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

8 May 2023

**Re: Request for comment on Safeguarding Advisory Client Assets
(Release No. IA-6240; File No. S7-04-23)**

Dear Ms. Countryman:

Ernst & Young LLP is pleased to provide comments to the Securities and Exchange Commission (SEC or Commission) on its proposal on safeguarding advisory client assets.

Our comments address the Commission's proposed Rule 223-1 under the Investment Advisers Act of 1940 (Advisers Act) that would expand the scope of Rule 206(4)-2 under the Advisers Act (Custody Rule) beyond client funds and securities to include any client assets that are in a registered investment adviser's possession or that the adviser has discretionary authority to trade. The proposal would also add requirements for qualified custodians to obtain internal control reports and have asset verification procedures performed by independent public accountants and would modify the requirements for surprise examinations and notifications to the Commission by independent public accountants.

Scope of the proposed rule

The proposed rule would retain a scope exception for registered investment companies at 223-1(b)(5).¹ We recommend that the Commission clarify whether this scope exception applies to business development companies that elect to be regulated under the Investment Company Act of 1940 (1940 Act) but do not register under the 1940 Act.

Qualified custodian's internal control report

The proposed rule would require all qualified custodians to obtain a written internal control report that includes an opinion from an independent public accountant at least annually. The Commission requested comment on whether the proposed internal control report should be based on an assessment of the

¹ 223-1(b)(5) states *Registered investment companies. You are not required to comply with this section [(17 CFR 275.223-1)] with respect to the account of an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 to 80a-64)*

same control objectives outlined in the 2009 Accounting Guidance.² We recommend that the Commission broaden certain control objectives for securities or cash to include all client assets³ as required under the proposed rule. Additional control objectives are necessary in order to appropriately safeguard all client assets as required under the proposed rule.

For crypto assets, we recommend that the Commission add control objectives that (1) private keys are safeguarded from loss and/or misappropriation, (2) new digital asset onboarding is authorized and considers key requirements and risk factors, and (3) existing digital assets are monitored for potential forks. For crypto assets, privately offered securities (POS) and physical assets, we recommend that the Commission expand the reconciliation between custodian and depositories to include other relevant parties or sources (e.g., public blockchains).

Asset verification requirement of privately offered securities and physical assets

The proposed rule would require client assets managed by a registered investment adviser (RIA), but not held at a qualified custodian, to be subject to certain asset verification procedures⁴ by an independent public accountant. Given that the proposal would require all client assets except POS and physical assets to be held at a qualified custodian, asset verification procedures would apply only to these asset types. Specifically, the proposed rule would require an RIA to notify the independent public accountant with which it has a written agreement of any purchase, sale, or other transfer of beneficial ownership of POS or physical assets within one business day, and the independent public accountant would be responsible for performing verification procedures on such transactions promptly and for providing notification to the Commission within one business day upon finding any material discrepancy. The proposal would also require all assets not held by a qualified custodian to be verified during the course of the surprise examination or annual financial statement audit rather than permitting such procedures to be performed on a sample basis.

The proposed rule would not require a written report on verification or prescribe the type of service for verification of POS or physical assets (i.e., whether the verification is a form of assurance and, if so, the level of assurance required). If the Commission adopts the verification requirement as proposed, we recommend that the Commission clarify the service(s) that would satisfy this requirement in the adopting release in order to minimize confusion in the industry about the level of assurance provided or disparate treatment among similar RIAs. To assist the Commission in making this determination, we list possible services that can be performed in accordance with American Institute of Certified Public Accountants (AICPA) standards, along with the advantages and disadvantages, in the table below.

² See Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940.

³ The proposed rule would define “assets” as “funds, securities, or other positions held in a client’s account.”

⁴ We believe such procedures would provide evidence about the existence of clients’ assets and the rights and obligations associated with them.

