SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 275 and 279

[Release No. IA-6240; File No. S7-04-23]

RIN 3235-AM32

Safeguarding Advisory Client Assets

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission ("Commission" or "SEC") is proposing a new rule under the Investment Advisers Act of 1940 ("Advisers Act" or "Act") to address how investment advisers safeguard client assets. To effect our redesignation of the current custody rule for the proposed new safeguarding rule, we are proposing to renumber the current rule. In addition we are proposing to amend certain provisions of the current custody rule for enhanced investor protections. We also are proposing corresponding amendments to the recordkeeping rule under the Advisers Act and to Form ADV for investment adviser registration under the Advisers Act.

DATES: Comments should be received on or before [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments*:*

- Use the Commission's internet comment form (*https://www.sec.gov/rules/submitcomments.html*); or
- Send an email to *rule-comments@sec.gov*. Please include File Number S7-04-23 on the subject line.

Paper Comments*:*

- Send paper comments to Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-04-23. This file number should be included on the subject line if email is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's website (https://www.sec.gov/rules/proposed.shtml). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Operating conditions may limit access to the Commission's Public Reference Room. All comments received will be posted without change. Persons submitting comments are cautioned that the Commission does not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly.

Studies, memoranda, or other substantive items may be added by the Commission or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on the Commission's website. To ensure direct electronic receipt of such notifications, sign up through the "Stay Connected" option at *www.sec.gov* to receive notifications by email.

FOR FURTHER INFORMATION CONTACT: Shane Cox, Laura Harper Powell, Michael Schrader, and Samuel Thomas, Senior Counsels; Holly H. Miller, Senior Financial Analyst; Alex Bradford and Michael Republicano, Assistant Chief Accountants; Christopher Staley, Branch Chief; and Melissa Roverts Harke, Assistant Director at (202) 551- 6787 or IArules@sec.gov,

Investment Adviser Regulation Office, Division of Investment Management, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Commission is proposing for public comment to amend and renumber 17 CFR 275.206(4)-2 (rule 206(4)-2) under the Investment Advisers Act of 1940 [15 U.S.C. 80b-1 *et seq*.] to redesignate it as rule 17 CFR 275.223-1 (rule 223-1) under the Advisers Act, and make corresponding amendments to 17 CFR 275.204-2 (rule 204-2) and 17 CFR 279.1 (Form ADV) under the Advisers Act.[1]

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[1] 15 U.S.C. 80b. Unless otherwise noted, when we refer to the Advisers Act, or any section of the Advisers Act, we are referring to 15 U.S.C. 80b, at which the Advisers Act is codified, and when we refer to rules under the Advisers Act, or any section of these rules, we are referring to title 17, part 275 of the Code of Federal Regulations [17 CFR 275], in which these rules are published.

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I. INTRODUCTION

A. Background

Rule 206(4)-2 under the Act (the "custody rule" or "current rule") regulates the custodial practices of advisers. Although the Commission has amended the rule over time as custodial and advisory practices have changed, since its adoption it has been designed to safeguard client funds and securities from the financial reverses, including insolvency, of an investment adviser and to prevent client assets from being lost, misused, stolen, or misappropriated.[2]

As originally adopted in 1962, the rule required all investment advisers with "custody" (*i.e.*, physical possession) of client funds and securities to deposit client funds in a bank account that was maintained in the adviser's name and contained only client funds.[3] Advisers, in

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[2] *See* Custody or Possession of Funds or Securities of Clients, Investment Advisers Act Release No. 123 (Feb. 27, 1962) [44 FR 2149 (Mar. 6, 1962)] ("1962 Adopting Release"). *See also* Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2176 (Sept. 25, 2003) [68 FR 56692 (Oct. 1, 2003)] ("2003 Adopting Release"); Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2044 (Jul. 18, 2002) [67 FR 48579 (Jul. 25, 2002)], at nn. 3, 15 ("2002 Proposing Release").

[3] As with the current rule, the proposed amendments would apply to investment advisers registered, or required to be registered, with the Commission. However, the original rule was broader in scope, applying to "all investment advisers," until it was amended in 1997. Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1633 (May 15, 1997) [62 FR 28112 (May 22, 1997)], at section II.I.5. Unless otherwise indicated, references throughout this release to "adviser" or "investment adviser" refer to investment advisers registered, or required to be registered, with the Commission. Further, we have previously stated, and would continue to take the position (if these amendments were adopted), that most of the substantive provisions of the Advisers Act do not apply with respect to the non-U.S. clients (including funds) of a registered offshore adviser. This approach was designed to provide appropriate flexibility where an adviser has its principal office and place of business outside of the United States. We believe it would be appropriate to continue to apply this approach, including in the proposed safeguarding rule context (if adopted). For an adviser whose principal office and place of business is in the United States (onshore adviser), the Advisers Act and rules thereunder, including the proposed safeguarding rule, would apply with respect to the adviser's U.S. and non-U.S. clients. *See* Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Release No. IA-3222 (June 22, 2011) [76 FR 39645 (July 6, 2011)] (Most of the substantive provisions of the Advisers Act do not apply to the non-U.S. clients of a non-U.S. adviser registered with the Commission.); Registration Under the Advisers Act of Certain Hedge Fund Advisers, Release No. IA-2333 (Dec. 2, 2004) [69 FR 72054, 72072 (Dec. 10, 2004)] ("Hedge Fund Adviser Release") (stating (1) that the following rules under the Advisers Act would not

addition, were required to segregate client securities and hold them in a "reasonably safe" place. In each case, the rule required investment advisers to provide their clients notice of these protocols and to engage an independent public accountant to conduct an annual surprise examination[4] to verify client funds and securities independently. These requirements were designed to protect client assets at a time when the system for owning and transacting in securities was paper-based.

The Commission amended the rule in 2003 to expand the definition of custody beyond physical possession to include situations in which an adviser had any ability to obtain possession of client funds or securities. The 2003 amendments made clear that the rule applied to any investment adviser "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them."[5] It included three illustrative examples in the rule's definition of "custody": (1) possession of client funds or securities, even briefly; (2) authority to withdraw funds or securities from a client's account; and (3) any capacity that gives the adviser legal ownership of, or access to, client funds or securities.[6] In the adopting release, the Commission stated this expansion of the concept of adviser custody would not include

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apply to a registered offshore adviser, assuming it has no U.S. clients: compliance rule, custody rule, and proxy voting rule; (2) stating that the Commission would not subject an offshore adviser to the rules governing adviser advertising [17 CFR 275.206(4)-1] or cash solicitations [17 CFR 275.206(4)-3] with respect to offshore clients; and (3) noting that U.S. investors in an offshore fund generally would not expect the full protection of the U.S. securities laws and that U.S. investors may be precluded from an opportunity to invest in an offshore fund if their participation would result in full application of the Advisers Act and rules thereunder, but that a registered offshore adviser would be required to comply with the Advisers Act and rules thereunder with respect to any U.S. clients it may have).

4 The terms "surprise examination" and "independent verification" are used throughout the release and are generally interchangeable.

5 *See* rule 206(4)-2(a). *See also* rule 206(4)-2(d)(v)(2) (defining "custody"). The original rule did not define "custody," which was conceptualized at that time as limited to physically holding securities.

6 *See id.*

authorized trading, however, stating that clients' custodians are generally under instructions to transfer funds or securities out of a client's account only upon a corresponding transfer of securities or funds into the account.[7]

In recognition of then-modern custodial practices, the Commission in 2003 required advisers to keep securities (not just funds as under the 1962 rule) with a custodian, and it expanded the types of custodians that would qualify under the rule.[8] The Commission expressed concern that some advisers were still keeping certificates in office files or safety deposit boxes, which put those securities at risk.[9] The Commission identified as "qualified custodians" the types of regulated financial institutions that customarily provided custodial services subject to regulatory examination.[10] The Commission also relied more on the protections of qualified custodians, eliminating the adviser's need to undergo the rule's annual surprise examination by an independent public accountant if the adviser had a "reasonable belief" that the qualified custodian would provide account statements directly to the adviser's clients. The Commission provided an exception, however, from the requirement to maintain client securities with a qualified custodian after commenters had pointed out that, *on occasion*, a client may purchase privately offered securities where the only evidence of the client's ownership was recorded on the issuer's books and the transfer of ownership requires the consent of the issuer or the holders of the issuer's outstanding securities. As a result, commenters argued that it was difficult to

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7 *See* 2003 Adopting Release at note 10 and accompanying text.

8 *See* 2003 Adopting Release *supra* footnote 2, at section I.

9 *See* 2002 Proposing Release, at section II.B.

10 The financial institutions identified by the Commission were broker-dealers, banks and savings associations, futures commission merchants, and certain foreign financial institutions. *See* 2003 Adopting Release at II.B.

maintain certain of these assets in accounts with qualified custodians. The Commission noted that these impediments to transferability along with the conditions it imposed in the privately offered securities exception ("privately offered securities exception"), including in some cases obtaining and distributing audited financial statements ("the audit provision"), provided external safeguards against the kinds of abuse the rule seeks to prevent.

The Commission most recently amended the rule in 2009 after several enforcement actions against investment advisers, including actions stemming from the frauds perpetrated by Bernard Madoff and Allen Stanford (which also resulted in criminal convictions), alleging fraudulent conduct that included, among other things, misappropriation or other misuse of client assets involving certain affiliates of the adviser.[11] These cases underlined additional risks both

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[11] *See* Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2968 (Dec. 30, 2009) [75 FR 1455 (Jan. 11, 2010)], at n.1 ("2009 Adopting Release") (referring to the cases cited in Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2876 (May 20, 2009) [74 FR 25353 (May 27, 2009)] ("2009 Proposing Release")). *See also* Judgment, ECF Doc No. 100, 4, *United States v. Madoff, No. 09 Cr. 213 (S.D.N.Y. June 29, 2009)* (Bernard L. Madoff pled guilty to eleven felony charges including securities fraud, investment adviser fraud, mail fraud, wire fraud, three counts of money laundering, false statements, perjury, and making false filings with the SEC); Order Granting Motion for Summary Judgment, *SEC v. Stanford International Bank, Ltd., et al*., Civil Action No. 3:09-CV0298 (N.D. Tex. Apr. 25, 2013) (the SEC obtained a $5.9 billion judgment against R. Allen Stanford who was convicted in a parallel criminal case of conspiracy to commit mail and wire fraud, four counts of wire fraud, five counts of mail fraud, one count of conspiracy to obstruct an SEC investigation, one count of obstruction of an SEC proceeding, and one count of conspiracy to commit money laundering and sentenced to a total of 110 years in prison); *SEC v. WG Trading Investors, L.P.*, 09-CV-1750 (S.D.N.Y. July 29, 2010) (involving a broker-dealer and affiliated registered adviser that orchestrated a fraudulent investment scheme misappropriating as much as $554 million and sending clients misleading account information); *Isaac I. Ovid*, SEC Admin. Proceeding No. 3-14313 (Mar. 30 2011) (registered investment adviser and manager of purported hedge funds, pled guilty in parallel criminal proceeding in connection with which he was required to pay restitution in excess of $12 million); *Young and Acorn Capital Management, LLC*, SEC Admin. Proceeding No. 3-14654 (Feb. 28 2012) (registered investment adviser and its principal convicted of misappropriating $95 million in a Ponzi scheme in a parallel criminal case whereupon the SEC issued an order revoking the adviser's registration and barred the principal from association with an investment adviser, broker, dealer, municipal securities dealer, or transfer agent); *SEC v. The Nutmeg Group, LLC, et al.*, Litigation Release No. 24677 (Nov. 26, 2019) (commingled investor funds with his personal assets, implemented flawed internal systems and methods for valuing and reporting assets under management, and transferred millions of dollars out of the investment pools to himself and companies controlled by family members).

when an adviser has access to client funds or securities not explicitly covered within the scope of the rule, as well as when the qualified custodian is a related person of the adviser. In direct response to certain of these cases, the 2009 amendments explicitly extended the scope of the rule to reach an adviser's ability to access client funds or securities through its related persons, expanded the circumstances in which a surprise examination is necessary, and required advisers to obtain an independent accountant's report evaluating internal controls related to custody where the adviser or its related person serves as qualified custodian.[12]

Following the Madoff and Stanford frauds, and on the heels of the Commission's recently adopted 2009 amendments to the custody rule, Congress expressly vested the Commission with authority to promulgate rules requiring registered advisers to take steps to safeguard client assets over which advisers have custody by adding section 223 to the Advisers Act in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[13] Leading up to the enactment of the Dodd-Frank Act, Congress heard testimony that certain client investments were not covered by the custody rule because they were neither funds nor securities, putting them at greater risk of loss, theft, misappropriation, or being subject to the financial reverses of an adviser.[14] Congress also heard testimony about the important role requiring advisers to maintain

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12 *See generally* rule 206(4)-2; *see also* 2009 Adopting Release, *supra* footnote 11, at sections II.A and B.

