May 13, 2021

Via Electronic Filing

Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Engaging on Non-DVP Custodial Practices

Dear Ms. Countryman:

The Investment Adviser Association ("**IAA**"), the Asset Management Group ("**AMG**") of the Securities Industry and Financial Markets Association ("**SIFMA**"), and the Loan Syndications and Trading Association ("**LSTA**") (together, the "**Associations**")[1] appreciate the opportunity to respond to the Division of Investment Management Staff's request for engagement on the application of the Custody Rule to non-DVP trading, as set forth in a letter from the Staff to the IAA.[2]

The Associations fully support the important investor protection goals of Rule 206(4)-2 (the "**Custody Rule**") under the Investment Advisers Act of 1940 ("**Advisers Act**") and share the Staff's interest in guarding against the misappropriation of client assets by investment advisers. It is well established, however, that authorized trading is not considered to confer custody on advisers. As we have previously commented to the Staff,[3] investment advisers have long understood that "authorized trading" includes, but is not limited to, trading that settles on a delivery versus payment ("**DVP**") basis. That understanding was seemingly contradicted by the Staff's 2017 inadvertent custody guidance.[4]

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[1] For descriptions of the Associations, see Appendix A.

[2] *See* Letter from Paul G. Cellupica, then-Deputy Director and Chief Counsel, Division of Investment Management to Karen Barr, President & Chief Executive Officer, Investment Adviser Association, *Engaging on Non-DVP Custodial Practices and Digital Assets* (Mar. 12, 2019), available at https://www.sec.gov/investment/non-dvp-and-custody-digital-assets-031219-206 (the "**non-DVP Letter**"). The Associations are only commenting on non-DVP issues in this letter and not on digital assets issues.

[3] *See* Letter to Dalia Blass, then-Director, Division of Investment Management and Peter B. Driscoll, Director, Office of Compliance Inspections and Examinations, *IM Guidance Update No. 2017-01 - Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority*, from SIFMA AMG and the IAA (Mar. 7, 2018), available at https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/publications/SIFMA_AMG_IAA_Letter_to_SEC_Re_February_2017_Guidance_on_Custody.pdf ("**2018 Letter**"). We have engaged with the Staff for a long time on these issues and have previously provided information on controls that advisers typically have for non-DVP instruments.

[4] *See* Guidance Update, Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority (Feb. 2017), available at https://www.sec.gov/investment/im-guidance-2017-01.pdf (the "**Guidance Update**").

If the Staff takes the position that an adviser could have custody if the instruments it trades settle on a non-DVP basis, that position could sweep into the Custody Rule a broad swath of securities transfers and settlement processes and a significantly larger number of advisers than appears to be anticipated in the Staff's cost-benefit analyses in 2003 under its prior amendments to the Custody Rule. In fact, the Commission's failure to address non-DVP at all in its cost-benefit analysis underscores our assessment that the Staff's view in the Guidance Update is inconsistent with the position taken by the Commission in that rulemaking, and would effectively reverse the Commission's prior position.

The Staff seeks the public's views in order to help formulate a recommendation to the Commission as to regulatory actions that might be taken regarding an adviser's authority to issue instructions to effect trades that are not settled on a DVP basis. We note that the Custody Rule was never intended to, and generally does not, address the risks of ordinary settlement failures, which can occur in both DVP and non-DVP settlement processes and are reliant upon third parties, nor was custody ever intended to be dependent on how a transaction settles. Moreover, we do not agree with the implied premise of the non-DVP Letter and the Guidance Update – *i.e.*, that non-DVP settlement creates significant additional risk of misappropriation of client funds by advisers. As a result, we submit that it would be inappropriate for the Commission to rely on the Custody Rule to address ordinary settlement risk and that the Custody Rule should not use DVP or non-DVP settlement as a distinguishing factor in determining whether an adviser has custody in connection with authorized trading. We believe that, as long as trading is authorized, it was intended to be excepted from the Custody Rule regardless of the settlement mechanism.