Level/Type of service	Authoritative standards	Advantages	Disadvantages
<i>No separate report is issued; the results of the independent public accountant's verification procedures form, in part, the basis for another opinion</i>			
1. Surprise examination	AICPA's Attestation Standards (AT-C) 205 and AT-C 315	<ul style="list-style-type: none"> ▶ The services for surprise examinations and financial statement audits offer reasonable assurance (the highest level of assurance contemplated by the AICPA standards). ▶ The services for surprise examinations and financial statement audits are more cost effective than performing an agreed-upon procedures engagement or providing reasonable assurance because no separate reporting is required. ▶ The written agreement requirement for surprise examinations and financial statement audits can be satisfied by virtue of expanding the provisions of the existing engagement agreement. 	▶ No separate report is issued (i.e., the report is on the subject matter as a whole rather than on individual transactions).
2. Financial statement audit	AICPA's Auditing Standards (AU-C)		
<i>Separate report is issued with respect to the verification</i>			
3. Agreed-upon procedures	AICPA's AT-C 215	<ul style="list-style-type: none"> ▶ The report is clearly linked to each POS or physical asset transaction. 	<ul style="list-style-type: none"> ▶ This service does not offer assurance. ▶ The procedures may need to be customized for every transaction. ▶ This service may cost more than a surprise examination or financial statement audit because cost relates to the need for a separate engagement under the standards with separate reporting requirements for each verification. ▶ There could be a significant number of reports if the volume of transactions is high.
4. Reasonable assurance ⁵	AICPA's AT-C 205	<ul style="list-style-type: none"> ▶ The report is clearly linked to each POS or physical asset transaction. ▶ The report offers reasonable assurance, which is the highest level of assurance offered under the AICPA standards. 	<ul style="list-style-type: none"> ▶ This service may cost more than a surprise examination, financial statement audit, or agreed-upon procedures engagement because cost relates to the level of assurance provided and the need for a separate engagement under the standards with separate reporting requirements for each verification. ▶ There could be a significant number of reports if the volume of transactions is high.

⁵ A limited assurance service option is not included in the table because (1) AICPA attestation standards do not permit limited assurance over compliance (AICPA's AT-C 210.07) and (2) we do not believe it would achieve the Commission's objectives.

We believe that options 1 and 2 above (surprise examination and financial statement audit) accomplish the Commission's objective of verifying the existence of assets and deterring fraudulent conduct by advisers. We do not believe the proposed asset verification procedures would add meaningful additional protections, and we believe they would be costly. As noted in the proposal, POS and physical assets, such as real estate and commodities, are not as likely to be subject to misappropriation. With the proposed rule's expanded definition of custody and expanded ability of financial statement audits to be used to satisfy the rule, surprise examinations and financial statement audits would become more prevalent in practice than they are today, and we believe these services would meet the Commission's stated objectives as mentioned above.

As part of a surprise examination and financial statement audit, an independent public accountant has access to all books and records to test the completeness and accuracy of transactions and obtains sufficient appropriate evidence, including evidence obtained on a sample basis to support the existence of assets, in order to express an opinion on the financial statements as a whole. We believe the Commission should require verification procedures substantially in the form used by independent public accountants pursuant to the 2009 Accounting Guidance, which allows for the use of sampling in the completion of surprise examination procedures, rather than the proposed form of verification and asset tracing, which would require 100% asset verification. This would better align with the AICPA standards, which require reasonable assurance^{6, 7} rather than absolute assurance. Independent public accountants regularly use sampling methods⁸ in the course of financial statement audits. Such methods form the basis for testing that is designed to be both effective and efficient, thereby enabling the independent public accountant to focus on matters most impactful to the users of the surprise examination attest report and financial statements.