13 *See* Section 411 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (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." 15 U.S.C. 80b-18b). Congress also required the U.S. Government Accountability Office to study the rule's compliance costs. *See id.* at Section 412.

14 *See* Regulating Hedge Funds and other Private Investment Pools, Hearing Before the House Subcommittee on Securities, Insurance, and Investment, 111 Cong. 50-51 (2009) (Statement of James S. Chanos, Chairman, Coalition of Private Investment Companies) (stating that the current rule's scope—which was "funds and securities" and with an exception from certain protections for privately offered securities—

client funds and securities with qualified custodians has in preventing fraud—a requirement that applies only if an adviser is subject to the custody rule and the assets are not subject to an exception from the qualified custodian requirement.[15] Subsequently, Congress authorized the Commission to prescribe rules requiring advisers to take steps to safeguard all client assets, not just funds and securities, over which an adviser has custody.[16]

In addition to this legislative context, industry developments prompt us again to reconsider the important prophylactic protections of the custody rule and to address certain gaps in protections—some of which Congress identified and gave us the tools to address 13 years ago.[17] We have seen changes in technology, advisory services, and custodial practices create

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excluded assets such as privately issued uncertificated securities, bank deposits, real estate assets, swaps, and interests in other private investment funds leaving a "gaping hole" in the rule) ("Dodd Frank Regulating Hedge Funds and other Private Investment Pools Testimony by James S. Chanos"). Congress also heard testimony about the benefits qualified custodians provide in preventing fraud. *See id.* ("Requiring independence between the function of managing a private investment fund and controlling its assets, by requiring that all assets be titled in the name of a custodian bank or broker-dealer for the benefit of the private fund and requiring all cash flows to move through the independent custodian, would be an important control. Similarly, requiring an independent check on the records of ownership of the interests in the private investment fund, as well as imposing standards for the qualification of private investment fund auditors ─ neither of which currently is required by the Advisers Act ─ would also greatly reduce opportunities for mischief.").

15 *See* S. Rep. No. 111-176, at 77 (2010) ("the custodian requirement largely removes the ability of an investment adviser to pay the proceeds invested by new investors to old investors. The custodian will take the instructions to buy or sell securities, but not to remit the proceeds of sales to the adviser or to others (except in return for share redemptions by investors). At a stroke, this requirement eliminates the ability of the manager to 'recycle' funds from new to old investors." *quoting* Testimony of Professor John C. Coffee, Jr.; The Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and the Need for Reform: Testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs, 111th Congress, 1st session, pp. 8,10 (2009)).

16 Earlier versions of this bill show that Congress considered retaining the current rule's funds and securities formulation. *See* Investor Protection Act of 2009, H.R. 3817, 111th Cong § 419 (2009).

17 The current rule has also been the subject of numerous inquiries and requests for staff views. *See*, *e.g.*, Staff Responses to Questions about the Custody Rule ("Custody Rule FAQs"), *available at* https://www.sec.gov/divisions/investment/custody_faq_030510.htm; Privately Offered Securities under the Investment Advisers Act Custody Rule, Division of Investment Management Guidance Update No. 2013-04 (Aug. 2013) ("2013 IM Guidance"); Private Funds and Application of the Custody Rule to Special Purpose Vehicles and Escrows, Division of Investment Management Guidance Update No. 2014-07 (June

new and different ways for client assets to be placed at risk of loss, theft, misuse, or misappropriation that may not be fully addressed under the current rule.

For example, advisory services have expanded and developed in recent years, leading to questions about the scope of activities that trigger application of the current rule. More specifically, nearly 20 years ago when the Commission interpreted authorized trading not to be within the definition of custody, it had stated that clients' custodians are generally under instructions to transfer funds or securities out of a client's account only upon corresponding transfer of securities or funds into the account. At the time, the Commission's view was that such an arrangement would minimize the risk that an adviser could withdraw or misappropriate the funds or securities in its client's custodial account.

Discretionary trading practices today, however, do not necessarily involve a one-for-one exchange of assets under a custodian's oversight. For instance, an adviser may instruct an issuer or a transfer agent that recorded ownership of a client's privately offered security to redeem the client's interest and direct the proceeds to a particular account. Because there is no qualified custodian involved in such a transaction, a client's ability to monitor its investments for suspicious activity is limited (*e.g.,* a qualified custodian would not attest to this transaction on the account statements it provides), and a surprise examination or an audit may not discover any

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2014) ("2014 IM Guidance"). Staff reports, statistics, and other staff documents (including those cited herein) represent the views of Commission staff and are not a rule, regulation, or statement of the Commission. Furthermore, the Commission has neither approved nor disapproved these documents and, like all staff statements, they have no legal force or effect, do not alter or amend applicable law, and create no new or additional obligations for any person. The Commission has expressed no view regarding the analysis, findings, or conclusions contained therein. As discussed in section II.J, staff in the Division of Investment Management is reviewing staff no-action letters and other staff letters to determine whether any such letters should be withdrawn in connection with any adoption of this proposal. If the rule is adopted, some of the letters and statements may be moot, superseded, or otherwise inconsistent with the rule and, therefore, would be withdrawn.

misappropriation until the assets are gone. Moreover, if the security is not included in the sample over which an accountant performs its procedures during a surprise examination or if the client's holdings of the security do not meet the materiality threshold for a financial statement audit, misappropriation may go undetected for an indeterminate amount of time.

Other times, advisers find themselves subject to the rule because of authority they do not wish to have. For instance, we understand that some advisory clients' custodial agreements empower investment advisers with a broad array of authority that they neither want nor use.[18] Advisers have little to no ability to eliminate this authority because they are usually not parties to the custodial agreements between clients and qualified custodians, but nonetheless these arrangements result in an adviser having custody under the rule.

While these developments suggest a need to protect clients better and modify the application of the current rule, other developments suggest a need to improve the rule's efficacy, including particularly the protections provided by the qualified custodian, who has long been the key gatekeeper under this rule. A growing number of assets are not receiving custodial protections as a result of certain of the current rule's exceptions from the requirement to maintain assets with a qualified custodian, particularly the exception for privately offered securities.[19] That exception and the exception for mutual fund shares were adopted at a time when dematerialized ownership of securities was still developing, and the exceptions were envisioned

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[18] We use the term "custodial agreement" throughout the release to refer to a contract between an advisory client and the qualified custodian. The adviser usually is not a party.

[19] Preqin Global Private Debt Report (2018), *available at* https://docs.preqin.com/samples/2018-Preqin-Global-Private-Debt-Report-Sample-Pages.pdf (showing the growth in private capital assets under management from 2007 to 2017 by the following asset classes: private equity, private debt, real estate, infrastructure, natural resources).

as being necessary "at times" or "on occasion." This rarity is no longer the case. We understand that, today, the overwhelming majority of securities are uncertificated, the volume of privately offered securities has vastly expanded with the expansion of private capital, and custodians have developed safeguarding and reporting practices, particularly with respect to publicly traded securities.[20] We acknowledge that the custodial market for privately issued securities is less developed,[21] but we believe that some custodians presently custody these assets and we understand that new custodial services are being developed.[22] What has also developed, however, is a practice by custodians in which the custodian lists assets for which it does not accept custodial liability on a client's account statement on an accommodation basis only; the custodian does not attest to the holdings of or transactions in those investments or take steps to ensure that the investments are safeguarded appropriately ("accommodation reporting"). The custodian merely reports the holdings or transactions as reported to it by the adviser. This practice undermines the account statement's integrity and utility in helping to verify that the client owns the assets and they have not been stolen or misappropriated. We view the integrity of custodial account statements to be critical to the safeguarding of client assets. Clients should be able to review their account statements to evaluate the legitimacy of any movement within their account, whether it is a trade, a payment, or a fee withdrawal. In contrast, the current exception for mutual fund shares requires a transfer agent of the mutual fund to fulfill all of the

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20 *See* discussion in section II.C *infra* and at text accompanying footnote 229.

21 We understand that many qualified custodians will not currently accept custodial liability for certain instruments including certain crypto assets, commodities, and privately issued securities. *See* Letter to Karen Barr re Engaging on Non-DVP Custodial Practices and Digital Assets: Investment Advisers Act of 1940: Rule 206(4)-2 (Mar. 12, 2019) ("2019 RFI").

22 *See*, *e.g.*, DTCC, Project Whitney Case Study (May 2020), *available at* https://www.dtcc.com/~/media/Files/Downloads/settlement-asset-services/user-documentation/Project-Whitney-Paper.pdf.

obligations assigned to a qualified custodian under the rule, including sending statements directly to the client. In our longstanding experience with the current rule, this exception has not raised similar types of investor protection concerns.

At the same time, the evolution of financial products and services discussed above has led to new entrants and new services in the custodial marketplace, including newly launched state-chartered trust companies, as well as established bank and broker-dealer custodians seeking to develop new practices to safeguard assets.[23] Our staff has also observed a general reduction in the level of protections offered by custodians, often resulting in advisory clients with the least amount of bargaining power (*i.e.,* retail investors) receiving the most limited protections. We understand, for instance, that it is decreasingly common for banks acting as custodians to do so in a fiduciary capacity.[24] These changes in the industry have caused us to reconsider the role of a "qualified custodian" under our rule and what minimum protections clients should receive.

Finally, since the Commission last amended the current rule, there have been significant developments with respect to crypto assets,[25] which generally use distributed ledger or

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23 *See*, *e.g.*, Tomito Geron, Companies Compete to Be Cryptocurrency Custodians, The Wall Street Journal (Sept. 17, 2019).

24 *See* OCC Bulletin 2019-21, April 29, 2019, "Fiduciary Regulations; Non-Fiduciary Activities; Advance Notice of Proposed Rulemaking." According to this Bulletin, Bank non-fiduciary custody activities have increased in asset size since 1996. This Bulletin reports, as of December 2018, bank non-fiduciary custody assets were about $42 trillion, whereas bank fiduciary custody assets were about $9 trillion. *See also* Edward H. Klees, How Safe are Institutional Assets in a Custodial Bank's Insolvency, 68 Bus. LAW. 103, 110, footnote 46 (2012) ("Klees Article"). In addition to certain institutions identified under the Home Owners' Loan Act and members of the Federal Reserve System, the Advisers Act generally identifies "banks" as banking institutions or savings associations a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks. Advisers Act sec. 202(a)(2).

25 There are also digital assets. The term "digital asset" refers to an asset that is issued and/or transferred using distributed ledger or blockchain technology, including, but not limited to, so-called "virtual currencies," "coins," and "tokens." *See Custody of Digital Asset Securities by Special Purpose Broker-Dealers*, Securities Exchange Act Release No. 90788 (Dec. 23, 2020), 86 FR 11627, 11627 n.1 (Feb. 26,

blockchain technology (broadly referred to as "DLT")[26] as a method to record ownership and transfer assets. While potentially creating certain efficiencies in transactions, this technology also presents technological, legal, and regulatory risks to advisers and their clients.[27] Unlike mechanisms used to transact in more traditional assets, this technology generally requires the use of public and private cryptographic key pairings, resulting in the inability to restore or recover many crypto assets in the event the keys are lost, forgotten, misappropriated, or destroyed.[28] By design, DLT finality often makes it difficult or impossible to reverse erroneous or fraudulent crypto asset transactions, whereas processes and protocols exist to reverse erroneous or fraudulent transactions with respect to more traditional assets. These specific characteristics could leave advisory clients without meaningful recourse to reverse erroneous or fraudulent transactions, recover or replace lost crypto assets, or correct errors that result from their adviser having custody of these assets.

2021) ("Commission Statement"). A digital asset may or may not meet the definition of a "security" under the Federal securities laws. *See*, *e.g.*, *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, Securities Exchange Act Release No. 81207 (July 25, 2017) ("DAO 21(a) Report"), *available at* https://www.sec.gov/litigation/investreport/34-81207.pdf; SEC v. W.J. Howey Co., 328 U.S. 293 (1946). To the extent digital assets rely on cryptographic protocols, these types of assets also are commonly referred to as "crypto assets." For purposes of this release, the Commission does not distinguish between the terms "digital asset" and "crypto asset."

[26] The terms DLT and blockchain, a type of DLT, generally refer to databases that maintain information across a network of computers in a decentralized or distributed manner. Blockchain networks commonly use cryptographic protocols to ensure data integrity. *See e.g.,* World Bank Group, "Distributed Ledger Technology (DLT) and Blockchain," FinTech Note No. 1 (2017), *available at*: https://openknowledge.worldbank.org/bitstream/handle/10986/29053/WP-PUBLIC-Distributed-Ledger-Technology-and-Blockchain-Fintech-Notes.pdf?sequence=1&isAllowed=y.