To the extent that the Staff's concerns about non-DVP transactions are about the risks arising from unauthorized trading, as with settlement risk, the risk that an adviser will trade without proper authorization does not depend on whether the trade would settle DVP or not, and it does not make sense for the Staff to apply the Custody Rule solely based on how a transaction settles. Instead, the Commission should look to more effective tools within the Advisers Act framework to address risks that might arise from the specific way an instrument settles. We believe that, where trading is authorized, other risks, including risks of misappropriation, can be most effectively addressed by appropriate policies, procedures, and controls that are reasonably designed to protect client assets. This approach also allows advisers to better tailor to their particular circumstances the controls that are appropriate given the available settlement systems.

In light of this, we offer the following observations:

I. The Staff's position that authorized non-DVP trading gives an adviser custody is inconsistent with the Authorized Trading Exception expressly acknowledged by the Commission.

II. Non-DVP settlement standards and processes routinely and reliably result in full, on-time delivery of securities and corresponding payments, without evidence of increased opportunity for misappropriation.

III. The Custody Rule's requirements were not intended to depend on how a transaction is settled.

IV. The Custody Rule is unsuitable to address settlement risks.

I. The Staff's Position that non-DVP Trading Gives an Adviser Custody is Inconsistent with the Authorized Trading Exception Expressly Acknowledged by the Commission.

The Custody Rule provides that it is a fraudulent, deceptive, or manipulative act, practice or course of business under Section 206(4) of the Advisers Act for an investment adviser that is, or is required to be, registered under the Advisers Act to have "custody" over client funds or securities unless that adviser complies with certain requirements. Custody is defined in the Custody Rule as "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them." The Custody Rule further provides three examples of arrangements that constitute custody: (i) possession of client funds or securities, with certain exceptions; (ii) any arrangement (including a general power of attorney) under which the adviser is authorized or permitted to withdraw client funds or securities; and (iii) any capacity that gives the adviser or its supervised person(s) legal ownership of or access to client funds or securities.

The original purpose of the Custody Rule was to protect the funds and securities of advisory clients whose advisers have custody of their assets from unlawful activities of the adviser or its employees.[5] This statement of purpose has been refined and clarified over the years in subsequent releases to make clear that the Custody Rule is intended to prevent client assets "from being lost, misused, misappropriated or subject to the advisers' financial reverses."[6] Consistent with this purpose, the Commission designed the Custody Rule to provide additional safeguards where an adviser has the power to withdraw client funds or securities. The Custody Rule, however, was never intended to capture advisers that have ordinary trading authority, which is a fundamental and routine aspect of managing discretionary advisory accounts, regardless of the settlement mechanism of these ordinary course transactions. The principle that an adviser whose authority is limited to trading does not have the power to withdraw funds or securities is clearly recognized by the Commission in the 2003 Proposing Release and 2003 Adopting Release. Together with the refinement of the Commission's view of the purpose of the Custody Rule from its adoption in 1961 to the more recent amendments in 2003 and 2009, we believe that the Custody Rule is intended to address the specific risks associated with holding or transferring assets and not to broadly address every risk that could be associated with trading and settlement of transactions executed by an adviser pursuant to its ordinary trading authority.

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[5] Proposal to Adopt Rule 206(4)-2 under the Investment Advisers Act of 1940, Advisers Act Rel. No. 122 (Nov. 6, 1961).

[6] Custody of Funds or Securities of Clients by Investment Advisers, Advisers Act Rel. No. 2176 (Sept. 25, 2003) ("**2003 Adopting Release**"), n. 10; Custody of Funds or Securities of Clients by Investment Advisers, Advisers Act Rel. No. 2968 (Dec. 30, 2009) ("**2009 Adopting Release**").

