**Managed Funds Association**
The Voice of the Global Alternative Investment Industry
Washington, D.C. | New York | Brussels | London

October 30, 2023

**Via Email**: rule-comments@sec.gov

Ms. Vanessa A. Countryman
Secretary
U.S. 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:

Managed Funds Association ("**MFA**")[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission ("**SEC**" or "**Commission**") in response to the Commission's reopening of the comment period on the proposed amendments to, and redesignation of, the current custody rule as a new safeguarding rule under the Investment Advisers Act of 1940 (the "**Advisers Act**"), together with related amendments to the Advisers Act books and records rule and Form ADV (together, the "**Safeguarding Proposal**" or "**Proposal**").[2] These comments supplement comments we submitted to the Commission on May 8, 2023 ("**May Comment Letter**"), July 24, 2023 ("**Aggregate Cost Comment Letter**"), and September 12, 2023 ("**Joint Trades Comment Letter**").[3]

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[1] MFA, based in Washington, DC, New York, Brussels, and London, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 170 member firms, including traditional hedge funds, credit funds, and crossover funds, that collectively manage nearly $2.2 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

[2] *See* Safeguarding Advisory Client Assets; Reopening of Comment Period, 88 Fed. Reg. 59818 (Aug. 30, 2023) ("**Reopening Release**"), available at: https://www.govinfo.gov/content/pkg/FR-2023-08-30/pdf/2023-18667.pdf; Safeguarding Advisory Client Assets, 88 Fed. Reg. 14672 (Mar. 9, 2023) (to be codified at 17 C.F.R. Pts. 275 and 279) ("**Proposing Release**"), available at: https://www.govinfo.gov/content/pkg/FR-2023-03-09/pdf/2023-03681.pdf.

[3] *See* Letter from Jennifer W. Han, Executive Vice President, Chief Counsel & Head of Global

While we appreciate the Commission's effort to seek additional comments on the Safeguarding Proposal, we believe it does not begin to adequately address the serious shortcomings in the Proposal or the interlocking nature of the avalanche of recent proposals that impact private fund advisers and fund investors ("**Related Proposals**") when considered in the aggregate. Instead of addressing these concerns, the Reopening Release merely requests comment on a very narrow issue regarding the proposed modifications to the audit requirement in the Safeguarding Proposal in light of the audit requirement in the recently adopted private fund adviser rule ("**Final Private Fund Adviser Rule**").[4] We are disappointed in the Commission's approach. At a minimum, we believe the Commission should have provided additional cost-benefit analysis for different asset classes affected by the Proposal and addressed certain other deficiencies in the Proposal identified by MFA and other commenters and solicited public comment.

In the following we address our concerns in more detail.

## *I. The Safeguarding Proposal is Overly Broad, not Appropriately Tailored to Accomplish the Commission's Investor Protection Goals, and Would Have Significant Unintended Consequences (Proposing Release Questions 1 – 6, and 136)*

We have significant concerns with the Safeguarding Proposal and its likely impact on investors and the financial market participants that serve them, including advisers, qualified custodians, independent accountants, and other market participants. Our members have long recognized the importance of safeguarding client assets subject to the custody rule, which currently includes client funds and securities.

We understand the Commission believes it has a statutory mandate to issue regulations implementing section 223 of the Advisers Act.[5] However, even if the Commission continues to believe the Dodd-Frank Act expands its authority to cover all assets, not merely funds and

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Regulatory Affairs, MFA, to Vanessa Countryman, Secretary, SEC (May 8, 2023), available at: https://www.sec.gov/comments/s7-04-23/s70423-186599-340484.pdf; Letter from Jennifer W. Han, Executive Vice President, Chief Counsel & Head of Global Regulatory Affairs, MFA, to Vanessa Countryman, Secretary, SEC (July 24, 2023), available at: https://www.sec.gov/comments/s7-04-23/s70423-233002-486782.pdf; Joint Trades Letter to Gary Gensler, Chair, SEC (Sep. 12, 2023), available at [*insert link*].

[4] *See* Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 88 Fed. Reg. 63206 (Sep. 14, 2023), available at: https://www.govinfo.gov/content/pkg/FR-2023-09-14/pdf/2023-18660.pdf (requiring a registered investment adviser to obtain an annual financial statement audit of each private fund it advises in accordance with the audit provision of the current custody rule. *See* 17 C.F.R. § 275.206(4)-10.