[27] We note that our staff has expressed a similar view. *See, e.g.,* SEC Staff Accounting Bulletin No. 121, [87 FR 21016 (Apr. 11, 2022)] (generally describing risks related to the safeguarding of crypto assets); Custody of Digital Asset Securities by Special Purpose Broker-Dealers, *supra* footnote 25 (generally discussing risks related to broker-dealer custody of crypto asset securities). *See also* Joint Statement on Crypto-Asset Risks to Banking Organizations (Jan 3, 2023), *available at* https://occ.treas.gov/news-issuances/news-releases/2023/nr-ia-2023-1a.pdf (generally discussing risks related to bank custody of crypto assets).

[28] *See, e.g.,* Not Your Keys, Not Your Coins: Unpriced Credit Risk in Cryptocurrency, at Section I, *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4107019.

Additionally, we understand that many advisers may be reluctant to provide a full range of advisory services to their clients with respect to crypto assets because of concerns that a market for custodial services to safeguard these assets has not yet fully developed. We understand that other advisers provide advisory services that would generally result in an adviser having "custody" within the meaning of the rule (*e.g.*, serving as the general partner for a private fund that holds crypto asset securities), and therefore are required to comply with the rule. Some of these advisers, however, may not maintain their client's crypto assets with a qualified custodian, instead attempting to safeguard their client's crypto assets themselves—a practice that is not compliant with the custody rule if those crypto assets are funds or securities and do not meet an exception from the qualified custodian requirement. Other advisers offering similar advisory services might take the position that crypto assets are not covered by the custody rule at all. This, however, is incorrect because most crypto assets are likely to be funds or crypto asset securities covered by the current rule.[29]

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[29] The application of the current rule turns on whether a particular client investment is a fund or a security. To the extent there is a question as to whether a *particular* crypto asset is an investment contract that is a security, the analysis is governed by the test first articulated by the Supreme Court in *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946). *See*, *e.g.*, *SEC v. Kik Interactive Inc.*, 492 F. Supp. 3d 169, 177-180 (S.D.N.Y. 2020) (applying *Howey* in granting the Commission's motion for summary judgment finding Kik's sale of Kin tokens to the public was a sale of a security and required a registration statement); *SEC v. LBRY*, No. 21-CV-260-PB, 2022 WL 16744741 (D.N.H. Nov. 7, 2022) (applying *Howey* in granting the Commission's motion of summary judgement finding "no reasonable trier of fact could reject the SEC's contention that LBRY offered LBC [a crypto asset] as a security." *Id*. at 21); Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Rel. No. 81207 (July 25, 2017) (describing how DAO tokens were securities under *Howey*); *see also* Spotlight on Crypto Assets and Cyber Enforcement Actions, *available at* https://www.sec.gov/spotlight/cybersecurity-enforcement-actions. Importantly, even if a particular crypto asset is not a security, the current rule also covers funds.

B. Overview of the Proposal

In the light of these developments and additional authority that Congress has given us under the Dodd-Frank Act to prescribe investment adviser custody rules, we are redesignating the custody rule as new rule 223-1 under the Advisers Act (the "safeguarding rule" or the "proposed rule") and proposing a number of amendments to strengthen its protections.[30] The proposal is designed to recognize the evolution in products and services investment advisers offer to their clients and to strengthen and clarify existing custody protections, while also proposing complementary refinements to how advisers report custody information on Form ADV and the books and records they are required to keep that are designed to improve our oversight and risk-assessment abilities.[31] Importantly, the proposal maintains the core purpose of protecting client assets from loss, misuse, theft, or misappropriation by, and the insolvency or financial reverses of, the adviser and maintains the Commission's ability to pursue advisers for failing to properly safeguard client assets under the Act's antifraud provisions.[32]

First, the proposed amendments are designed to modernize the scope of assets and activities that would trigger application of the rule. In today's increasingly complex and global

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30 We are also renumbering portions of the custody rule that we are not amending.

31 In a technical, conforming change from the current rule, the proposed rule would replace, in certain places, references to "you" with "investment adviser."

32 While we are renumbering the current rule as rule 223-1, section 206(4) is still available to the Commission and is also a basis of statutory authority for this proposed rulemaking. To establish a violation of section 206(4) for an adviser's failure to safeguard client assets, the Commission does not need to demonstrate that an investment adviser acted with scienter. *See SEC v. Steadman*, 967 F.2d 636, 646-7 (D.C. Cir. 1992). As we noted when we adopted rule 206(4)-8, the court in *Steadman* analogized section 206(4) of the Advisers Act to section 17(a)(3) of the Securities Act, which the Supreme Court had held did not require a finding of scienter (citing *Aaron v. SEC*, 446 U.S. 680 (1980)). *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Investment Advisers Act Rel. 2628, (Aug. 3, 2007), 72 FR 44763 (Aug. 9, 2007). *See also* Steadman at 643, n.5.

financial markets, this update also would simplify the rule's application and better align the rule with the Commission's statutory authority.[33] Because investment advisers provide services related to an array of financial products beyond just funds or securities, the proposed rule would require certain minimum protections, particularly the safeguards of a qualified custodian, for substantially all types of client assets held in an advisory account. Specifically, the safeguarding rule would specify the types of assets subject to the safeguarding requirements of the rule by defining "assets" as "funds, securities, or other positions held in a client's account," as opposed to the custody rule's use of "funds and securities."[34] This change would expressly include certain assets that may not have previously been categorized as "funds" or "securities" and would accommodate developments in the market for various investment types that develop in the future, irrespective of their status as funds or securities. By expanding the scope of the rule to include client assets instead of only client funds and securities, we believe we are properly balancing the desire of investment advisers to provide advisory services regarding novel or innovative asset types with the need to ensure that such assets are properly safeguarded.

The proposed rule also would explicitly include discretionary authority to trade within the definition of custody.[35] When an adviser has discretion to trade client assets, it has an arrangement in which it may instruct the adviser's custodian to dispose the client's assets. An adviser with discretion may also have broad authority to direct purchases or sales of client assets

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33 *See supra* note 16 and accompanying text.

34 *See* 15 U.S.C. 80b-23 ("Section 223") "An 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." *See* proposed rule 223-1(a).

35 Proposed rule 223-1(d)(3).

that may not currently involve a qualified custodian, such as loan participation interests. An adviser's ability or authority to effect a change in beneficial ownership of a client's assets, including for purposes of trading, could place client assets at risk of loss that the rule is designed to address.[36] This change would rectify any unintended consequences of our prior interpretive position.[37]

Like the custody rule, the safeguarding rule would entrust safekeeping of client assets to a qualified custodian because we continue to believe it provides critical safeguards for those assets. Unlike the custody rule, however, the safeguarding rule would specify that a qualified custodian does not "maintain" a client asset for purposes of the rule if it does not have "possession or control" of that asset. The proposed rule would further define "possession or control" to mean holding assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets.[38] This change is designed to improve account statement integrity and reliability by eliminating an adviser's ability to request accommodation

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[36] *See* section II.A.2. Recognizing that there are times when an investment adviser neither wants nor uses the ability or authority that would trigger the proposed rule and that there are times when an adviser inadvertently receives client investments, the proposed rule would provide limited and tailored exclusions in these circumstances. *See infra*, discussion of discretionary trading authority in section II.G.2.**Error! Reference source not found.**

[37] When adopting amendments to the custody rule in 2003, we stated in a footnote: "An adviser's authority to issue instructions to a broker-dealer or [other] custodian to effect or settle trades does not constitute 'custody.' Clients' custodians are generally under instructions to transfer funds (or securities) out of a client's account only upon corresponding transfer of securities (or funds) into the account. This 'delivery versus payment' arrangement minimizes the risk that an adviser could withdraw or misappropriate the funds or securities in its client's custodial account." 2003 Adopting Release, *supra* footnote 2, at n.10. Absent this narrowly drawn exception for "delivery versus payment" transactions, authorized trading comes within the definition of custody.

[38] Proposed rule 223-1(d)(8). For further discussion of possession or control, please see discussion *infra* section II.B.2.

reporting.[39] Further, in a change from the current rule, the proposed rule would require an adviser to enter into a written agreement with and receive certain assurances from the qualified custodian to make sure the qualified custodian provides certain standard custodial protections when maintaining client assets.[40]

Under the proposal, the written agreement would require two provisions that are not explicitly addressed by the current rule. One provision would require the qualified custodian to provide promptly, upon request, records relating to clients' assets held in the account at the qualified custodian to the Commission or to an independent public accountant engaged for purposes of complying with the safeguarding rule. The other would specify the adviser's agreed-upon level of authority to effect transactions in the account. The proposed rule's written agreement requirement would also incorporate, and expand, two components of the current rule: account statements and internal control reports. Under the first, the written agreement must contain a provision requiring the qualified custodian to deliver account statements to clients and to the adviser, as currently advisers must have only a reasonable basis for believing this is done. The other provision would require the qualified custodian to obtain a written internal control report that includes an opinion of an independent public accountant regarding the adequacy of the qualified custodian's controls. This provision expands the internal control requirement to all qualified custodians from the current rule's application to an adviser or its related person[41] that acts as a qualified custodian.

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39 *See infra* discussion section II.B.3.b.ii.

40 Proposed rule 223-1(a)(1).

41 The term "related person" would have the same meaning as in the current rule.

In addition to the written agreement requirement, advisers would have to obtain reasonable assurances that the qualified custodian satisfies five additional enumerated items.[42] These include assurances that the custodian will: (1) exercise due care in accordance with reasonable commercial standards in discharging its duty as custodian and implement appropriate measures to safeguard client assets from theft, misuse, misappropriation, or other similar type of loss; (2) indemnify the client against losses caused by the qualified custodian's negligence, recklessness, or willful misconduct; (3) not be excused from its obligations to the client as a result of any sub-custodial or other similar arrangements; (4) clearly identify and segregate client assets from the custodian's assets and liabilities; and (5) not subject client assets to any right, charge, security interest, lien, or claim in favor of the qualified custodian or its related persons or creditors, except to the extent agreed to or authorized in writing by the client.

We are proposing to modify the current rule's privately offered securities exception from the obligation to maintain client assets with a qualified custodian by expanding the exception to include certain physical assets.[43] We are also proposing refinements to the definition of privately offered securities that are designed to ensure appropriate application and interpretation of this exception.[44] In addition, we are proposing to modify the conditions for relying on this exception to improve investor protections in the absence of one of the rule's key gatekeepers. Specifically, an adviser could rely on the exception only if it reasonably determines that ownership cannot be recorded and maintained by a qualified custodian, the adviser reasonably safeguards the assets, the adviser notifies the independent public accountant performing the

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42 *See* proposed rule 223-1(a)(1)(ii).

43 See proposed rule 223-1(b)(2).

44 *See* proposed rule 223-1(d)(9).

verification of such an asset transfer within one business day, an independent public accountant verifies asset transfers and notifies the Commission upon the findings of any material discrepancies, and the existence and ownership of the assets are verified during an annual independent verification or as part of a financial statement audit by an independent public accountant.[45] The modifications are also designed to limit availability of the exception to circumstances that truly warrant it because we believe the bulk of advisory client assets are able to be maintained by qualified custodians and should be safeguarded in the manner contemplated under the safeguarding rule.

Under the proposed rule, advisers with custody of client assets would be required to segregate those assets by (1) titling or registering the assets in the client's name or otherwise holding the assets for the client's benefit, (2) not commingling the assets with the adviser's or any of its related persons' assets, and (3) not subjecting the assets to any right, charge, security interest, lien, or claim of any kind in favor of the investment adviser or its related persons or creditors, except to the extent agreed to or authorized in writing by the client.[46] This provision, which would apply regardless of whether the client's assets are maintained by a qualified custodian, is designed to prevent the adviser, or its related person, from using client assets for its own purposes or in a manner not authorized by the client or in a manner inconsistent with its fiduciary duty. We believe this will also help to protect client assets and enable them to be returned in the event that an adviser experiences financial hardship.

The proposed rule would continue to depend on the protections provided by independent public accountants. We have long relied on these third-party gatekeepers to provide "another set

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45 *See* proposed rule 223-1(b)(2).