We believe that the Commission's intent to exclude access to client funds as part of the settlement of transactions executed pursuant to authorized trading authority from the definition of "custody" is well evidenced by the 2003 rule amendments. In the 2003 Proposing Release, the Commission proposed, as its first example of custody, "possession or control" of client funds or securities.[7] Commenters expressed significant concerns that, without any modifier, the term "control" was ambiguous and could be interpreted to bring ordinary trading activity under the Custody Rule. Confronted by this potential unintended ambiguity, the Commission dropped "control" from the example and specifically stated in the 2003 Adopting Release that authority to transfer funds for the purpose of "authorized trading" would not constitute custody (the "**Authorized Trading Exception**").[8]

The Commission further grounded this concept of authorized trading in its explanation of the second example of custody that was added to the definition in 2003, noting that: "[this] example clarifies that an adviser has custody if it has the authority to withdraw funds or securities from a client's account. An adviser with power of attorney to sign checks on a client's behalf, to withdraw funds or securities from a client's account, or to dispose of client funds or securities ***for any purpose other than authorized trading*** has access to the client's assets."[9] The Authorized Trading Exception is further explained in two footnotes in the 2003 Adopting Release. In the first of these – footnote 5 – the Commission stated that custody includes authority to access client accounts for purposes ***other than*** authorized trading,[10] clearly acknowledging that effecting trades for a discretionary account as authorized by the client is understood to be a fundamental aspect of the advisory relationship and that any potential possession (or authority to obtain possession) of client funds or securities attendant to the trading or settlement process for those transactions so effected should not result in the adviser having custody. In the second of these – footnote 10 – the Commission stated unequivocally that "[a]n adviser's authority to issue instructions to a broker-dealer or custodian to effect ***or to settle*** trades does not constitute 'custody.'" This clear and absolute statement – that the Authorized Trading Exception applies whenever an adviser has the "authority to issue instructions . . . to effect or settle trades" – is followed by a single sentence that notes that most trades settle on the basis of delivery versus payment. In our view, this single observation about the commonness of one settlement method cannot fundamentally change the clear and absolute preceding statement by the Commission. In fact, the first of the sentences following the broad grant of the Authorized Trading Exception notes that trades "are ***generally*** [conducted] under instructions to [the client's custodian to]

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[7] Custody of Funds or Securities of Clients by Investment Advisers, Advisers Act Rel. No. 2044 (July 18, 2002) ("**2003 Proposing Release**").

[8] 2003 Adopting Release at n. 5.

[9] 2003 Adopting Release, text accompanying n. 10.

[10] "In our proposed rule, our first example of custody referred to 'possession or control' of client funds or securities, but commenters suggested that the term 'control' improperly suggested that an adviser that merely has trading authority over a client's securities account has custody for purposes of the rule. See infra note 10. We believe that the definition and other examples make it clear that an adviser has custody when it can control client funds or securities ***for purposes other than authorized trading***, and that the word 'control' is therefore not needed in the first example." (emphasis added) 2003 Adopting Release at n. 5.

transfer funds (or securities) out of a client's account only upon corresponding transfer of securities (or funds) into the account" and the next observes that "[t]his 'delivery versus payment' arrangement minimizes the risk that an adviser could withdraw or misappropriate the funds or securities in its client's custodial account." Neither of these explicitly limits the absolute statement with which the footnote begins to DVP settlement nor, as one might have expected if such a limit was intended, does the initial sentence include "generally" or some other indication that there would be times when such authority would constitute custody. It is our view that the Commission's observation that many trades settle on the basis of "delivery versus payment" is merely an example of a protection that distinguishes "authorized trading" from a general power of attorney of the type contemplated by the second example, but that this example in no way suggests that authorized non-DVP trading would be treated differently.

Nonetheless, the Staff now appears to read footnote 10, including in the Guidance Update and the non-DVP Letter, as suggesting that even if an adviser's authority is limited to "authorized trading," the adviser could still have custody when such authority relates to assets that trade and settle on a non-DVP basis. This recent view asserts, without regard for the overall context, that footnote 10 "does not address authorized trading of securities that do not settle on a delivery versus payment basis." However, as set forth above, a plain reading of the Commission's discussion in the 2003 Adopting Release does not support the apparent conclusion of the Staff that the Commission intended to limit the Authorized Trading Exception to only DVP settlements. Rather, the *absence* of any discussion in the 2003 Adopting Release of specific non-DVP settlement standards or practices suggests the opposite conclusion. Indeed, if it were the case that the 2003 Adopting Release intended to limit the Authorized Trading Exception to transactions that settle on a DVP basis, then we believe that the cost-benefit analysis accompanying the 2003 Adopting Release would have addressed non-DVP trading and reflected a significantly larger percentage of advisers as being subject to the amended rule.

