Investment Advisers: Requirements and Costs Associated with the Custody Rule, GAO-13-569 (July 8, 2013), *available at* https://www.gao.gov/assets/660/655754.pdf (**GAO Report**).

[16] GAO Report at 13-15.

[17] GAO Report at 14.

[18] Because the timing of the exam is a surprise, an adviser may have to temporarily bring in additional resources or pay overtime because it is unable to plan in advance for when the exam will occur. In addition, although investment advisers to pooled investment vehicles typically undergo an annual financial statement audit in lieu of a surprise examination, they too incur direct and indirect costs associated with the audit.

[19] List of Rules at 60792.

to initiate retrospective reviews of regulations to ascertain whether they need to be modernized, streamlined, or rescinded.[20]

As it conducts its review, the SEC should not view the Custody Rule in isolation but rather as part of the robust investor-protective framework of the Advisers Act. Investment advisers, as fiduciaries under the Advisers Act, take seriously the protection of client funds and securities and take active steps, many of which are already built into the Advisers Act and regulations beyond the Custody Rule, to protect against misappropriation and related risks to client funds and securities. Indeed, the Custody Rule was never intended to be a panacea for all potential fraud. The Commission should thus bear in mind that the Custody Rule is only one of the protections afforded to advisory clients under the Advisers Act. There are other regulations that better address (or may be more suitable to amend in order to better address) many of the Commission's underlying concerns.

We intend to comprehensively comment on any proposed amendments to the Custody Rule as part of the Commission's review of the rule under its long-term regulatory agenda. In the meantime, we take this opportunity to provide some examples of areas where the Custody Rule could benefit from being overhauled. We welcome the opportunity to engage in a more in-depth dialogue with the Commission staff regarding these and other areas that are ripe for modernization and revision.

Limit the Custody Rule to Actual Physical Custody. The Custody Rule and the term "custody" should cover only arrangements where the adviser (or related person) has actual physical custody of client assets. The Commission should catalogue situations where the adviser's authority, access, or legal status presents genuine risks to the safety of client assets. The Commission could then assess (i) whether these risks are already addressed by the existing regulatory framework, (ii) whether these risks can be appropriately addressed by amending existing rules, or (iii) whether it is necessary to consider new rules reasonably designed and narrowly tailored to address the actual risks identified.

For example, identity theft risks (which we understand are part of the staff's justification for its interpretive guidance relating to constructive custody) may be addressed by existing regulations requiring investment advisers to implement policies and procedures reasonably designed to prevent identity theft causing client harm.[21] Similarly, the Commission has shoe-

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[20] Other areas that would benefit from a fresh look include Rule 206(4)-5 under the Advisers Act governing political contributions by investment advisers (the so-called "Pay-to-Play Rule"), guidance on electronic delivery of required disclosures, privacy rules, rules related to private offerings, and regulations governing short sales. We appreciate that the Commission is already taking a fresh look at the Advisers Act Advertising Rule.

[21] *See, e.g.*, SEC Regulation S-ID, Identity Theft Red Flags Rule (Duties regarding the detection, prevention, and mitigation of identity theft), 17 CFR 248.201.

horned advisers that act as trustees into the Custody Rule,[22] when reasonable alternative safeguards could suffice to address any risks.[23] The Commission should consider the full panoply of rules available to it and avoid using the Custody Rule as a means to address policy concerns or broader fraud risks that are not truly custody in nature.

Internal Controls. One area in which the staff could assess whether risks are already addressed is by considering internal controls. We have previously provided the Commission staff with illustrative examples of controls that investment advisers use to address risks related to client assets, as appropriate to their businesses. These include maintaining a list of personnel authorized to instruct the movement of client funds or securities between the client's qualified custodian(s) and counterparties; employee training; separation of responsibilities or the institution of other checks and balances; verification of non-routine instructions; review of transfer instructions; periodic reviews of client account trading activity; and internal or external auditing or testing of controls relating to the handling of client funds and securities.