46 *See* proposed rule 223-1(a)(3).

of eyes" on client assets, and we believe they serve an important role in safeguarding client assets. In light of the proposed changes to the rule's scope, however, the proposal seeks to balance better the costs associated with obtaining a surprise examination with the investor protections it offers by providing exceptions to the surprise examination requirement when the adviser's sole reason for having custody is because it has discretionary authority or because the adviser is acting according to a standing letter of authorization, each subject to certain conditions.[47] We believe that the risk to client assets is lower in these contexts and the protections offered by the surprise examination may not justify the cost of obtaining one. Finally, the proposed safeguarding rule amendments would expand the scope of who can satisfy the rule's surprise examination requirement through financial statement audits by specifying that an entity is not required to be a limited partnership, limited liability company, or another type of pooled investment vehicle to rely on this provision.[48]

The proposal also seeks to update and enhance recordkeeping requirements for advisers that would work in concert with the proposed rule. We believe that these updates would enhance the Commission's oversight of the safeguarding practices of advisers and their compliance with the rule, which will, in turn, promote investor protections.

Finally, we are proposing amendments to Form ADV to align reporting obligations with the proposal and improve the accuracy of custody-related data available to the Commission, its staff, and the public. In addition, we are improving the structure of Form ADV Item 9.[49] More

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47 See proposed rule 223-1(b)(7) and (8).

48 *See* proposed rule 223-1(b)(4).

49 *See infra* discussion at section II.I.

accurate and comprehensive information that aligns with the proposed rule would inform the Commission's examination initiatives and would allow the Commission and its staff to better assess risks specific advisers pose to investors.[50]

II. DISCUSSION

A. Scope of Rule

Like the current rule, the proposed rule would apply to any investment adviser registered or required to be registered with the Commission under section 203 of the Act that has "custody" of a client's assets.[51] Also consistent with the current rule, the proposed rule would also apply to any adviser whose "related persons" have custody in connection with advisory services the adviser provides to the client.[52]

The proposed rule would change the current rule's scope, however, in two important ways. First, it would expand the types of investments covered by the rule. Currently, the rule applies to client "funds and securities" of which an adviser has custody. The proposed rule would extend the rule's coverage beyond client "funds and securities" to client "assets" so as to

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50 *See infra* discussion at section II.J. Because Form ADV Part 1A is submitted in a structured, XML-based data language specific to that form, the information in the proposed amendments to Part 1A would continue to be structured (*i.e.*, machine-readable).

51 Proposed rule 223-1. As with the current rule, an adviser would be required to comply with the proposed rule in circumstances where the adviser provides advisory services to a person's assets, even if uncompensated. "Although a person is not an 'investment adviser' for purposes of the Advisers Act unless it receives compensation for providing advice to others, once a person meets that definition (by receiving compensation from *any* client to which it provides advice), the person is an adviser, and the Act applies to the relationship between the adviser and any of its clients (whether or not the adviser receives compensation from them)." *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3221 (June 22, 2011) [76 FR 42,950 (July 19, 2011)], at text accompanying n.74.

52 Consistent with the current rule, under the proposed rule, the term "related person" would mean "any person, directly or indirectly, controlling or controlled by [the investment adviser], and any person that is under common control with [the investment adviser]." Proposed rule 223-1(d)(11).

include additional investments held in a client's account. Second, the proposed rule would make explicit that the current rule's defined term "custody" includes discretionary authority.

1. Scope of Assets

The proposed rule would define "assets" as "funds, securities, or other positions held in a client's account."[53] The proposal, like the current rule, therefore would apply to a client's funds as well as a client's securities. However, the proposed rule also would apply to other positions held in a client's account that are not funds or securities. This proposed change uses the more expansive and explicit language employed by Congress in empowering the Commission to develop rules to protect client *assets* when advisers have custody.[54] Congress made this change following several high profile enforcement actions relating to misappropriation of client assets.[55] The proposed amendments also recognize the continued evolution of the types of investments held in advisory accounts since the custody rule was amended in 2009 and since the enactment of Section 223. Looking forward, the proposed definition of assets is designed to remain evergreen, encompassing new investment types as they continue to evolve and multiply to recognize that the protections of the rule should not depend on which type of assets the client entrusts to the adviser.

The proposed rule's use of the term "other positions" in the definition of assets encompasses holdings that may not necessarily be recorded on a balance sheet as an asset for

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53 Proposed rule 223-1(d)(1).

54 *See* Section 223, *supra* footnote 34.

55 *See supra* footnote 11.

accounting purposes, including, for example, short positions and written options.[56] We believe, in the advisory account context, that the entirety of a client account's positions, holdings, or investments should receive the protections of the proposed rule regardless of how they may be treated for accounting purposes. Moreover, the fiduciary duty extends to the entire relationship between the adviser and client regardless of whether a specific holding in a client account meets the definition of funds or a security.[57] Consequently, the proposed rule's definition of assets would include investments such as all crypto assets, even in the instances where such assets are neither funds nor securities.[58] Assets under the rule also would include financial contracts held for investment purposes, collateral posted in connection with a swap contract on behalf of the client, and other assets that may not be clearly funds or securities covered by the current rule.[59] Additionally, physical assets, including artwork, real estate, precious metals, or physical commodities (*e.g.,* wheat or lumber), would be within the scope of the proposed rule. "Assets" also would encompass investments that would be accounted for in the liabilities column of a balance sheet or represented as a financial obligation of the client including negative cash, which

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[56] Similarly, rule 6(c)-11 under the Investment Company Act of 1940 [15 U.S.C. 80a-1 et seq.] (the "Investment Company Act") defines an exchange-traded fund's portfolio holdings as the securities, assets, or other positions held by the exchange-traded fund. *See* 17 CFR § 270.6c-11. *See* Exchange Traded Funds, Investment Company Act Release No. 33646 (Sept. 25, 2019) [84 FR 57162 (Oct. 24, 2019)], at n.249 (including within the term "other positions" short positions in equity, overdrawn or negative cash balances, written call or put options (where the other side has the option and can put or call the underlying instrument to the party who wrote the contract)).

[57] *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248 (Jun. 5, 2019) at footnote 17 (discussing the broad scope of the fiduciary duty in a variety of contexts, including situations where securities are not specifically involved).

[58] Crypto assets that are funds or securities are subject to the current custody rule, which applies to all "funds and securities" over which an adviser has custody. *See* discussion of whether crypto assets or digital assets meet the definition of security at *supra* footnote 29.

[59] *Id*. Our staff has taken a similar position regarding collateral for transactions, such as swaps. *See* Custody Rule FAQs, *supra* footnote 17, at Question II.10.

we believe would be consistent with the purposes of the Act and the longstanding policy goal of the rule to prevent potential fraud, misuse, or misappropriation.[60]

We also request comment on all aspects of the proposed definition of "assets," including the following items:

1. Should the rule apply to client "assets" beyond the scope of the current rule's formulation of "funds or securities," as proposed? Should the proposed rule include the term "other positions" as a catch-all for a client's positions subject to the adviser-client relationship? Should another term, such as client investments, be used instead?
2. Should we define client "assets" by referencing other terms, such as "securities and similar investments" or "any investment," which are used but not defined in the Investment Company Act custody rules?[61] Should we instead incorporate the term "investment" from the definition of "qualified purchaser" under the Investment Company Act?[62]
3. Are there particular types of assets held in a client's advisory account that should or should not be subject to the proposed rule? If so, what are they and why should they be included or excluded? Are there other safeguards outside of the proposed rule that apply to these positions that would satisfy the policy goals of the rule? Does the answer depend on the type of asset?

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60 *See* rule 6c-11, *supra* footnote 56. The release discussed that liabilities were contemplated to be part of "other positions."

61 *See* rules 17f-1, 17f-2, 17f-5, and 17f-6 under the Investment Company Act.

62 *See* rule 2a51-1(b) under the Investment Company Act.

4. To the extent that the adviser has custody of certain physical assets, should we narrow the proposed definition to exclude such physical assets? For example, should the proposed definition exclude artwork, real estate, precious metals, or physical commodities (*e.g.,* wheat or lumber), for example?
5. It is our understanding that some advisers treat client assets that may not be "funds or securities" consistent with rule 206(4)-2. If so, what types of assets do they maintain with a qualified custodian under the current rule? If not, how do the advisers safeguard these client assets?
6. Should we provide guidance about how the proposed rule would apply to certain asset types? If so, for what types of assets? Should we provide guidance for certain assets that would be subject to exceptions from the proposed rule, such as privately offered securities or physical assets?
7. Should the proposed rule apply to assets that are treated as liabilities from an accounting perspective? Is it sufficiently clear that the proposed rule would apply to portfolio holdings that are liabilities on a balance sheet? Should we provide additional clarification as to what types of investments may appear as liabilities within the scope of the advisory relationship? What types of holdings typically appear as liabilities? Are there any exemptions or provisions required for such investments if they are included within the scope of the rule?

2. Scope of Activity Subject to the Proposed Rule

The proposal generally would preserve the current rule's definition of "custody," and apply when an adviser "holds, directly or indirectly, client assets, or has any authority to obtain

possession of them."[63] The general principle of this definition is to apply the rule when an adviser has the ability or authority to effect a change in beneficial ownership of a client's assets.[64] An adviser with this ability or authority can subject a client's assets to the risks of loss, misuse, misappropriation, theft, or financial reverses of the adviser. Moreover, the rule would continue to apply when an adviser's related person has the ability to obtain client assets in connection with advisory services. Like the current rule, the proposed rule would institute prophylactic safeguards where there is this *potential* for loss or harm to a client given the adviser's ability or authority to deprive the client of ownership and to obtain possession of the client's assets.

In addition to this overarching principle, the current definition of custody includes three categories that serve as examples of custody: physical possession, certain arrangements when the adviser is authorized or permitted to instruct the client's custodian, and circumstances when the adviser acts in certain capacities.[65] The proposed rule would retain these categories because,

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63 *See* proposed rule 223-1(d)(3).

64 For example, an adviser that physically holds a check drawn by the advisory client and made payable to a third party is not subject to the rule solely as a result of holding the check, since the adviser cannot use the check to change ownership of the client's underlying cash holdings. *See* rule 206(4)-2(d)(2)(i). Similarly, if a stock certificate is non-transferable (*i.e.*, it cannot be used to effect a change in beneficial ownership of the client's investment), an adviser would not be subject to the rule as a result of holding it. Our staff previously took a similar view. *See* 2013 IM Guidance, *supra* footnote 17.

65 Under the current rule, custody includes three prongs: (i) Possession of client funds or securities (but not of checks drawn by clients and made payable to third parties) unless the adviser receives them inadvertently and returns them to the sender promptly but in any case within three business days of receiving them; (ii) Any arrangement (including a general power of attorney) under which the adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the adviser's instruction to the custodian; and (iii) Any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives the adviser or its supervised person legal ownership of or access to client funds or securities.

going forward, we believe this approach will continue to provide flexibility as the asset management industry continues to evolve, introduces novel investment products, and provides new services to its advisory clients.

We believe we need to provide specificity, however, regarding the arrangement category of the custody definition to state explicitly that discretionary trading authority is an arrangement that triggers the rule.[66] Specifically, the amended custody definition would include any arrangement (including, but not limited to, a general power of attorney or discretionary authority) under which the adviser is authorized or permitted to withdraw or transfer beneficial ownership of client assets upon the adviser's instruction.[67] In addition, the proposed discretionary authority definition is consistent with the definition in Form ADV and is the authority to decide which assets to purchase and sell for the client.[68]

The Commission previously stated that an adviser's authority to issue instructions to a broker-dealer or a custodian to effect or to settle trades, or authorized trading, does not constitute custody.[69] We had explained then that the risk of an adviser withdrawing or misappropriating funds and securities are minimized when a client's custodian is under instructions to transfer

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66 Proposed rule 223-1(d)(3) (proposed custody definition) and proposed rule 223-1(d)(4)(discretionary authority definition). The second prong of the current custody definition states: "Any arrangement (including a general power of attorney) under which you are authorized or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian." *See* current rule 206(4)-2(d)(3).

67 The proposed amended definition also removes the reference "to the custodian" from the arrangement category. This formulation ensures that custody is triggered if, for example, an adviser can instruct a transfer agent or administrator to withdraw or transfer beneficial ownership of client assets. *See* proposed rule 223-1(d)(3).