Based on the unconditional statements in footnote 5 and the first sentence of footnote 10 of the 2003 Adopting Release, as well as the use of the word "generally" in the second sentence of footnote 10, the Associations have long understood that "authorized trading" includes – but is not limited to – trading that settles DVP. Footnote 10 does not indicate, nor has any other statement of the Commission indicated, that only the authority to issue trading instructions for assets that settle DVP is authorized trading for these purposes. That the Authorized Trading Exception did not discriminate based on settlement mechanics was such a settled understanding that no discussion of the concept of authorized trading was included in the 2009 Adopting Release. In reliance on the Commission's clear words in the 2003 Adopting Release, advisers have commonly engaged in non-DVP transactions on behalf of their clients all this time and have not understood those transactions to be subject to the Custody Rule.

Because the Staff's view that authorized trading creates custody if transactions are settled non-DVP is, in our assessment, inconsistent with the unqualified position taken by the Commission in the 2003 Adopting Release that authorized trading does not create custody and would effectively reverse the Commission's prior position, we believe that this position exceeds the Staff's authority.[11] Moreover, if it were to be adopted by the Commission, the Staff's current position could sweep into the Custody Rule a broad array of securities traded and settled on a non-DVP basis that are not commonly treated as creating custody, and with respect to which controls under other Advisers Act requirements would be more effective and appropriate.

The Associations believe that the 2003 Adopting and Proposing Releases, as a whole, reflect a clear intent to exclude authorized trading from the definition of custody without regard to the nature or timing of settlements, and that this view is consistent with the purpose of the Custody Rule, as set forth by the Commission in those releases. A substantial reversal of the well-understood position articulated in the 2003 Adopting Release would be counter-productive and largely ineffective to address any risks of misappropriation presented by non-DVP settlement.

II. Non-DVP Settlement Standards and Processes Routinely and Reliably Result in Full, On-time Delivery of Securities and Corresponding Payments, Without Evidence of Increased Opportunity for Misappropriation.

We also do not agree with the suggestion in the non-DVP Letter that non-DVP settlement processes are inherently less reliable than DVP settlement. DVP is not the only settlement standard that is reliable, and it is not the only settlement mechanism that contains settlement risk. However, the Custody Rule does not distinguish – nor should it distinguish – transactions on the basis of how they settle.

Advisers can be engaged to manage, and authorized to trade, a variety of instruments that settle differently. Many advisers are engaged and authorized by clients to provide discretionary advice and/or exercise trading authority in instruments such as derivatives, privately offered securities including interests in private funds, bank loans,[12] and foreign securities that do not settle on a DVP basis. For these advisers, and the clients who retain them, trades in these instruments are (and have long been) considered part of ordinary, authorized trading activities subject to reliable settlement processes and controls that have demonstrably improved over time. Transactions that do not claim to settle on a DVP basis routinely and reliably result in full, on-time delivery of securities and corresponding payments. In our view, an increase across the industry in non-DVP trading is not an indicator of greater risk-taking by advisers and clients as it relates to settlements but, rather, demonstrates the industry's increasing confidence in other settlement standards and a response to changes in market demand.

This is not to say there is no settlement risk. Reliable settlement of any transaction inherently involves implementing controls to mitigate settlement risk for all parties. Indeed, DVP is a principle developed by global banking, clearing, and settlement institutions to mitigate

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[11] Indeed, the Associations question whether such a position is consistent with ordinary notice and comment rulemaking.

