



May 8, 2023

Submitted by SEC Webform (<https://www.sec.gov/rules/submitcomments.html>)

Vanessa A. Countryman  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

**RE: File No. S7-04-23: Safeguarding Advisory Client Assets**

Dear Ms. Countryman:

On behalf of the North American Securities Administrators Association (“NASAA”),<sup>1</sup> I am writing in response to U.S. Securities and Exchange Commission (the “Commission”) Release No. IA-6240, *Safeguarding Advisory Client Assets* (the “Proposal”),<sup>2</sup> in which the Commission seeks to amend and redesignate the current custody rule as a new safeguarding rule under the Investment Advisers Act of 1940 (the “Advisers Act”).<sup>3</sup> The Proposal would revise how investment advisers safeguard client assets and implement changes to prevent those assets from becoming lost, misused, stolen, or misappropriated. It would also expand the definition of assets to include positions in addition to funds and securities, broaden the definition of custody to include discretionary authority to trade, enhance custodial protection standards, and change surprise examination requirements.<sup>4</sup>

NASAA supports the Commission’s overall goal to modernize safeguarding requirements to ensure certain minimum protections for assets held in or managed under advisory accounts.<sup>5</sup> We also support efforts to mitigate the risks of misuse, misappropriation, or loss through appropriate safeguarding protections. However, as detailed below, we believe the Commission should improve the Proposal by offering guidance on the content of custodial account statements,

<sup>1</sup> Organized in 1919, NASAA is the oldest international organization devoted to investor protection. NASAA’s membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico, the U.S. Virgin Islands, and Guam. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

<sup>2</sup> The Proposal is available at <https://www.sec.gov/rules/proposed/2023/ia-6240.pdf>.

<sup>3</sup> *Id.* at 1.

<sup>4</sup> *Id.* at 19-26.

<sup>5</sup> *Id.* at 20.

offer guidance on the controls that should be tested in internal control reports, and include discretionary authority to trade on a delivery versus payment basis within the scope of the surprise examination requirement.

## **I. Qualified Custodian Protections**

The Proposal would require an investment adviser to maintain client assets with a “qualified custodian”<sup>6</sup> pursuant to a written agreement that contains certain contractual terms to address recordkeeping, client account statements, internal control reports, and the adviser’s agreed-upon level of authority to effect transactions in the account.<sup>7</sup> The proposed rule would also require that an adviser obtain reasonable assurances from the qualified custodian with respect to the custodian’s standard of care, indemnification, limitation of liability for sub-custodial services, segregation of client assets, and attachment of liens to client assets.<sup>8</sup>

In general, NASAA supports the Commission’s effort to “formalize the minimum standard of protections to advisory clients’ assets held by qualified custodians in a manner that would provide consistent investor protections across all qualified custodians under [the] proposed rule.”<sup>9</sup> Doing so would reduce instances where custodial protections may be inadequate due to varying practices of advisers or custodians.

### **A. The Commission Should Seek to Make Account Statements More Uniform and Informative.**

Under the Proposal, qualified custodians would be required to provide account statements, at least quarterly, to both advisers and their clients.<sup>10</sup> NASAA supports this aspect of the Proposal. It would be an improvement over the current requirement that an adviser merely needs to have a reasonable basis, after due inquiry, to believe a qualified custodian is sending account statements, at least quarterly, to the adviser’s clients that identifies the amount of funds and securities in the account at the end of the period and all transactions in the account during the period.<sup>11</sup> The new requirement would increase the likelihood that investors receive regular updates regarding their advisory accounts. Regular and frequent account information would help investors track account performance more closely and identify concerns more quickly. A requirement to provide periodic

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<sup>6</sup> The Proposal would define the term “qualified custodian” to mean “a bank or savings association, registered broker-dealer, registered futures commission merchant [ ], or certain type of foreign financial institution [ ] that meets the specified conditions and requirements.” *Id.* at 43.

<sup>7</sup> *Id.* at 42.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> *Id.* at 97.

<sup>11</sup> *See id.*

statements to investors should also encourage even more advisers to observe their obligations faithfully and make investment decisions carefully.