68 Proposed rule 223-1(d)(4).

69 2003 Adopting Release, *supra* footnote 2, at n.10.

funds (or securities) out of a client's account only upon corresponding transfer of securities (or funds) into the account.[70] However, while we continue to believe that there is a more limited risk of loss to a client from authorized trading when a qualified custodian participates in a one-for-one exchange of assets like this, we also believe that discretionary authority presents the types of risks the rule is designed to address. The adviser, for instance, could use its discretionary authority over a client's assets to instruct an issuer's transfer agent or administrator (*e.g.*, the administrator for a loan syndicate) to sell its client's interest and to direct the cash proceeds of the sale to an account that the adviser owns and controls, thereby depriving the client of ownership, unbeknownst to the client or its qualified custodian. Unless a client or its custodian is required to participate in these transactions, such as when the client must sign the subscription agreement to purchase the security (*i.e.*, the adviser does not have a power of attorney and cannot sign for the client in any other capacity), the client will be unable to monitor the assets in its account for potential misuse or misappropriation effectively.[71]

We believe it is important to extend the protections of the rule by explicitly including "discretionary authority" within the definition of custody. However, because we continue to believe more limited risk of loss exists when a qualified custodian participates in transactions, we are also proposing a limited exception to the surprise examination requirement of the rule. The exception would generally apply to client assets that are maintained with a qualified custodian when the sole basis for the application of the rule is an adviser's discretionary

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70 *Id.*

71 Our staff stated a similar view under the current rule. *See* Custody Rule FAQs, *supra* footnote 17, at Question VII.3.

authority that is limited to instructing the client's qualified custodian to transact in assets that settle only on a delivery versus payment ("DVP") basis.[72] In DVP transactions, clients' custodians are under instructions to transfer assets out of a client's account only upon corresponding transfer of assets into the account. This "delivery versus payment" arrangement minimizes the risk that an investment adviser could withdraw or misappropriate the assets in its client's custodial account. In our view, DVP transactions reduce the risk that the seller of an asset could deliver the asset but not receive payment or that the buyer of an asset could make payment but not receive delivery of the asset.[73]

We request comment on all aspects of the proposed application of the rule to advisers with discretionary authority, along with the continuing application of the rule more generally, including the following items.

8. Should the proposal generally retain the current rule's definition of custody? The proposed rule would generally retain the three categories that serve as examples of custody in the current rule: physical possession, certain arrangements when the adviser is authorized or permitted to withdraw or transfer beneficial ownership of client assets upon the adviser's instructions, and circumstances when the adviser acts in certain capacities. Should the proposed rule change the current definition of custody from these three categories? What should the proposal provide alternatively?

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72 Proposed rule 223-1(b)(8). *See infra* at section II.G.2.

73 For discussion of delivery versus payment settlement operations, *see* Bank for International Settlements, "Delivery versus Payment in Securities Settlement Systems," Sept. 1992, p. 1 at https://www.bis.org/cpmi/publ/d06.pdf.

9. Should the rule apply to when an adviser has discretionary authority over client assets, as proposed? Are there provisions of the proposed rule that should or should not apply to advisers who have custody because they have discretionary authority?
10. Do advisers with discretionary authority over a client's assets (regardless of settlement method) currently have safeguards in place that effectively limit the risks to clients of loss, misuse, theft, or – in particular – misappropriation? If so, what are they? Do these safeguards differ depending on whether the arrangement involves a qualified custodian?
11. When a trade settles in a manner that is not DVP, are there controls that are or could be established in the event one leg of the trade does not complete? If so, how commonly are such controls utilized? Are there circumstances when such controls could not be established or implemented? Should we require controls or policies and procedures for advisers and/or the respective custodians in these circumstances?
12. Should the definition of custody contain an exception (or should we interpret the definition of custody not to include) when the adviser has authority to instruct the client's custodian to remit assets from the custodial account to the client at his or her mailing address of record? If so, should such an exception or interpretation be subject to any conditions? For example, should the client be required to grant the adviser this authority in writing to the qualified custodian? Should an exception or interpretation also be conditioned on the adviser lacking authority to open an account on behalf of the client? Should the adviser also lack authority to designate or change the client's mailing address of record with the qualified custodian, or if the adviser has this authority, would it be sufficient protection for the adviser to have a

reasonable belief that the custodian would send a notice of any change of mailing address to the client at the client's old address of record upon receiving the request from the adviser to change the mailing address?[74] For example, broker-dealers must send a customer who is a natural person a notification of a change of mailing address to the customer's old mailing address.[75] Similarly, banks that follow guidance issued by banking regulators send confirmation of a customer request for a change of mailing address to both the old and new address on record.[76] Is there adequate protection when the custodian is subject to these regulatory requirements because the adviser would be unable to remit its client's assets to the client at a mailing address other than the client's address of record at the custodian? Alternatively, should such an exception or interpretation hinge on whether advisers design policies and procedures under rule 206(4)-7 (the "Compliance Rule") that address the risk to clients of remitting client investments to non-clients?

13. Should we make clear that an adviser is subject to the custody rule and would also be subject to the proposed rule with respect to its client's assets that are held, or accessible, by a related carrying broker or executed through a related introducing

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74 We note that the staff has issued an FAQ on this topic. *See* Custody Rule FAQs, *supra* footnote 17, at FAQ II.5.A. and B.

75 Exchange Act Rule 17a-3(a)(17)(i)(B)(2).

76 *See*, *e.g.,* Federal Reserve System Supervisory Letter SR 0-11 (Apr. 26, 2001), Office of Comptroller of the Currency ("OCC") Advisory Letter 2001-4 (Apr. 30, 2001), Federal Deposit Insurance Corporation Financial Institution Letter 39-2001 (May 9, 2001), Office of Thrift Supervision CEO Letter No. 139 (May 4, 2001), and National Credit Union Administration Letter No. 01-CU-09 (Sept. 2001).

broker?[77] Conversely, should we make clear that an adviser would not be subject to the rule solely due to its related person acting as the trustee of a participant-directed defined contribution plan established for the benefit of the adviser's employees, provided the adviser does not provide investment advisory services to the plan or any investment option available under the plan?[78] Similarly, should we clarify the meaning of "in connection with advisory services" in the context of related person custody?[79] For example, should we make clear that where an adviser's client has a bank account with a bank that is the adviser's related person, but does not use the bank account in connection with the adviser's advisory activity, we would not view the bank's authority to be "in connection with advisory services" that the adviser provides to its client and that the rule, therefore, would not apply?

14. Advisers that act as trustee of a trust would have custody of that trust's assets under the proposed rule. Should we adopt an exception from the definition of custody for (or should we interpret the definition of custody not to include) cases where an adviser acts as co-trustee of a trust and no single co-trustee is able to effect any change in control of the beneficial ownership of the trust's investments without the prior written consent of a co-trustee(s) that is not a related person?[80] In what

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77 We note that the staff has issued an FAQ on this topic. *See* Custody Rule FAQs, *supra* footnote 17, at Question XIV.2-3. *See* also section II.J, *infra.*

78 We note that the staff has issued an FAQ on this topic. Our staff has stated that it would not consider an adviser to have custody where the investment adviser and the related person trustee are, to the extent applicable, in compliance with the Employee Retirement Income Security Act of 1974 (ERISA) and rules and regulations issued thereunder with respect to the plan. *See* Custody Rule FAQs, *supra* footnote 17, Question XII.1.

79 *See* proposed rule section 223-1(d)(3).

80 We note that the staff has issued an FAQ on this topic. *See* Custody Rule FAQs, supra footnote 17, at Question XII.2.

circumstances is a co-trustee required either by law or the trust instrument to protect the trust beneficiaries from the actions of a single trustee acting alone? Similarly, should we adopt an exception in (or should we interpret the definition of custody not to include) circumstances where an adviser has the ability or authority to effect a change in beneficial ownership of a trust's investments, where an adviser is co-trustee along with the grantor of a revocable grantor trust, and the adviser is prohibited by the trust instrument or by law from withdrawing any investments from the trust without the prior written consent of all of its co-trustees?[81]

15. An adviser would have custody under the proposed rule when it comes into possession of client assets. The rule contains an exception from the definition of custody for possession of client assets when the adviser receives them inadvertently and returns them to the sender within three business days. Should we amend the exception to accommodate (or interpret the definition of custody not to include) other situations in which the adviser inadvertently receives client assets?[82] For example, should such an exception or interpretation be conditioned such that the adviser return the client's assets to the sender or forward them to the client or the client's custodian within five days of receipt? Should such an exception or

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81 We note that the staff has issued an FAQ on this topic. *See* Custody Rule FAQs, supra footnote 17, Question XII.3. *See also,* 2003 Adopting Release, *supra* footnote 1 at note 15 (stating that the Commission would not view the adviser to have custody of the funds or securities of the estate, conservatorship, or trust solely because the supervised person has been appointed in these capacities as a result of family or personal relationship with the decedent, beneficiary or grantor (and not a result of employment with the adviser)).

82 We note that the staff has issued a no-action letter on this topic. The Commission's staff has stated that when advisers infrequently receive specific types of client funds or securities from a list of enumerated third parties that the staff identified, the staff would not recommend enforcement for violation of the current custody rule if the adviser meets specified conditions. *See* Investment Adviser Association, SEC Staff No-Action Letter (Sep. 20, 2007) ("2007 IAA No-Action Letter"). *See also* Custody Rule FAQs, *supra* footnote 17, at Question II.1.

interpretation be available only when client assets are received from senders, such as those identified in staff statements? Rather than specify senders in such an exception, should the exception or interpretation be available when an adviser determines it would be unfeasible to return the assets, or when there is a risk that the client's assets could be lost if the adviser attempted to return them to the sender? Should such an exception or interpretation be available only if the investment adviser's receipt of its client's assets is inadvertent? Should we condition such an exception or interpretation on recordkeeping requirements under proposed rule 204-2 or on whether advisers design policies and procedures under rule 206(4)-7? We understand that for certain private fund advisers and trustees it is difficult to avoid temporarily possessing client checks and physical assets because there may not be an independent representative to arrange the movement of such assets into a qualified custodian. Are there any particularities to these contexts that would benefit from an exception or interpretation? In addition, are there other circumstances that involve checks written to third parties, checks written to clients, and checks written to advisers where the adviser has no authority to deposit client assets into any account other than directed by the client that would benefit from exceptions or interpretations? Are there certain policies and procedures maintained by advisers that mitigate the custody risks associated with receiving checks that may be beneficial to include in this rulemaking? For example, if the adviser has policies and procedures reasonably designed to maintain such assets with a qualified custodian, should we provide an exception if an adviser to a private fund or serving as a trustee

would not be subject to the rule for the brief handling of client checks or physical assets?

16. Should we include an exception from the rule for assets for which the adviser provides advice in certain sub-adviser relationships, such as was described in our staff's statements?[83] In what circumstances should such an exception apply? Would an exception designed to capture circumstances where the proposed rule would apply to the sub-adviser only because its related person triggers the rule with respect to the same advisory clients be beneficial? Such an exception could be conditioned on the related person being fully subject to (and in compliance with) the applicable requirements of the custody rule. Would such a condition to the exception work in practice? Should such exception be conditioned on the adviser's related person fully complying with the requirements of the proposed rule? If not, why not? If so, how would advisers determine whether their related person is fully complying with the rule? Are there alternative safeguards that commenters would suggest? Alternatively, should such sub-advisers be subject to all or certain requirements of the rule? If only certain requirements, which ones and why? Should we condition such an exception on recordkeeping requirements under proposed rule 204-2 or on whether advisers design policies and procedures under rule 206(4)-7?
17. Are there are any other arrangements or circumstances where an adviser would have custody under the proposed rules but an exception would be beneficial and not

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83 We note that the staff has issued a no-action letter on this topic. *See Investment Adviser Association*, SEC Staff No-Action Letter (Apr. 25, 2016), available at: https://www.sec.gov/divisions/investment/noaction/2016/investment-adviser-association-042516-206(4).htm.

inconsistent with the policy goals of the rule? For example, are there specific circumstances involving custody at electronic platforms, investment adviser aggregators, benefit plans, introducing broker-dealers, plan sponsors, record-keepers, or third party administrators that would benefit from an exception or interpretation that these arrangements constitute or do not constitute custody?

B. Qualified Custodian Protections

Qualified custodians would continue to serve as key gatekeepers under the proposed rule. These institutions' custodial activities are subject to regulation and oversight.[84] Accordingly, as under the current rule, investment advisers with custody of client assets would be required to maintain those assets with a qualified custodian.[85] We are proposing several ways to strengthen the requirement, however, in light of the evolution of the market for custodial services, financial products, and advisory services over the last decade. These proposed changes aim to provide investors with certain standard custodial protections that will improve the safeguarding of their assets in the current market as well as in the future as the market for financial products and advisory services continues to evolve.

The proposed rule would continue to allow banks or savings associations, registered broker-dealers, registered futures commission merchants, and certain foreign financial institutions to act as qualified custodians, but, in a change from the current rule, only if they have "possession or control" of client assets pursuant to a written agreement between the qualified

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84 2002 Proposing Release, *supra* footnote 1, at n. 30; 2009 Proposing Release, *supra* footnote 11, at n. 4.