[5] *See* section 411 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) ("**Dodd-Frank Act**") (adding section 223 to the Advisers Act which provides "[a]n investment adviser registered under this subchapter shall take such steps to safeguard client assets over which such adviser has custody, including, without limitation, verification of such assets by an independent public accountant, as the Commission may, by rule, prescribe").

securities (which we believe is not the case),[6] the Commission still needs to conduct a cost-benefit analysis for each of the new asset classes affected by the new requirements. In proposing to expand equity-like safekeeping requirements to all asset classes, the Commission has not demonstrated any pervasive weaknesses or risks to advisory clients resulting from existing custodial practices for traditional asset classes (a market failure), including privately placed securities, futures, swaps, security-based swaps, other bilateral contracts such as loans and repurchase agreements, and commodities. The Commission has failed to consider how the proposed exception for privately offered securities and physical assets would apply to the wide spectrum of asset classes in which investment advisers transact on behalf of their clients (recognizing that this exception would not even be available to those asset classes that are not securities or physical assets). In an appendix to our May Comment Letter, we offered the Commission a preliminary analysis of certain implications of the Proposal on a range of asset classes in which investment advisers may transact on behalf of their clients, but we did not include all asset classes in which investment advisers transact or attempt to replace the thorough cost-benefit analysis that the Commission is must undertake before any determination to re-propose a new safeguarding rule.[7]

In light of the negative unintended consequences of the Safeguarding Proposal and the Commission's failure to identify a market failure (as opposed to hypothetical dangers that are already addressed by the current custody rule), we recommend the Proposal be withdrawn. Then, only to the extent necessary and following an appropriate cost-benefit analysis, the Commission should, if appropriate, propose a tailored rule to address any gaps in market practices that the Commission identifies, focusing on the primary purpose of the custody rule: to reduce the risk that client assets will be lost, misused, stolen or misappropriated, or captured by the financial reverses of the adviser.

## *II. The Commission Should Consider the Aggregate Costs of the Related Proposals on Private Fund Advisers, their Investors, and the Markets Generally (Proposing Release Questions 98, 118, and 186)*

As noted above, the Reopening Release requests comment only on a very narrow issue regarding the proposed modifications to the audit requirement in the Safeguarding Proposal in light of the audit requirement in the Final Private Fund Adviser Rule. This is inadequate if the

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[6] It is more reasonable to consider that Congress' use of the term "client assets" should be read to only refer to those assets under the scope of the Commission's regulatory authority, that is, securities and cash related to buying and selling securities. *See, e.g.*, Public Interest Comment Letter from the Mercatus Center at George Mason University (Apr. 7, 2023), available at: https://www.sec.gov/comments/s7-04-23/s70423-20163827-333933.pdf (noting that the Commission "used the phrase 'client assets' as a convenient shorthand form for 'funds or securities' in a 2009–10 rulemaking, and a Senate Report indicates that Congress probably picked up that usage in the Dodd-Frank custody statute").

[7] Moreover, the Commission has failed to adequately consider the likelihood that otherwise qualified custodians would exit certain markets (including by refusing to provide the contractual terms or assurances required by the Proposal) or provide custodian services only on uneconomic terms.

Commission intends to get meaningful comment. We urge the Commission instead to evaluate the costs and benefits of the Related Proposals, in the aggregate, for private fund advisers, their investors, and the markets generally, and then solicit public comment on this revised cost-benefit analysis, before proceeding to adopt any more of the Related Proposals, including the Safeguarding Proposal. Looking solely at the incremental cost of one additional rulemaking, compared to the preexisting baseline (established by final rules, not proposals), will not give the Commission or interested parties a true reflection of the overall costs of the Safeguarding Proposal and other Related Proposals.[8]

We continue to believe the sheer volume and scope of recent Commission rulemakings will have negative unintended consequences the Commission has not fully considered. The Commission has failed to conduct a comprehensive cost-benefit analysis of the Related Proposals, when considered in the aggregate, and that if the Related Proposals were adopted as proposed, they would impose staggering aggregate costs and unprecedented operational and other practical challenges, particularly for smaller and emerging managers.

## *III. Operational Costs and Impact on Small and Emerging Managers (Proposing Release Questions 58, 79, and 125)*

In addition to our objections to the Safeguarding Proposal's approach and general concerns with its cost-benefit analysis, we believe the Commission has failed to account for how the Safeguarding Proposal would negatively affect smaller and emerging managers. Many smaller and emerging managers would not have the scale and ability to absorb the increased costs and regulatory obligations of the Safeguarding Proposal, particularly when combined with the increased costs and regulatory obligations of the Related Proposals. Smaller advisers who face new increased compliance costs would be among those most likely to exit the market in response to the final rules.