NASAA encourages the Commission to further strengthen the Proposal by offering guidance regarding the minimum information that qualified custodians should include in custodial account statements. As has been noted by the Commission's Investor Advisory Committee, the rules governing the information that must be made available in brokerage account statements have remained largely unchanged for almost 30 years, and advisers have no obligation to send account statements to their clients.<sup>12</sup> While the Proposal properly identifies and addresses the need for clients to receive account statements regularly, it does not seek to standardize the information provided, or ensure that custodial account statements provide the information that investors need.<sup>13</sup> NASAA encourages the Commission to offer guidance on account statement formats, performance and fee disclosures, definitions of terms of art, standards for clarity, and brief guides to help clients read and understand their account statements.<sup>14</sup>

**B. The Commission Should Offer Guidance to Custodians and Independent Public Accountants on Suitable Custodial Controls.**

The Proposal would require advisers to obtain reasonable assurances that their qualified custodians will employ appropriate account protections.<sup>15</sup> The Proposal would also require advisers to obtain internal control reports from custodians which would give visibility into the adequacy of their controls.<sup>16</sup> NASAA supports this requirement as especially helpful for smaller advisers who may not have the means or bargaining power to obtain thorough information about whether a custodian's controls are suitably designed or operating effectively.

NASAA encourages the Commission to offer guidance on minimum standards for suitably designed custodial controls. While the Commission notes that many qualified custodians obtain internal control reports already, it also recognizes that "the scope of those reports may not cover the financial institutions' safeguarding activities that this proposed requirement is designed to cover."<sup>17</sup> Commission guidance on this topic would be helpful to custodians and the independent public accountants who generate such reports. While we agree with the Commission's assessment

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<sup>12</sup> SEC, *Recommendation of the SEC Investor Advisory Committee's Disclosure Subcommittee to Improve Customer Account Statements to Better Inform Investors* at 1 (Mar. 2, 2023), <https://www.sec.gov/files/20230302-recommendation-customer-account-statements.pdf>.

<sup>13</sup> *See id.* at 2.

<sup>14</sup> *See id.*

<sup>15</sup> Proposal at 77, 83.

<sup>16</sup> *See id.* at 22, 100.

<sup>17</sup> *Id.* at 101-02.

that it need not specify the type of report,<sup>18</sup> guidance as to what internal controls need to be tested to meet the objectives of the rule would help independent public accountants tailor their work.

## **II. Surprise Examination Exceptions**

The Proposal would provide an exception from the surprise examination requirement for client assets if the adviser's sole basis for having custody is discretionary authority to trade or because the adviser is acting according to a standing letter of authorization.<sup>19</sup> For an adviser to rely on this exception, the Proposal would require a qualified custodian to maintain the client assets, and that discretionary authority would be limited to instructing the custodian to transact in assets that settle on a delivery versus payment ("DVP") basis.<sup>20</sup> The Commission reasons that under these circumstances, there is a reduced risk of misappropriation or theft.<sup>21</sup>

However, as the Commission recognizes, the risk of misappropriation still exists.<sup>22</sup> For instance, an adviser could use client assets to purchase substandard securities and split the proceeds in a collusive arrangement with an issuer. Further, the Proposal notes that an adviser with discretionary trading authority may act without first obtaining the client's consent.<sup>23</sup> Thus, if an adviser were to use its discretionary authority to trade an asset that settles on a DVP basis, but that transaction is not in the client's best interest, the asset is worthless, or the selling entity is found to engage in illicit or fraudulent activities, these issues may not be captured as a result of the proposed exception to the surprise examination requirement.

The Proposal seeks to focus the requirement to obtain a surprise examination where the risk of misappropriation is greatest.<sup>24</sup> However, to leave a gap where misappropriation is still a possibility would result in a non-comprehensive surprise examination scheme that could result in weakened protections and an opportunity for advisers to engage in misconduct. While this proposed exception may appear to balance the costs and protections of the proposed rule in the instant future, we believe that the Commission should seek to achieve comprehensive safeguarding of client assets. Consequently, we believe such an exception would be imprudent and contradictory to the Proposal's aim of risk reduction.

## **III. Conclusion**

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<sup>18</sup> *See id.* at 102.

<sup>19</sup> *Id.* at 178, 206.

<sup>20</sup> *Id.* at 33-34, 206-07.

<sup>21</sup> *Id.* at 34, 207.

<sup>22</sup> *Id.* at 275.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.* at 323-24.

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For the reasons expressed above, NASAA encourages the Commission to refine certain areas of the Proposal to ensure all client assets receive adequate minimum protections and are appropriately safeguarded. Should you have any questions about this letter, please contact either the undersigned or NASAA's General Counsel, Vince Martinez, at (202) 737-0900.

Sincerely,

A handwritten signature in black ink that reads "Andrew Hartnett". The signature is written in a cursive, flowing style.

Andrew Hartnett  
NASAA President and  
Deputy Commissioner  
Iowa Insurance Division