85 Proposed rule 223-1(a)(1)(i). The proposed rule would provide an exception, and another means of compliance with the rule, for certain assets that are unable to be maintained with a qualified custodian. *See* proposed rule 223-1(b)(2).

custodian and the investment adviser.[86] Also in a change from the current rule, the proposed rule would modify the definition of foreign financial institution and requirements for banks and savings associations in the definition of qualified custodian.[87] In the case of a qualified custodian that is the adviser, the proposed rule would require that the written agreement be between the adviser and the client.

The proposed rule would require that the written agreement contain contractual provisions that we believe are critical to providing important protections for advisory client assets. As discussed in further detail below, the contractual terms would address recordkeeping, client account statements, internal control reports, and the adviser's agreed-upon level of authority to effect transactions in the account. In addition, the proposed rule would require that an adviser obtain reasonable assurances from a qualified custodian relating to certain protections the qualified custodian will provide to the advisory client, including with respect to the qualified custodian's standard of care, indemnification, limitation of liability for sub-custodial services, segregation of client assets, and attachment of liens to client assets. Also as discussed below, we believe that many of these important protections are already provided—through contract or practice—by certain custodians to certain custodial customers in the current market. However, the proposed rule is designed to expand and 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 our proposed rule. We believe that the proposed rule leverages the expertise and regulatory regimes of qualified custodians with respect to a wide range of assets, while, at the same time, tailoring and bolstering the protections

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86 *See* proposed rule 223-1(a)(1).

87 *See* proposed rule 223-1(d)(10)(i) and (iv); section II.B.1.b, *infra*.

afforded to advisory clients to improve the safeguarding of client assets over which advisers have custody.

1. Definition of Qualified Custodian

Qualified custodians under the proposed rule would include the types of financial institutions that clients and advisers customarily turn to for custodial services and that have in place practices that are designed to protect custodial assets. We continue to believe that the use of a qualified custodian would enhance the protections afforded to client assets.[88]

The proposed rule, like the current rule, would define the term "qualified custodian" to mean a bank or savings association, registered broker-dealer, registered futures commission merchant ("FCM"), or certain type of foreign financial institution ("FFI") that meets the specified conditions and requirements.[89] We continue to believe that these financial institutions should be permitted to act as qualified custodians because, as discussed in more detail below, they operate under regular government oversight, are subjected to periodic inspection and examination, have familiarity with providing custodial services, and are in a position to attest to custodial customer holdings and transactions[90]—all critical components of safeguarding client assets under the proposed rule. As a result, with the exception of proposed amendments to the

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88 *See* 2003 Adopting Release, *supra* footnote 2; 2009 Adopting Release, *supra* footnote 11.

89 Proposed rule 223-1(d)(10). Not all registered broker-dealers and registered FCMs meet the definition of qualified custodian under the custody rule or the proposed safeguarding rule. Notably, only those broker-dealers or FCMs holding client assets in customer accounts meet this definition. This would include the broker-dealers subject to the customer protection rule (Exchange Act Rule 15c3-3) and FCMs holding futures customers funds subject to 17 CFR 1.20.

90 *See, e.g.*, 2009 Adopting Release, *supra* footnote 11, at section I (describing qualified custodians under the rule as the types of financial institutions to which clients and advisers customarily turn for custodial services and as subject to regulation and oversight).

definition of qualified custodian relating to banks, savings associations, and FFIs, we are not changing the types of institutions that may serve as qualified custodians under the rule.[91]

a. Bank and Savings Association Qualified Custodian Proposed Amendments

The current rule includes in the definition of qualified custodian a bank as defined in section 202(a)(2) of the Advisers Act (15 U.S.C. 80b-2(a)(2)) or a savings association as defined in section 3(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(b)(1)) that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act (12 U.S.C. 1811). The proposed rule would largely retain this definition of qualified custodian relating to banks and savings associations. However, in connection with the proposed rule's focus on setting certain minimum protections for client assets, the rule would require that a qualifying bank or savings association hold client assets in an account that is designed to protect such assets from creditors of the bank or savings association in the event of the insolvency or failure of the bank or savings association (*i.e.,* an account in which client assets are easily identifiable and clearly segregated from the bank's assets) in order to qualify as a qualified custodian. We believe that requiring banks and savings associations to hold client assets in such an account brings the requirements for bank and savings association qualified custodians in line

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[91] We remind advisers that as additional financial institutions become available to custody assets, advisers must continue to exercise their fiduciary duties to clients in connection with selection and monitoring of the qualified custodian. *See, e.g.*, Standard of Conduct for Investment Advisers Release, *supra* note57, at section II ("The investment adviser's fiduciary duty is broad and applies to the entire adviser-client relationship.") (citations omitted).

with the protections required for broker-dealers, FCMs, and FFIs acting as qualified custodians under the current custody rule and under the proposed safeguarding rule.[92]

We believe that the proposed account requirement would improve the safeguarding of client assets. We understand that, generally, a bank deposit account creates a debtor-creditor relationship between the bank and depositor.[93] This debtor-creditor relationship typically does not create a special or fiduciary relationship.[94] While applicable insolvency law and procedures vary depending on any particular bank or savings association's regulatory regime,[95] we understand that assets held in accounts of the type proposed by the rule are more likely to be returned to clients upon the insolvency of the qualified custodian because they may pass outside of a bank's insolvency, may be recoverable if wrongly transferred or converted, and are not treated as general assets of the bank.[96]

We believe that the proposed rule would provide flexibility to banks and savings associations to use the appropriate accounts available to them under applicable law and offered

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92 The current custody rule requires that in order to be included in the definition of qualified custodian, a broker-dealer registered under section 15(b)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(b)(1)), must hold the client assets in customer accounts, a futures commission merchant registered under section 4f(a) of the Commodity Exchange Act (7 U.S.C. 6f(a)) must hold the client assets in customer accounts subject to certain additional requirements, and an FFI must customarily hold financial assets for its customers and must keep the advisory clients' assets in customer accounts segregated from its proprietary assets. *See* rule 206(4)-2(d)(6)(ii), (iii), and (iv). *See also* proposed rule 223-1(d)(10).

93 *See generally*, Graham, Heitz, Lapine, *et al.*, 6a Banking Law § 134.05 (2022) § 134.05 (collecting cases) ("Banking Law"). We understand that a deposit in a bank is either general or special and that a deposit is a general deposit unless there is an agreement or understanding that it should be special. *See* 5C Michie on Banks and Banking, Deposits § 339 (Sept. 2022) (collecting cases) ("Michie on Banks & Banking"); Banking Law, § 134.05 ("Accounts are either special accounts or general accounts.") (collecting cases).

94 *Id.*

95 *See* 3 Michie on Banks & Banking, Insolvency and Dissolution. § 17. Jurisdiction and Powers of Courts and Officials in General (discussing state-by state jurisdiction and certain regulatory powers).

96 *See* Michie on Banks & Banking, Deposits § 339 (collecting cases under a wide variety of state laws where a bank may be acting as a trustee, bailee, or agent in connection with a customer account that is treated as other than a general deposit account).

by them to customers. Rather than consider the treatment of custodial customer assets upon a bank's failure in all 50 states, and risk the protections of our rule eroding if state banking law protections vary or evolve, we are proposing to establish a consistent and uniform standard to protect all advisory clients. The account terms should identify clearly that the account is distinguishable from a general deposit account and clarify the nature of the relationship between the account holder and the qualified custodian as a relationship account that protects the client assets from creditors of the bank or savings association in the event of the insolvency or failure of the bank or savings association.

b. Proposed Enhancements to Definition of Foreign Financial Institution

Advisory clients often invest in assets traded on foreign exchanges and their advisers must, as a practical matter, maintain those assets with financial institutions in foreign countries where the assets are traded. In order to facilitate these types of holdings, the current rule includes FFIs that customarily hold financial assets for their customers, as qualified custodians, provided that the FFI keeps the advisory clients' assets in customer accounts segregated from the FFI's proprietary assets.[97]

We are proposing to require that an FFI satisfy seven new conditions in order to serve as a qualified custodian for client assets under the proposed rule.[98] These proposed conditions are

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97 *See* rule 206(4)-2(d)(6)(iv). Under the current rule, when an adviser selects an FFI to hold clients' assets, we believe the adviser's fiduciary obligations require it either to have a reasonable basis for believing that the FFI satisfies the conditions and would provide a level of safety for client assets similar to that which would be provided by a "qualified custodian" in the United States or to disclose fully to clients any material risks attendant to maintaining the assets with the foreign custodian. *See* 2003 Adopting Release, *supra* footnote 2, at note 22.

98 We also propose to eliminate the requirement under the current definition that the FFI keeps the advisory clients' assets in customer accounts segregated from its proprietary assets because the proposed rule, more

partly drawn from our experience with the factors relevant to the safekeeping of "Foreign Assets" by the types of foreign financial entities that can act as an "Eligible Foreign Custodian" as defined in rule 17f-5 under the Investment Company Act.[99] Such conditions are also designed to address our understanding of market developments since the adoption of rule 17f-5 by providing enhanced investor protections for advisory clients and their assets that we believe would help promote an FFI having generally similar protections as a U.S.-based qualified custodian. Recent events in crypto assets markets also have highlighted the need for similarly enhanced custody safeguards of client assets held outside the United States.

For an FFI to be a qualified custodian under the proposed rule, it would need to be:

- Incorporated or organized under the laws of a country or jurisdiction other than the United States, provided that the adviser and the Commission are able to enforce judgments, including civil monetary penalties, against the FFI;
- Regulated by a foreign country's government, an agency of a foreign country's government, or a foreign financial regulatory authority[100] as a banking institution, trust company, or other financial institution that customarily holds financial assets for its customers;

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broadly, would require advisers to obtain reasonable assurances from qualified custodians that *all* advisory client assets are segregated from the qualified custodian's proprietary assets and liabilities. *See* proposed rule 223-1(a)(1)(ii)(D).

99 Rule 17f-5 under the Investment Company Act defines an Eligible Foreign Custodian as an entity that is incorporated or organized under the laws of a country other than the United States and that is a Qualified Foreign Bank or a majority-owned direct or indirect subsidiary of a U.S. Bank or bank-holding company. For these purposes, a Qualified Foreign Bank is defined as a banking institution or trust company, incorporated or organized under the laws of a country other than the United States, that is regulated as such by the country's government or an agency of the country's government. *See* 17 CFR 270.17f-5(a)(1) and (a)(5). Rule 17f-5(c)(1) under the Investment Company Act lists the factors relevant to the safekeeping of Foreign Assets, as defined in rule 17f-5(a)(2). *See* 17 CFR 270.17f-5(c)(1) and (a)(2).

100 Defined in section 202(a)(24) of the Advisers Act [15 U.S.C. 80b-2(a)(24)].

- Required by law to comply with anti-money laundering and related provisions similar to those of the Bank Secrecy Act [31 U.S.C. 5311, et seq.] and regulations thereunder;
- Holding financial assets for its customers in an account designed to protect such assets from creditors of the foreign financial institution in the event of the insolvency or failure of the foreign financial institution;
- Having the requisite financial strength to provide due care for client assets;
- Required by law to implement practices, procedures, and internal controls designed to ensure the exercise of due care with respect to the safekeeping of client assets; and
- Not operated for the purpose of evading the provisions of the proposed rule.[101]

We believe each of these proposed new conditions would enhance the ability and responsibility of advisers to protect client assets maintained outside the United States for the following reasons.

Regarding the first condition, we are proposing to require the adviser to determine that the adviser and the Commission are able to enforce judgments, including civil monetary penalties, against the FFI. The FFI could satisfy this condition by such means as appointing an agent for service of process in the United States or having offices in the United States, and the adviser can request the relevant documentation for verification purposes. This condition would thus limit the types of foreign financial entities to those that are subject to or consent to U.S. jurisdiction.

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[101] Proposed rule 223-1(d)(10)(iv).

Regarding the second condition, we believe requiring an FFI be regulated by a foreign country's government, an agency of a foreign country's government, or a foreign financial regulatory authority, as defined in section 202(a)(24) of the Advisers Act, would help ensure that client assets maintained with an FFI are subject to regulatory oversight that would better serve our policy goal of protecting custodial assets by the use of qualified custodians that meet our proposed requirements. In addition to banking institutions and trust companies, we would permit foreign-regulated financial institutions who customarily hold financial assets for their customers (*e.g.*, the foreign equivalent of broker-dealers or FCMs) to serve as "qualified custodians."