We believe the proposed asset verification requirement has other disadvantages. Specifically, an independent public accountant performing procedures to meet the proposed asset verification requirement would only have access to transactions that are reported to them and would not review a complete population at the time the asset verification procedures are required to be performed. As a result, there may be a risk of overreliance on individual transaction detail. Additionally, performing asset verification procedures on 100% of all transactions, in addition to 100% asset verification procedures during the course of the surprise examination or financial statement audit, would be costly because it would require significant additional time to test potentially immaterial transactions and asset balances. This additional time would be incurred by staff members to complete and document the work, and multiple senior audit team members would need to be involved to provide appropriate

⁶ AICPA's AT-C 315.11 states that the practitioner should seek to obtain reasonable assurance that the entity complied with the specified requirements, in all material respects. AICPA's AT-C 105.12 defines reasonable assurance as a high, but not absolute, level of assurance.

⁷ AICPA's AU-C 200.06 states that the auditor obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high, but not absolute, level of assurance because there are inherent limitations of an audit that result in most of the audit evidence being persuasive rather than conclusive.

⁸ AICPA's AU-C 530.05 defines audit sampling (sampling) as the selection and evaluation of less than 100% of the population of audit relevance such that the auditor expects the items selected (the sample) to be representative of the population and, thus, likely to provide a reasonable basis for conclusions about the population. Audit sampling can be applied using either statistical or nonstatistical sampling approaches.

supervision and review.^{9, 10} Further, the timing and extent of the proposed verification procedures generally would not be commensurate with the level of risk of misstatement or misappropriation of POS and physical assets.

Another disadvantage is that the additional time incurred to perform the asset verification procedures would occur at or near the time of each transaction, which could either disrupt the timing of surprise examination and financial statement audit timelines or require the participation of additional audit team members, both of which would increase costs to RIAs. Additionally, as observed in the proposal's Economic Analysis, the higher demand for independent public accountant resources created as a result of the proposed asset verification procedures could increase the cost of independent public accountant services overall without a commensurate benefit to relevant stakeholders.

However, in response to the Commission's request for comment, if the Commission were to require the proposed form of verification and asset tracing, we believe there are benefits to using the same independent public accountant to both verify privately offered securities and physical assets and conduct the annual surprise examination or financial statement audit. This approach would likely be more cost effective because, in connection with performing a surprise examination or a financial statement audit, an independent public accountant obtains an understanding of the adviser's business, processes and risks related to client assets. This understanding better enables the independent public accountant to identify the most reliable evidence available in the circumstances of the engagement. This approach would also be more efficient and cost effective because certain procedures, such as vendor evaluation and assessment of independence, would have already been performed. However, we do not take a position on whether the Commission should require that the same independent public accountant verify privately offered securities and physical assets and conduct the annual surprise examination or financial statement audit.

We also do not take a position on the Commission's proposal to require that an independent public accountant, rather than an independent representative, perform verification procedures of POS and physical assets. We observe, however, that an independent public accountant is required to follow a robust set of attestation or auditing standards when executing assurance and agreed-upon procedures engagements (i.e., AICPA attestation or auditing standards). If the Commission amends the final rule to allow independent representatives to perform verifications of POS and physical assets, in order to avoid confusion regarding the nature of the procedures being followed and assurance being provided, we recommend that the Commission consider requiring the independent representative to have expertise in providing assurance services and that they be subject to requirements (e.g., qualifications of the service provider, standards to be followed, disclosures to be made) similar to those in the Commission's proposed rule *The Enhancement and Standardization of Climate-Related Disclosures for Investors*.¹¹

⁹ AICPA's AU-C 300.11 indicates that the auditor should plan the nature, timing, and extent of direction and supervision of engagement team members and the review of their work.

¹⁰ AICPA's AT-C 105.35 indicates that the engagement partner should take responsibility for the overall quality on each attestation engagement, including responsibility for the engagement being planned and performed (including appropriate direction and supervision) and reviews being performed in accordance with the firm's review policies and procedures and reviewing the engagement documentation.

¹¹ See [comment letter](#) from Ernst & Young LLP dated 17 June 2022.