[12] With respect to custody issues related to bank loans, see Letter to Paul Cellupica, *Custody Rule and Trading Controls Relating to Bank Loans*, from the Loan Syndications and Trading Association (July 22, 2019), available at https://www.sec.gov/files/loan-syndications-and-trading-association-072219.pdf ("**LSTA Letter**").

settlement risk for the institutions involved.[13] But it cannot eliminate settlement risk, which includes credit risk, including principal and liquidity risk, and potential systemic risks.[14]

In a DVP transaction, the clearing and settlement institution requires that settlement of a transaction be final. The clearing and settlement institution generally seeks to meet the DVP goal by establishing and implementing policies, procedures, and controls to ensure the finality of the transaction and to subject the transaction to risk management protocols.[15] While for DVP transactions, these risks are inherently of concern to banking, clearing and settlement institutions,[16] as we explain in Section III below, DVP settlement risk involves a fundamentally different set of concerns for advisers and their clients.

However, transactions in assets that settle pursuant to a non-DVP process are also generally subject to extensive policies, procedures, controls, and risk management protocols that are just as effectively designed to prevent loss and misappropriation. What the non-DVP letter describes as "non-DVP" settlement seems to include a wide range of securities transfers and settlement mechanisms that have been in existence under other names and conducted reliably for a long time. The Associations are concerned that limiting the Authorized Trading Exception only to those that the Staff views as DVP could sweep into the Custody Rule such routine ordinary course trading activities as posting funds or securities as margin to cover derivative positions and ordinary trading and settlement of syndicated bank loans. As described below, these processes are already subject to extensive controls, and the authority or control that an adviser may have as a result of trading in these assets on behalf of its clients is not the type of authority or control over client assets that was designed to be or is effectively addressed by the Custody Rule.

Examples that illustrate the ill fit of the Custody Rule with transactions that settle non-DVP are options, futures, swaps, and bank loans. With respect to options, when an investor writes an option to buy or sell securities, the investor may initially receive the contract price or premium for writing the option and then post margin (*i.e.*, pledge funds or securities to

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[13] However, as noted herein, the DVP mechanism does not eliminate settlement risk.

[14] *See* BIS, Delivery Versus Payment in Securities Settlement Systems, Sept. 1992.

[15] *See generally* Self-Regulatory Organizations; The Depository Trust Company; Order Granting Approval of Proposed Rule Change Relating to Processing of Transactions in Money Market Instruments, SEC Rel. No. 34-79764 (Jan. 9, 2017), available at https://www.sec.gov/rules/sro/dtc/2017/34-79764.pdf.

[16] *See* Standards of Covered Clearing Agencies, Final Rule SEC Rel. No. 34-78961 (Dec. 12, 2016) (adopting amendments to Rule 17Ad-22 and adopting Rule 12Ab2-2 under the Securities Exchange Act of 1934, as amended); Financial Markets Utilities, Regulation HH, Proposed Rule (Jan. 22, 2014) (79 Fed Reg. 3666) ("The settlement of a financial transaction by a designated FMU may involve the settlement of two linked transactions, such as the delivery of securities against payment of cash (i.e., DVP), delivery of securities against delivery of other securities (i.e., DVD), or the delivery of a payment in one currency against delivery of a payment in another currency (i.e., PVP). Substantial credit losses and liquidity pressures may result from the failure to complete the settlement of both sides of the linked obligations. Accordingly, under proposed § 234.3(a)(12), a designated FMU that settles transactions that involve the settlement of two linked obligations, such as a transfer of securities against payment or the exchange of one currency for another, must condition the final settlement of one obligation upon the final settlement of the other.").

collateralize that option). The Associations are concerned that in the context of the non-DVP letter, posting margin could be deemed to be non-DVP because the transfer of a security interest to the pledgee would occur without any corresponding payment at the time of transfer. Similarly, where an investor purchases an option to buy or sell securities, the investor pays a contract price or premium for that right, but is not guaranteed anything in return. The option could expire worthless if the strike or exercise price of the option is not reached. Even where the option expires in the money, the option holder must still exercise the option by either buying or selling the securities.