We believe the requirement in the third condition for an FFI to comply with anti-money laundering ("AML") and related provisions similar to those of the Bank Secrecy Act ("BSA") and regulations thereunder would help increase the likelihood that the FFI would readily identify and investigate aberrant behavior in a client account, such as activity that might suggest misappropriation or some other type of loss to a client. We generally believe an FFI would be able to satisfy this condition if it is required to comply with the laws and regulations established by a member or observer jurisdiction of the Financial Action Task Force ("FATF") and not otherwise listed on any sanctions list administered by the Office of Foreign Assets Control of the U.S. Department of the Treasury ("OFAC"),[102] or on any special measures list administered by

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[102] The FATF is an inter-governmental body whose purpose is the development and promotion of policies, both at the national and international levels, to combat money laundering and the financing of terrorism and proliferation. The FATF monitors members' progress in implementing AML measures, reviews money laundering techniques and counter-measures, and promotes the adoption and implementation of AML measures globally. *See* https://www.fatf-gafi.org/en/the-fatf/what-we-do.html/. To search sanctions lists administered by OFAC, such as the Specially Designated Nationals and Blocked Persons list, *see* https://sanctionssearch.ofac.treas.gov.

the Financial Crimes Enforcement Network of the U.S. Department of the Treasury (FinCEN").[103]

The fourth condition would replace and strengthen the segregation requirement for FFIs in the current definition of qualified custodian in the custody rule, and it is designed to complement the proposed segregation requirements of the safeguarding rule. In the current rule, an FFI that customarily holds financial assets for its customers is permitted to serve as a qualified custodian, provided that the FFI keeps the advisory clients' assets in customer accounts segregated from its proprietary assets. The proposed new condition would require the FFI to hold financial assets for its customers in accounts designed to protect such assets from creditors of the FFI in the event of the insolvency or failure of the FFI.[104] This condition would thereby impose investor protections, particularly in the event of an FFI insolvency or bankruptcy, that are more comparable to those we are proposing for assets held with U.S.-regulated bank or savings association qualified custodians. We believe advisers would be able to assess whether an FFI is holding client assets in such accounts in the course of obtaining the reasonable assurances we are proposing to require advisers obtain from all qualified custodians, which are discussed more fully below.[105]

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103 *See* Section 311 of the USA PATRIOT Act [Pub. L. 107-56] (granting the Secretary of the Treasury the authority to conclude, if reasonable grounds exist, that a foreign jurisdiction, foreign financial institution, or an international transaction or account is of "primary money laundering concern," and to require domestic financial institutions and financial agencies to take certain "special measures," such as additional due diligence and special attention to particular account transactions, among other measures, against the designated entity).

104 *Compare* rule 204-2(d)(6)(iv) *with* proposed rule 223-1(d)(10)(iv)(D).

105 *See infra* section II.B.3.a.iv (discussing the adviser's requirement to obtain reasonable assurances from qualified custodians regarding the required account segregation requirements).

The fifth condition is designed to limit the types of FFIs that can serve as qualified custodians to those that have the requisite financial strength to meet the proposed due care standard for client assets. We believe the determination of an FFI's financial strength could be based on objective measures and other indicators of financial health that are reasonably comparable to those that apply to U.S. banks and other regulated financial institutions.[106] Given that advisers would be required to maintain an ongoing reasonable belief that the FFI qualified custodian is meeting its due care standard, advisers also could require notifications from the FFI of any changes, including changes in the financial strength of the FFI, that would have an impact on the agreed terms of the written custodial contract. Such notifications may provide timely information to help advisers, as fiduciaries, to react and respond to emerging risks of loss of client assets.

Under the sixth condition, FFI qualified custodians would be required by law to implement practices, procedures, and internal controls designed to ensure the exercise of due care with respect to the safekeeping of assets. Since FFIs are subject to a broad range of regulatory regimes, we believe this condition would help promote a minimum level of practices, procedures, and internal controls across qualified custodians for safekeeping client assets under the proposed rule, regardless of where and how they are held. Further, we believe this requirement will help to ensure that an FFI's practices, procedures, and internal controls, including, but not limited to, those with respect to the safekeeping of certificated and

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106 When the Commission adopted amendments to rule 17f-5 (17 CFR 270.17f-5) in 1997, its adopting release offered guidance to evaluate financial strength by "assess[ing] the adequacy of the custodian's capital with a view of protecting the fund against the risk of loss from a custodian's insolvency." *See* Custody of Investment Company Assets Outside the United States, Investment Company Act Release No. 22658 (May 12, 1997) [62 FR 26923 (May 16, 1997)], at 26928. We understand that relevant governments and their banking regulators typically set regulatory capital requirements for foreign banking institutions.

uncertificated assets, custodial recordkeeping, and security and data protection, should not differ in material ways from those of U.S.-regulated qualified custodians. Similar to the fourth condition, advisers should be able to assess and evaluate an FFI's internal controls while obtaining the reasonable assurances we are proposing advisers obtain from all qualified custodians.[107]

Finally, we have included an anti-evasion requirement in the seventh condition for FFI qualified custodians that is similar to the anti-evasion provision currently in the definition of "bank" under section 202(a)(2) of the Advisers Act and in the definition of "U.S. Bank" under rule 17f-5 of the Investment Company Act.[108] Given the broad scope of foreign financial entities that we would permit to serve as qualified custodians, we believe it is appropriate to apply the anti-evasion requirement to all types of FFIs, rather than limiting its application to only banking institutions or trust companies.

We request comment on all aspects of the proposed rule's qualified custodian requirement, including the following items.

18. Should we continue to require that client assets be maintained with qualified custodians? If not, what alternative protections for client assets should we require as part of the rule?
19. Should the rule continue to include banks as defined in section 202(a)(2) of the Advisers Act or savings associations as defined in section 3(b)(1) of the Federal

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107 *See infra* section II.B.3.a.i (discussing the adviser's requirement to obtain reasonable assurances from a qualified custodian regarding the qualified custodian's required exercise of due care and implementation of appropriate measures to safeguard client assets from theft, misuse, misappropriation, or other similar type of loss).

108 17 CFR 270.17f-5(a)(7)(iii).

Deposit Insurance Act as qualified custodians, as proposed? Should the rule narrow the definition to include only certain banks and savings associations as qualified custodians? If so, how? For example, should the rule permit only banks or savings associations that are subject to Federal regulation and supervision to act as qualified custodians? Alternatively, should the rule permit only state banks and savings association that are members of the Federal Reserve System to act as qualified custodians?[109] Would narrowing of the types of banks and savings associations that meet the definition of qualified custodian provide additional protections to advisory clients in the event of the custodian's insolvency? Is there another way to achieve our policy goal?

20. Should we require banks and savings associations to hold client assets in an account designed to protect such assets from creditors of the bank or savings association in the event of the insolvency or failure of the bank or savings association as proposed? Is our understanding correct that requiring banks and savings associations to hold client assets in an account of this type would provide client assets with enhanced protection from general creditors in the event of the qualified custodian's insolvency and increase the likelihood of return of client assets to advisory clients upon a qualified custodian's insolvency? Do commenters agree with our view that this enhanced protection is especially important in light of the broad range of regulatory regimes and insolvency processes to which a growing number of state-chartered trust

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[109] *See generally* Membership of State Banking Institutions in the Federal Reserve System (Regulation H) 12 CFR 208.01 *et. seq*.

companies and other state-chartered, limited purpose banking entities entering the custodial market may be subject?

21. Should the rule require the account terms to identify clearly that the account is distinguishable from a general deposit account? Should the rule require the terms of the account clarify the nature of the relationship between the account holder and the qualified custodian, for example, whether the account is a special account,[110] a fiduciary account,[111] or whether the bank or savings association is acting as a trustee, a bailee, or agent of the account holder?
22. Would requiring banks and savings associations to hold client assets in an account designed to protect such assets from creditors of the bank or savings association in the event of the insolvency or failure of the bank or savings association reduce the availability of banks or savings associations that could offer services as a qualified custodian? Would it increase costs to advisory clients?
23. Rather than requiring accounts of this type for all banks and savings associations, should the rule require accounts that protect client assets from creditors of a bank or savings association in the event of the insolvency or failure of the bank or savings association for a subset of these institutions that are not federally insured or OCC

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110 *See, e.g.,* Bank of America, N.A. v. Lehman Bros. Holdings, Inc. (In re Lehman Bros. Holdings, Inc.), 439 B.R. 811, 824-825 (Bankr. S.D.N.Y. Nov. 16, 2010) ("Other factors that courts have examined to ascertain the parties' mutual intent [to create a special rather than general account] include: (1) whether the parties agreed to segregate the funds; (2) whether the bank paid interest on the funds; (3) whether the depositor lacked an unfettered right to withdraw the funds; and (4) whether a third party possessed an interest in the funds.").

111 *See, e.g.*, 12 CFR 9.13 and 12 CFR 150.230 (addressing custody of fiduciary assets for banks and savings associations, respectively).

member banks? For example, should the rule require accounts of this type for state banks that are not members of the Federal Reserve System?

24. Are there alternative bank and savings association account safeguards we should require?

25. Should the rule continue to include broker-dealers registered under section 15(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act") as qualified custodians, as proposed? Are there additional requirements we should require when a broker-dealer is acting as a qualified custodian under the rule? For example, should we explicitly clarify that this would include only registered broker-dealers that carry customer accounts, or is that already understood from the current rule?

26. Should the rule continue to include FCMs as qualified custodians, as proposed? Should we remove the condition in the current rule that prohibits maintaining client securities with an FCM unless the securities are "incidental" to client futures transactions? In 2013, the CFTC enhanced protections afforded to customers and customer assets held by FCMs including protections covering, among other things, risk management, recordkeeping and disclosure, and the treatment of customer-segregated funds secured in foreign futures and options accounts.[112] Are the 2013

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[112] The CFTC in 2013 enhanced FCM requirements surrounding the holding and investment of customer funds, including the ability of FCMs to withdraw funds from futures customer segregated accounts. Under the enhanced protections, FCMs are required to deposit proprietary funds (*i.e.* residual interest) into futures, cleared swap, and foreign futures customer accounts for purposes of creating a buffer to ensure compliance with segregation requirements. In addition, FCMs are required to file electronically their segregation calculations with the CFTC and their self-regulatory organization each business day. Further, FCMs are required to establish risk management programs designed to monitor and manage risks associated with customer funds. *See* Enhancing Protections Afforded Customers and Customer Funds Held by Future Commission Merchants and Derivatives Clearing Organizations, ("CFTC Enhanced Protections Release") [78 FR 68506 (Nov. 14, 2013)].

CFTC regulatory enhancements sufficient grounds to eliminate that condition of the current rule?

27. Should the rule limit the FFIs that can act as qualified custodians under this rule, as proposed? Are the proposed conditions on an FFI sufficiently clear, and if not, how should they be made clearer? Should we eliminate any condition, add any condition, or require only certain conditions and not others when an FFI is acting as a qualified custodian under the rule? For example, as part of the rule, should we require an adviser to find that the FFI provides a level of safety for client assets equivalent to that which would be provided by a qualified custodian in the United States or to fully disclose to clients any material risks attendant to maintaining the assets with the foreign custodian? Should this requirement apply only when the adviser is involved in selecting (or assisting a client in selecting) a qualified custodian? Are there types of FFIs that currently serve as qualified custodians that would no longer be eligible to serve as qualified custodians under the proposed rule? Would the proposed changes to the definition of FFI enhance or inhibit investor protections? Would the proposed changes to the definition of FFI cause any investments that an investment adviser currently is able to select on behalf of its clients to become unavailable for selection by the adviser due to the lack of the existence of an FFI that satisfies the conditions of the proposed rule? Should we only permit institutions regulated by a specific foreign financial regulatory authority? If so, which foreign financial authority and why? Should we require the adviser to obtain documentation that identifies the FFI's specific financial regulatory authority or authorities? Should the rule permit only certain types of FFIs to qualify as qualified custodians and if so,

which ones? Are there any types of regulated foreign entities that should not hold certain types of client assets outside the United States? Should the proposed rule account for the country or jurisdiction where an FFI is primarily operating, rather than the country or jurisdiction of incorporation or organization, as proposed? If so, how would the adviser determine where the FFI is primarily operating?

28. Should the proposed rule limit the types of FFIs that can be qualified custodians? If so, which institutions should be included? Only banking institutions or trust companies? Should we also specifically include foreign securities depositories and clearing agencies or broker-dealer and FCM equivalents?

29. Is the proposed definition to include regulated FFIs that customarily hold financial assets for customers too broad; would it allow unsound institutions to act as qualified custodians under the proposed rule?

30. What, if any, impacts would our proposed conditions have on the availability of FFIs that can serve as qualified custodians? What would be the positive and negative effects of requiring FFIs to provide custodial protections similar to the protections provided by U.S. qualified custodians?