Additionally, if the Commission were to require the proposed form of verification and asset tracing, we recommend that the Commission clarify whether an independent public accountant engaged for a financial statement audit would need to verify all POS and physical assets as of a fund's fiscal year-end or whether the procedures could be performed as of an interim date based on audit strategies employed. Interim procedures are frequently performed by independent public accountants in the course of completing financial statement audits, which allows for earlier identification of issues with an update at year-end as needed.

In response to the Commission's request for comment on whether a timeline of one or two business days would be sufficient for completing such verification procedures, we believe that such a timeline would generally not be sufficient, given the need to gather and document appropriate evidence and complete supervision and review in accordance with AICPA standards. The verification procedures would require staff to complete the work, as well as more senior resources to perform supervision and review. The extent of evidence (e.g., purchase agreement, deed, title for real estate) and timing of the availability of evidence between trade and settlement dates may vary greatly for the broad array of physical assets and POS that may be covered by the proposed rule. In our experience, the evidence needed to perform such asset verification procedures can be extensive, and there may be a lag in timing due to the availability of evidence as documents are signed, records are updated, and cash is transferred. Procedures vary greatly depending on the facts and circumstances, and timelines may range from one to two business days to multiple weeks, depending on the audit evidence needed and whether it must be obtained from domestic or foreign third parties.

Surprise examinations

The proposed rule discusses an exception to the surprise examination requirement for RIAs whose sole basis for having custody is the RIA's discretionary authority over client assets, which is limited to instructing the client's qualified custodian to transact in assets that settle only on a delivery versus payment (DVP) basis. We recommend that the Commission clarify whether DVP assets should be subject to the independent accountant's procedures during a surprise examination when an RIA has custody over both DVP assets and non-DVP assets in the same client account. Additionally, we recommend that the Commission clarify whether more than one surprise examination needs to be performed if more than one RIA is deemed to have custody over the same group of client assets. For example, there may be situations where both an RIA and a sub-adviser are deemed to have custody over the same pool of assets. In such a situation, we recommend that the Commission clarify whether one surprise examination and Form ADV-E submission would suffice or whether two would be required.

We recommend the Commission clarify the scope of surprise examination procedures relevant to the new rules and more narrowly tailor required surprise examination procedures to the most relevant parts of the new rules. The 2009 Accounting Guidance specified that the surprise examination to be performed by an independent public accountant should cover the RIA's compliance with Rule 206(4)-2(a)(1) and Rule 204-2(b) under the Advisers Act. Rule 206(4)-2 would be redesignated and broadened by Rule 223-1, and Rule 204-2(b) would be broadened under the proposal. We believe the current surprise examination procedures as outlined in the 2009 Accounting Guidance achieve the Commission's objectives of providing a deterrent against fraudulent conduct by RIAs and are sufficient to detect misappropriation of assets. As such, we recommend that the Commission clarify that surprise examination procedures should test compliance with proposed Rule 204-2(b)(2)(v) *Transaction and*

position information and the portion of proposed Rule 223-1(a)(1)(i) that requires client assets to be maintained with a qualified custodian because these two portions of the proposed rules most closely align with the current surprise examination requirements. We do not believe that an independent public accountant can or should test the RIA's reasonable belief that various provisions of the written agreement under Rule 223-1(a)(1)(i) have been implemented.¹² Additionally, requiring a surprise examination to cover the RIA's compliance with Rule 223-1(a)(1)(i) and Rule 204-2(b) in their entirety would be costly and would go beyond the stated objectives of a surprise examination. Further, to the extent that the 2009 Accounting Guidance is updated to reflect changes from the proposal, we recommend the updated guidance be exposed for public comment.

Commission notification by independent public accountants

The proposed rule would require an independent public accountant that completes a financial statement audit, surprise examination or independent verification to notify the Commission electronically in the following situations: (1) within one business day of issuing an audit report to the entity that contains a modified opinion; (2) within four business days of resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed; (3) within one business day upon finding any material discrepancies during the course of performing its verification procedures; and (4) within one business day upon finding any material discrepancies during the course of the surprise examination.