The 2023 Consolidated Appropriations Act urged the Commission to redo its economic analysis of the proposed Private Fund Adviser Rule to "ensure the analysis adequately considers the disparate impact on emerging minority and women-owned asset management firms, minority and women-owned businesses, and historically underinvested communities."[9] In adopting the Private Fund Adviser Rule, the Commission responded to this concern by suggesting that some registered advisers may have the option of reducing their assets under management ("**AUM**") to forgo registration, thereby avoiding the costs of the final rule that only apply to registered investment advisers, such as the mandatory audit rule.[10] We are troubled that the Commission

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[8] By way of analogy, carrying one rock up a hill may be manageable, carrying two or three rocks up a hill may also be manageable, but there comes a point when the stack of rocks becomes an unbearable load. The fact that one rock is carriable does not mean that a stack of rocks is. The Commission should look at the costs and burdens of the Safeguarding Proposal and other Related Proposals, in the aggregate, in order to properly assess their cumulative impact, not merely analyze the incremental cost of individual rulemakings.

[9] P.L. 117-328, available at: https://www.congress.gov/bill/117th-congress/house-bill/2617/text.

[10] Final Private Fund Adviser Rule at 63361.

thinks it can address the effect of the Final Private Fund Adviser Rule, or any rule, on competition, by pointing to the ability of advisers to avoid registration by staying small.

This concern for the disparate impact of the rule on emerging minority and women-owned asset management firms is equally true for the Safeguarding Proposal, which similarly will impose significant compliance burdens on investment advisers. Previously, we identified a number of business impacts of the Proposal and the significant costs and delays for a variety of transactions, as well as a number of compliance costs of the Safeguarding Proposal. These business impacts and compliance challenges are significant and will raise costs for investors in private funds. New entrants are pipelines for talent and contribute to innovation and competition in the industry. The result of the Safeguarding Proposal and other Related Proposals, if adopted in their current form, would be to harm investors by increasing costs, making private funds less accessible, and decreasing competition by making it cost-prohibitive for many private fund advisers to remain in business and for new advisers to enter the market. This would lead to industry consolidation as smaller and even mid-sized advisers would be forced out of the market because they do not have the scale and ability to absorb the increased costs and regulatory obligations.

## *IV. The Audit Requirement Should Be More Narrowly Tailored (Reopening Release)*

In the Reopening Release, the Commission requests comment on the limited question of whether the proposed amendments to the current custody rule's audit provision should be modified. First, we ask the Commission to consider additional situations in which the audit requirement should not apply, for example, when an adviser elects to undergo a surprise audit under the custody rule, during stub periods, or when a private fund that holds a single asset is winding down.[11] In these cases, the audit is generally without benefit and an unnecessary cost. Second, in the Safeguarding Proposal, the Commission proposed to require *each* transaction involving an exempt asset be verified promptly and the requirement that the existence of *each* exempt asset be verified in a surprise examination or financial statement audit, rather than a representative sample. We continue to believe that maintaining the current practice of accountants selecting a representative sample of assets in surprise examinations and financial statement audits would avoid subjecting investors to unnecessary market and counterparty risks associated with delayed settlement cycles and would continue to ensure investor protection while preventing unnecessary costs and burdens that would ultimately fall on investors.[12]

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[11] *See* Letter from Jennifer W. Han, Executive Vice President, Chief Counsel & Head of Global Regulatory Affairs, MFA, to Vanessa Countryman, Secretary, SEC (Apr. 25, 2022), available at: https://www.sec.gov/comments/s7-03-22/s70322-20126631-287270.pdf.

[12] *See* May Comment Letter (noting that "the current practice of the accountant selecting the representative sample sufficiently balances the need for independent verification with concerns of cost and practicality").

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MFA appreciates the opportunity to provide comments to the Commission on the Safeguarding Proposal. If you have any questions about these comments, please do not hesitate to contact Matthew Daigler, Vice President & Senior Counsel, or the undersigned at (202) 730-2600.

Respectfully submitted,

/S/ Jennifer W. Han

Jennifer W. Han

Executive Vice President
Chief Counsel & Head of Global Regulatory Affairs

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