Futures contracts involve an agreement by a participant to buy or sell an asset at a certain price at a future date. When entering into the contract, a participant will post initial margin to its futures commission merchant. Market participants rarely take delivery of the underlying asset of the futures contract, so whether the futures contract investment is profitable to the participant depends on the change in the futures price during the term of the futures contract which is reflected in the daily exchange of variation margin as the contract is marked to market. Swaps trading operates in a similar fashion to futures trading. As with options, the Associations are concerned that the deposit of margin in a futures or swaps transaction by an advisory client could also be considered a non-DVP transaction. The margin requirements inherent in derivative transactions are part of a comprehensive regulatory framework designed to reduce counterparty risk, increase transparency, and promote market integrity. Collateral and margin requirements are in essence good-faith deposits that help ensure that each customer will abide by its agreements.[17] Collateral and margin transfers are subject to extensive documentation and controls and overseen by the Commodity Futures Trading Commission.

As discussed in greater detail in the LSTA Letter, purchases of syndicated loan interests are typically structured as assignments that settle on a non-DVP basis. After the credit agreement governing the loan has been executed, the assignment and assumption agreement effects the legal transfer of syndicated loan interests. Upon execution of the assignment agreement by the administrative agent, the client purchasing loan interests is recorded as a lender of record. Payment is only transmitted subsequently in accordance with wire instructions set forth in a funding memorandum generated by the settlement platform. However, the settlement process for syndicated loans includes extensive documentation and controls designed to reduce counterparty risks and settlement failures. As detailed in the LSTA Letter, the custodian for the buyer of a syndicated bank loan does not authorize the release of client funds for the purchase of loan interests unless the custodian receives all trade documentation and confirms that funds should be sent pursuant to the settlement instructions in the funding memorandum. The administrative agent for the loan syndicate performs its own due diligence on a buyer before the execution of any loan documentation, and the custodian for the seller of a syndicated loan is subject to, among other controls, obligations to match payables and receivables.[18]

[17] *See* U.S. Department of Labor, Letter to Melanie Franco Nussdorf, Steptoe & Johnson LLP, 2013-01A ERISA Sec. 3(21), 3(14), 406 PTE 84-14, PTE 96-23 (Feb. 7, 2013).

[18] LSTA Letter, supra n. 12.

The Associations believe that the robust processes and controls in place for non-DVP settlement of derivative and syndicated bank loan transactions are better tailored to the risks that are relevant to settlement of these transactions and thus more effective than pulling these transactions into the scope of the Custody Rule. There is little precedent for overlaying a whole settlement standard onto the Custody Rule, and in our view it would pose significant challenges without effectively addressing the Staff's concerns.

III. The Custody Rule's Requirements Were Not Intended to Depend on How a Transaction is Settled.

In the 2009 Adopting Release, the Commission stated its intent that the amended rule, "together with our examination program's increased focus on the safekeeping of client assets, will help deter fraudulent conduct, and increase the likelihood that fraudulent conduct will be detected earlier so that client losses will be minimized." The Commission's rationale for the Custody Rule never turned on a transaction's settlement method and the Staff's interpretation should not change that. In fact, the evolution of reliable settlement methods since 2009 includes many different non-DVP methods, each suitable to different types of authorized transactions. It is inevitable that new methods and processes will develop and evolve, and that settlement methods will continue to improve in the future. Given the variety of asset classes that investors rely on advisers to manage, each of these methods is essential to ordinary course authorized trading activity. The Custody Rule's requirements should not, and we believe that they were not intended to, hamper ordinary course settlement.

Likewise, the Custody Rule is neither an appropriate nor an effective means to address the risks of ordinary settlement failures. As noted above, any settlement process, whether DVP or non-DVP, is subject to some risk that a transaction will fail to settle for reasons outside of the adviser's control. Subjecting advisers whose authorized trading includes assets that settle through non-DVP transactions to the Custody Rule simply because of the settlement mechanism would impose costs and burdens on advisers (and their clients) that are not commensurate with any potential (although likely illusory) reduction in settlement risks that advisers do not create or control.