Material discrepancy

The Commission requested comment on whether the material discrepancy requirement is clear and whether the SEC should provide guidance regarding how independent public accountants should make the materiality determination. While the 2009 Accounting Guidance defines a material discrepancy for purposes of the surprise examination, we recommend that the Commission define what a material discrepancy is for purposes of the asset verification requirement. The 2009 Accounting Guidance refers to the definition of material noncompliance under AICPA's AT 601,¹³ which is an attestation standard appropriate for a surprise examination. However, these asset verification procedures may also be used in completion of a financial statement audit, which uses concepts of financial statement materiality rather than compliance with a rule or regulation. There are specific requirements for RIAs that an independent public accountant may test for compliance with certain SEC rules and regulations in the course of completing a surprise examination; however, there are no requirements under the proposed rule specific to asset verification that an independent public accountant would test for compliance, with the exception of the one-day notification requirement for RIAs.

Additionally, we recommend that the Commission clarify the definition of the term material discrepancy to avoid the reporting of numerous material discrepancies that would be unrelated to misappropriation of assets and may not be of benefit to the Commission. For example, if an

¹² AICPA's AT-C 105.27(b)(ii) requires an independent public accountant to determine that the criteria for an examination engagement are suitable in order to accept such an examination. Evaluation of an RIA's reasonable belief would likely not meet the measurability characteristic of suitable criteria under AICPA's AT-C 105.A44, which requires reasonably consistent measurements, qualitative or quantitative, of underlying subject matter.

¹³ This is currently AICPA's AT-C 315.

independent public accountant interpreted the definition of material discrepancy to be not in compliance with the proposed rule, material discrepancies may be reported each time an RIA provided notification of a transaction in two business days rather than one.

Further, we believe that the Commission should revise the definition of a material discrepancy for purposes of the surprise examination. Currently, independent public accountants are required to provide a notification to the Commission for material discrepancies related to non-compliance with Rule 206(4)-2 (i.e., the entire Custody Rule) or Rule 204-2(b) under the Advisers Act. We recommend that independent public accountants be required to provide a notification to the Commission for material discrepancies related to non-compliance with the specific provisions of the Advisers Act with which independent public accountants test compliance in the course of their surprise examinations. We further recommend that the Commission clarify that material discrepancies should be reported for the period covered by the surprise examination engagement period.

Notification requirement

The Commission also requested comment on whether the written agreement between the adviser and the independent public accountant should require the independent public accountant to notify the Commission within one business day upon finding any material discrepancies during the course of its examination, within one business day upon issuance of a modified opinion, and within four business days of resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed. Consistent with our comment letter on proposed Rule 206-(4)(10) under the Advisers Act (Private Fund Comment Letter),¹⁴ we agree that the Commission should be notified in these situations. However, we believe that the adviser, rather than the independent public accountant, should be responsible for notifying the Commission if any of these events occur, consistent with Rule 17a-5(f)(3) and other existing SEC requirements, since the adviser is principally responsible for compliance with the proposed rule. We note that upon an auditor termination, both Rule 17a-5(f)(3) for broker-dealers and Item 4.01 of Form 8-K for issuers impose on the registered entity the primary responsibility for direct communications with the Commission. That is, the registered entity is required to make certain disclosures, and the auditor is required to provide the entity with a letter for it to file with the Commission stating whether the auditor agrees with the statements made by the entity or, if not, stating which statements the auditor does not agree with.

Similarly, if an issuer is advised by or receives notice from its auditor that disclosure should be made or action should be taken to prevent future reliance on a previously issued audit report or completed interim review related to previously issued financial statements, Item 4.02 of Form 8-K requires the issuer to make certain disclosures and the auditor to provide the issuer with a letter for it to file with the Commission stating whether the auditor agrees with the statements made by the issuer or, if not, stating which statements the auditor does not agree with. Likewise, under Rule 17(a)(5)(h), a broker-dealer is required to notify the Commission of certain serious noncompliance with the financial responsibility rules or material weaknesses; the auditor is only required to notify the Commission if the broker-dealer does not self-report or the auditor disagrees with the broker-dealer's notification.