As a means to remind investment advisers of internal controls that they should consider implementing, as tailored to their business, the Commission staff could re-issue its 2012 Risk Alert on preventing and detecting unauthorized trading. For instance, the staff could suggest that firms segregate custodial duties from advisory functions. Segregation of duties makes it extremely difficult for any one person to perpetrate and hide a fraud.

Reconsider the Treatment of Privately Offered Securities. The Custody Rule's provision requiring that a qualified custodian hold certain privately offered securities over which an investment adviser has custody is unnecessary and, in any event, overbroad. Through interpretative guidance, the Commission staff has implicitly recognized that there is little risk that an adviser could misappropriate privately offered securities that are not generally transferable.[24] Thus, the Commission should simply eliminate the requirement that privately

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[22] Under the Custody Rule, an adviser that is both providing investment advice for a client account and serving as trustee for that account is constructively deemed to have custody of the account and must comply with the rule. An adviser can also have custody indirectly through a "related person."

[23] Prior to revising the Custody Rule in 2003, no-action letters permitted advisers that acted as trustees for advisory clients to not conduct surprise exams if the adviser: (i) used an independent third-party qualified custodian to hold client trust assets; (ii) required the custodian to send quarterly statements to the trust beneficiaries; (iii) required the custodian to send a trust accounting to the current and remainder beneficiaries of the trust; or (iv) issued instructions to the custodian limiting its authority to deliver trust assets to the adviser other than fees, and limiting its authority to otherwise transfer trust assets. *See, e.g.*, Blum Shapiro Financial Services, Inc., SEC Staff Letter (Apr. 16, 1993); Clifford Associates, SEC Staff Letter (Sept. 22, 1992); and Wallington Asset Management, Inc., SEC Staff Letter (Nov. 20, 1990).

[24] For example, in 2013 the Commission staff provided partial relief from the Custody Rule to advisers to pooled investment vehicles. *See* IM Guidance Update, *Privately Offered Securities under the Investment Advisers Act Custody Rule* (Aug. 2013), *available at* https://www.sec.gov/divisions/investment/guidance/im-guidance-2013-04.pdf.

offered securities must be held by a qualified custodian. Given the nature of these securities, the qualified custodian requirement adds no benefit. The client is already protected by the hurdles to effecting transfers of such securities, including the fact that most privately offered securities are transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.

If the Commission does not eliminate this requirement, it should broaden its existing relief to take into account how various instruments are "held" and provide an exception from the audit requirement for pools where an audit may result in unnecessary costs for the client without being useful.

Exceptions for Certain Clients/Services. We suggest that the Commission consider whether it can better tailor the Custody Rule to actual risks and, in so doing, except certain types of clients or services from the rule. For example, the Commission should consider whether a U.S. adviser to specific types of clients, such as foreign public funds that do not have any U.S. investors and are heavily regulated in their home jurisdictions, should be excepted from the Custody Rule, similar to registered investment companies. Also, the Commission should consider whether certain services, such as providing trustee services to the adviser's own defined contribution plans, should be excepted from the costly provisions of the rule given that there are existing protections for retirement plan assets and the conditions of the relief impose undue expense on plan participants.

Surprise Exams. We also urge the Commission to consider whether there are circumstances that do not warrant an annual surprise exam, such as constructive custody that does not involve legal ownership of client assets, *e.g.*, constructive custody that arises by virtue of withdrawal requests, provided that the client confirms to the qualified custodian that the adviser is authorized to make such withdrawals. Alternatively, the frequency of surprise exams could be lessened to, *e.g.*, every two or three years.

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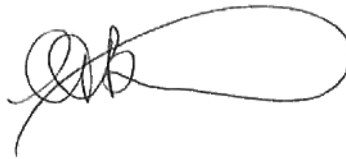
We appreciate the Commission's consideration of our comments and would be happy to provide any additional information that may be helpful. Please contact the undersigned or Associate General Counsel Laura Grossman at [redacted] if we can be of further assistance.

Respectfully Submitted,



Gail C. Bernstein
General Counsel

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