In the 2009 Adopting Release, the Commission acknowledged that "no set of regulatory requirements we could adopt will prevent all fraudulent activities by advisers or custodians."[19] Indeed, misappropriation can occur in an authorized non-DVP transaction, just as it can occur in an authorized DVP transaction. For example, an intermediary or counterparty could intentionally fail to deliver the security (or the payment) to the client's account, or could act contrary to the adviser's instructions. However, the risk of misappropriation in this circumstance should not be attributed to the adviser, nor would the Custody Rule protect against this third-party misconduct. Indeed, the watchful eyes of investment advisers can help guard against third-party misconduct in the settlement process. No professional investment adviser wants its client's transactions to experience delayed settlements or failed settlements, and there is no reason to assume that

[19] 2009 Adopting Release.

advisers that can or must settle on a non-DVP basis intend to create delayed settlements or failed settlements – or would be able to use a delayed or failed settlement to further a misappropriation. Accordingly, non-DVP settlement is an inaccurate measure for the risk of loss, misuse, or misappropriation by an adviser.

As noted above, many non-DVP settlement processes are already reasonably designed to mitigate the risk of loss of principal due to the failure of a counterparty or intermediary to deliver payment or securities to the correct accounts on a timely basis. For example, market participants serving investment advisers and their clients in the settlement of derivatives transactions are highly regulated institutions with robust systems and controls that accurately process, record, and settle transfers during the life of a derivative. Delayed or failed settlements of authorized trades are already routinely remediated in accordance with the institutions' systems, policies, procedures and controls without the need for applying the ill-fitting and significant burdens of the Custody Rule. These settlement systems and controls are real and significant mitigants against the risk of loss.[20]

IV. The Custody Rule is Unsuitable to Address Settlement Risk.

In the non-DVP Letter, the Staff expressed concern that non-DVP settlement creates a risk that "an investment adviser could misappropriate funds or securities in its client's custodial account." As noted above, we believe that these risks do not and should not be viewed as turning on how a transaction settles. The Staff's concerns in the non-DVP Letter seem better characterized as general misappropriation risks, but, because advisers seldom control the settlement process, misappropriation in connection with settlements is significantly more likely to be attributable to an intermediary or counterparty than to the adviser. In contrast to settlement risk, described above, which relates to a failure or delay in completing a transaction, misappropriation risk can be described generally as the risk of theft of a client's assets. Misappropriation risks arising from a non-DVP settlement process rest largely with third parties that advisers do not control.

The Staff also appears to be concerned with unauthorized trading risks in the context of non-DVP transactions. Unauthorized trading involves an adviser taking actions that are inconsistent with the adviser's contractual authority thereby subjecting a client's assets to loss. The Staff has previously characterized unauthorized trading as referring to a range of risks, including: (i) "rogue" or other unauthorized trading or trade execution in client accounts; (ii) exceeding firm limits on position exposures, risk tolerances and losses; (iii) intentional

[20] In fact, non-DVP settlement in many cases can be seen as safer than DVP settlement as a result of the involvement of highly sophisticated counterparties and other intermediaries that keep a watchful eye on authorized persons lists and would notice soon after a transaction if payment or delivery of securities failed.

mismarking of positions; and (iv) creating records of nonexistent (or sham) transactions.[21] Unlike settlement risk, unauthorized trading risk is largely within an adviser's control.

As fiduciaries, investment advisers place utmost importance on protecting client assets, regardless of the regulatory requirements or the settlement mechanism used, and we share the Staff's concerns with unauthorized trading. However, neither unauthorized trading nor misappropriation risk is dependent on whether settlement is DVP or non-DVP and we do not believe it makes sense to subject transactions to the Custody Rule based entirely on their settlement process.[22]

Although it is impossible to completely eliminate these risks for any transaction type, we share the Staff's desire for robust controls to limit both misappropriation and unauthorized trading risks, while still assuring that authorized transactions can proceed without undue burden. The Custody Rule, however, is not the best framework to address these types of risks. Rather, we believe that tailored internal controls pursuant to the Compliance Program Rule, Rule 206(4)-7 under the Advisers Act, are more appropriate and likely to be more effective. The Staff has previously recognized the potential effectiveness of such internal controls to address these risks,[23] and we urge the Staff to proceed under that framework rather than under the Custody Rule. By approaching these risks through the principles-based Compliance Program Rule rather than the more rigid Custody Rule, advisers will be able to more easily tailor their policies, procedures, and controls to their individual business and specific risks, regardless of the settlement method of a transaction. This should result in more effective protection for clients who hold and trade in assets that settle non-DVP, without undue cost or burden.[24]