¹⁴ See [comment letter](#) from Ernst & Young LLP dated 25 April 2022.

Auditing standards for foreign entity financial statements

Consistent with the Custody Rule, the proposed rule would require audits to be performed in accordance with US generally accepted auditing standards (US GAAS).¹⁵ Consistent with the Private Fund Comment Letter, we believe the proposed rule should explicitly allow foreign entity financial statements to be audited in accordance with the International Standards on Auditing (ISAs), which are high-quality auditing standards that are widely accepted worldwide and largely converge with US GAAS.

If the Commission were to adopt the proposed rule without modification and not provide for the use of the ISAs, investors in foreign entities whose financial statements are currently audited in accordance with the ISAs may incur additional costs to obtain an audit that is also performed in accordance with US GAAS. We believe the differences between US GAAS and the ISAs are not of such significance to warrant the incremental cost of requiring audits of the financial statements of foreign entities to be performed in accordance with US GAAS. Also, auditors in foreign jurisdictions who customarily perform audits in accordance with the ISAs would have to become proficient in US GAAS to perform a high-quality US GAAS audit along with the ISA audit already being performed.

Independence requirements for independent public accountants – transition

Consistent with the Custody Rule, the proposed rule would define “independent public accountant” to mean a public accountant that meets the standards of independence described in Rules 2-01(b) and (c) of Regulation S-X (SEC independence requirements). Currently, independent public accountants of private funds and qualified custodians whose financial statements and internal control reports, respectively, are not used to satisfy the Custody Rule and who are not otherwise required to comply with SEC independence requirements instead comply with the independence requirements contained in the relevant auditing and attestation standards they use to audit the private fund’s financial statements and examine the qualified custodian’s internal control report (e.g., AICPA independence rules).

The Commission proposed a one-year transition for RIAs with more than \$1 billion in regulatory assets under management or an 18-month transition for RIAs with up to \$1 billion in regulatory assets under management for compliance with the proposed rule. Consistent with the Private Fund Comment Letter, if the Commission were to adopt the proposed rule, we recommend that the Commission extend, for at least one additional year, the transition period for compliance with the SEC independence requirements for private funds and qualified custodians whose independent public accountants are not already subject to SEC independence requirements. This would provide sufficient time for private funds and qualified custodians and their independent public accountants to properly assess independence, as well as for private funds and qualified custodians to hire an independent public accountant that meets SEC independence requirements if the private funds and qualified custodians and their existing independent public accountants are unable to terminate timely any services or relationships that would be inconsistent with SEC independence rules.

¹⁵ An audit that is conducted in accordance with both US GAAS and the auditing standards of the Public Company Accounting Oversight Board would also satisfy the proposed rule.

For example, if the Commission were to adopt a final rule that would become effective in 2023, the compliance date would be one year or 18 months after the effective date, which would result in a compliance date in 2024 or 2025. Since an independent public accountant must begin to comply with SEC independence requirements as of the beginning of the earlier of the audit period or the professional engagement period, this would mean that, for purposes of the audited financial statements of a private fund and the internal control report of a qualified custodian for the year ended 31 December 2024, an independent public accountant that is not independent in accordance with SEC independence requirements would need to become compliant no later than 1 January 2024. That may not provide sufficient time for the private fund or qualified custodian and its independent public accountant to properly assess the independent public accountant's independence and for the private fund or qualified custodian to hire an independent public accountant that meets SEC independence requirements if the private fund or qualified custodian and its existing independent public accountant are unable to terminate timely any services or relationships that would be inconsistent with SEC independence rules.

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We would be pleased to discuss our comments with the Commission or its staff at its convenience.

Very truly yours,



Copy to:

Mr. Jenson Wayne, Chief Accountant, Division of Investment Management
Mr. Paul Munter, Chief Accountant, Office of the Chief Accountant