V. Conclusion.

The Associations share the Staff's goal of ensuring that funds and securities of advisory clients whose advisers have custody are protected from unlawful activities of the adviser or its employees. However, we believe that assets that settle on a non-DVP basis create little or no significant additional risks of unlawful activity by an investment adviser or its employees that merit singling out these assets as creating "custody" based solely on the settlement mechanism. The Staff should also consider that an increase across the industry in non-DVP trading is not an indicator of greater risk-taking by advisers and clients as it relates to settlements but, rather, demonstrates the industry's increasing confidence in other settlement standards and a response to

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[21] National Examination Risk Alert: Strengthening Practices for Preventing and Detecting Unauthorized Trading and Similar Activities (Feb. 27, 2012) available at https://www.sec.gov/about/offices/ocie/riskalert-unauthorizedtrading.pdf ("**OCIE 2012 Risk Alert**").

[22] Not all non-DVP settlement mechanisms are the same or involve the same risks.

[23] OCIE 2012 Risk Alert, supra n. 21.

[24] Investment advisers are required, at a minimum, to establish and maintain policies and procedures that address, among other matters: (i) the safeguarding of client assets from conversion or inappropriate use by advisory personnel; and (ii) trading practices, including procedures by which the adviser satisfies its best execution obligation and allocates trades among clients.

changes in market demand. Given this backdrop, we believe that there are more effective ways to address the potential for misappropriation and unauthorized trading than amending the Custody Rule to reverse the position taken in the 2003 Adopting Release. In particular, we believe that investment advisers can better address these risks through reasonably designed policies, procedures, and controls that take into account the nature of the assets and the trading conducted by the adviser and the manner in which those trades are settled. We believe the Staff's prior guidance on unauthorized trading risk and corresponding policies and procedures may be a useful place to start in this regard.[25]

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[25] *Id.* OCIE 2012 Risk Alert, supra n. 21.

We commend the Staff for soliciting feedback on the Custody Rule. We are pleased to engage with the Commissioners and Staff when specific amendments to the Custody Rule are proposed. We appreciate the Staff's consideration of our comments in this letter and welcome the opportunity to discuss these matters further.

Sincerely,

By: Gail C. Bernstein
General Counsel
Investment Adviser Association

By: Timothy W. Cameron, Esq.
Asset Management Group – Head
and Managing Director
Securities Industry and Financial
Markets Association

By: Elliot Ganz
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cc: Michael Sherman, Dechert LLP
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Appendix A

About IAA

The IAA is the leading organization dedicated to advancing the interests of investment advisers. For more than 80 years, the IAA has been advocating for advisers before Congress and U.S. and global regulators, promoting best practices and providing education and resources to empower advisers to effectively serve their clients, the capital markets, and the U.S. economy. The IAA's 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 www.investmentadviser.org.

About SIFMA AMG

SIFMA AMG brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms whose combined assets under management exceed $45 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds. For more information, visit http://www.sifma.org/amg.

About LSTA

The LSTA is a not-for-profit trade association that is made up of a broad and diverse membership involved in the origination, syndication, and trade of commercial loans. The 350 members of the LSTA include commercial banks, investment banks, broker-dealers, hedge funds, mutual funds, insurance companies, fund managers, and other institutional lenders, as well as service providers and vendors. The LSTA undertakes a wide variety of activities to foster the development of policies and market practices designed to promote just and equitable marketplace principles and to encourage cooperation and coordination with firms facilitating transactions in loans. Since 1995, the LSTA has developed standardized practices, procedures, and documentation to enhance market efficiency, transparency, and certainty. For more information, visit www.lsta.org.