31. Should the proposed rule require an FFI to be subject to or consent to U.S. jurisdiction for judgment enforceability, as proposed? Alternatively, should judgment enforceability be a factor relevant to the adviser's consideration of whether client assets will be subject to the requisite due care standard by an FFI, similar to the approach in rule 17f-5(c)(1) under the Investment Company Act?[113] Should we

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[113] *See* 17 CFR 270.17f-5(c)(1)((iv).

require the adviser to obtain the FFI's consent to service of process in the United States to verify that it meets this condition? Should such consent to service of process be effected by the FFI's submission of a specified form to the Commission, similar in effect to Form ADV-NR for the appointment of an agent for service of process by a non-resident general partner or a non-resident managing agent of any investment adviser?

32. Should an FFI be required to comply with laws and regulations similar to the BSA to act as a qualified custodian, as proposed? Do the AML requirements for FFIs help ensure that a qualified custodian would more readily identify and investigate aberrant behavior in a client's account? Alternatively, should we specify the types of AML programs that must be in place for FFIs?

33. Should we treat an FFI as being required to comply with laws and regulations similar to the BSA if the FFI is required to comply with the laws and regulations established by a member or observer jurisdiction of the FATF and not otherwise listed on any sanctions list administered by the OFAC or on any special measures list under section 311 of the USA PATRIOT Act administered by FinCEN? Alternatively (or in addition), should we automatically consider an FFI to *not* be required to comply with similar laws and regulations if it is required to comply with the laws and regulations of a country identified by the FATF as a high-risk or other monitored jurisdiction?[114]

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[114] The FATF identifies jurisdictions with weak measures to combat money laundering and terrorist financing in two FATF public documents that are issued three times a year. *See* https://www.fatf-gafi.org/en/topics/high-risk-and-other-monitored-jurisdictions.html.

34. Should we require that an FFI hold financial assets in accounts designed to protect such assets from creditors of the FFI in the event of the FFI's insolvency or failure, as proposed? Alternatively, should we require advisers to obtain reasonable assurances from an FFI qualified custodian that the FFI is holding client assets in such accounts? Should we require an FFI to have account protections that are generally similar to those of a U.S. bank or savings association in the event of its insolvency or failure? If so, should we provide guidance around how an adviser would make such determinations of general similarity and to maintain records of these determinations?
35. Should we provide additional guidance around how an adviser would determine that an FFI's practices, procedures, and internal controls are designed to ensure the exercise of due care with respect to safekeeping of client assets? Should we require an FFI's practices, procedures, and internal controls to be generally similar to those of a U.S.-regulated bank or savings association? If an FFI is not a bank or savings association, but rather a foreign-equivalent to a U.S. broker-dealer or U.S. FCM, should we require the adviser to determine that such FFI's practices, procedures, and internal controls are generally similar to those required by U.S. broker-dealers or FCMs? If so, should we provide guidance around how advisers would make such determinations of general similarity and to maintain records of these determinations?
36. Should we provide additional guidance around how an adviser would determine the requisite financial strength of an FFI qualified custodian? Should we require advisers to maintain records of these determinations? Should we require advisers to have policies and procedures to determine and monitor the financial strength of all

qualified custodians, not just FFI custodians? Should this requirement apply only when the adviser is involved in selecting (or assisting a client in selecting) a qualified custodian?

37. To what extent do advisers or qualified custodians utilize sub-custodians, such as foreign subsidiaries of a domestic qualified custodian? What types of sub-custodians are utilized? Do these sub-custodians have direct relationships with the adviser or client or do they only interact directly with the qualified custodian? How are sub-custodians overseen? Is this oversight performed by the adviser or the qualified custodian? If it is by the qualified custodian, how do advisers ensure that the client assets are safeguarded properly?
38. Should the rule permit securities depositories, administrators, or other intermediaries to be qualified custodians? Do they offer similar services to the other types of financial institutions that meet this definition, for example, by safeguarding and providing account statements to advisory clients? Would they be able to agree to the contractual terms contained in the proposed written agreement requirement? Would advisers be able to satisfy the reasonable assurances requirement under the proposed rule if one of these types of entities were holding client assets? Do these types of entities maintain "possession or control" of client assets, as discussed below? Do they have similar capital adequacy requirements under their respective regulatory regimes to the other types of financial institutions that are included in the definition of qualified custodian? Are there certain categories of these entities that would more easily function as qualified custodians than others?

39. The rule currently excepts advisers from complying with the requirement to maintain mutual fund shares with a qualified custodian, provided they are maintained with a transfer agent.[115] Should transfer agents be included in the definition of qualified custodian in the final rule? Do they offer similar services to the other types of financial institutions that meet this definition, for example, by providing account statements to advisory clients? Would they be able to agree to the contractual terms contained in the proposed written agreement requirement? Would advisers be able to satisfy the reasonable assurances requirement under the proposed rule if a transfer agent were holding client assets?

40. Should insurance companies be included in the definition of qualified custodian under certain circumstances, such as in the variable annuity context?[116] Do they offer services similar to the other types of financial institutions that meet this definition, for example, by safeguarding and providing account statements to advisory clients? Would they be able to agree to the contractual terms contained in the proposed written agreement requirement? Would advisers be able to satisfy the reasonable assurances requirement under the proposed rule if an insurance company were holding client assets? Do insurance companies maintain "possession or control" of client assets, as discussed below? Do insurance companies have similar capital adequacy requirements to the other types of financial institutions that are included in the definition of qualified custodian? Are there certain categories or

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115 Rule 206(4)-2(b)(1).

116 Our staff indicated it would not recommend enforcement action when an insurance company served a particular role with respect to variable annuity contracts similar to the role of a transfer agent with respect to mutual fund shares. *See* American Skandia Life Assurance Corporation, May 16, 2005.

types of insurance companies that would more easily function as qualified custodians than others?

2. Possession or Control

In a change from the current rule, the proposed rule would require that an investment adviser maintain client assets with a qualified custodian that has possession or control of those assets. For the purposes of proposed rule, "possession or control" would be defined to mean holding assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets, the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership, and the qualified custodian's involvement is a condition precedent to the change in beneficial ownership.[117] We understand that a qualified custodian's participation in a change in beneficial ownership may take different forms depending on the type of asset involved.[118] Similarly, we view participation by a qualified custodian to require the qualified custodian to participate in a way that it is willing to attest to the transaction on an account statement and for which it customarily takes custodial liability. By contrast, we would not view "accommodation reporting," as described above, to constitute "participation." The proposed requirement and related definition are designed to achieve several objectives. First, a critical custodial function is to prevent loss or unauthorized transfers of ownership of the client's assets. It is our understanding that a custodian will only provide this

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117 *See* proposed rule 223-1(a)(1)(i) and (d)(2)(8). Exchange Act Rule 15c3-3(c) prescribes when securities shall be deemed to be under the control of a broker-dealer. See 17 CFR 240.15c3-3(c).

118 For example, for certain privately offered securities, we understand banks will put the securities in their name as nominee. We also understand that a change in beneficial ownership may occur at different points in the transaction lifecycle based on the type of asset involved. For example, when purchasing an equity security, the change in beneficial ownership occurs on trade date (*see, e.g.*, rule 240.13d-3 - Determination of beneficial owner), but we understand that when purchasing real property, the change in beneficial ownership typically occurs on the settlement date.

safeguarding function, however, and assume custodial liability for a custodial customer's loss, if the custodian had possession or control of the asset that is lost. Second, because the qualified custodian would be required to participate in any change in beneficial ownership of a client asset, the proposed possession or control definition would provide assurance that a regulated party who is hired for safekeeping services by the client to act for the client is involved in any change in beneficial ownership of the client's asset. Finally, we believe it would help ensure the integrity of account statements provided by qualified custodians because the custodian would report only on the holdings in its possession or control (unless the client requests that the qualified custodian report on holdings that are not in its possession or control). As a result, a client could take comfort that what is reported on its account statement is an accurate attestation of holdings and transactions by that custodian.

The proposed definition of "possession or control" in proposed rule 223-1 is designed to be consistent with the laws, rules, or regulations administered by the qualified custodian's functional or primary financial regulator for purposes of its custodial activities. Under the existing regulatory regimes under which qualified custodians currently operate, a qualified custodian must generally maintain assets in its physical possession or control. We believe our proposed definition of possession or control (*i.e.,* being required to participate in any change of beneficial ownership) is consistent with how the concept of possession or control is understood currently by most qualified custodians and does not conflict with the requirements of qualified custodians' respective regulatory regimes. The proposed rule would formalize that understanding.

For example, under the Exchange Act, broker-dealers are required promptly to obtain and maintain in their physical possession or control all of their customers' fully paid and excess

margin securities.[119] As a result, a broker-dealer would necessarily be involved in the transfer of beneficial ownership of those securities. In addition, national banks that offer safeguarding of customer assets are responsible for maintaining adequate custody or control of their customer assets.[120] Again, as a result, national banks would have to relinquish their custody or control of an asset to transfer ownership. Similarly, the protections under section 4d(a)(2) of the Commodity Exchange Act and regulations promulgated thereunder, including, among others, CFTC regulation 1.20 (Futures customer funds to be segregated and separately accounted for), CFTC regulation 1.22 (Use of futures customer funds restricted), and CFTC regulation 1.25

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119 *See* 17 CFR 240.15c3-3(b) and (c).

120 National banks that fail to exercise proper control over customer securities may be subject to enforcement proceedings by the Comptroller of the Currency. *See* 12 U.S.C. 92a(k) (proceeding to revoke trust powers on account of unlawful or unsound exercise of powers). *See also* OCC, Comptroller's Handbook on Asset Management Operations and Control (Jan. 2011), *available at* https://www.occ.gov/publications-and-resources/publications/comptrollers-handbook/files/asset-mgmt-ops-controls/index-asset-mgmt-ops-controls.html; OCC regulation 12 CFR 9.13 (requiring, in connection with the custody of fiduciary assets, among other things, that "assets of fiduciary accounts [be placed] in the joint custody or control" of certain fiduciary officers or specially designated persons). The OCC has issued guidance relating specifically to custody of crypto assets by banks and federal savings associations. *See* Interpretive Letter 1170, Authority of a National Bank to Provide Cryptocurrency Custody Services for Customers (July 22, 2020), available at https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2020/int1170.pdf ("As with all other activities performed by national banks and FSAs, a national bank or FSA that provides cryptocurrency custody services must conduct these activities in a safe and sound manner, including having adequate systems in place to identify, measure, monitor, and control the risks of its custody services. Such systems should include policies, procedures, internal controls, and management information systems governing custody services. Effective internal controls include safeguarding assets under custody, producing reliable financial reports, and complying with laws and regulations. The OCC has previously described that custody activities should include dual controls, segregation of duties and accounting controls. A custodian's accounting records and internal controls should ensure that assets of each custody account are kept separate from the assets of the custodian and maintained under joint control to ensure that that an asset is not lost, destroyed or misappropriated by internal or external parties. Other considerations include settlement of transactions, physical access controls, and security servicing. Such controls may need to be tailored in the context of digital custody. Specialized audit procedures may be necessary to ensure the bank's controls are effective for digital custody activities. For example, procedures for verifying that a bank maintains access controls for a cryptographic key will differ from the procedures used for physical assets. Banks seeking to engage in these activities should also conduct legal analysis to ensure the activities are conducted consistent with all applicable laws.").

(Investment of customer funds),[121] are predicated on the acceptance of, and receipt by, a futures commission merchant of futures customers money, securities, or property.[122] It is our understanding that together, these, and other regulations applicable to FCMs, holistically serve the same purpose. In each of the foregoing cases, the respective custodian is required by its functional regulator to possess or control customer assets. While functional regulators have not defined possession or control in the custody context in a manner identical to our proposed rule (*i.e.*, holding assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets), we view the proposed definition to be crucial to safeguarding client assets and reflective of the fundamental underlying principle of the custody industry—a custodian holds client assets for safekeeping until directed by the client or the client's duly authorized agent to enter into a transaction with a counterparty resulting in a change of the client's beneficial ownership.[123]

For purposes of an FFI, we believe that the proposed requirement would promote the institution's accountability for client assets and would thereby help to promote more comparable

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121 *See also* Section 4d(a)(2) of the Commodity Exchange Act and CFTC Regulations 1.20 – 1.30 (Customers' Money, Securities, and Property); *and see* CFTC Regulation 1.32 (Reporting of segregated account computation and details regarding the holding of futures customer funds; CFTC Regulation 1.36 (Record of securities and property received from customers). These regulations address, among other things, segregation of customer funds, limitations on institutions in which the FCM may deposit customer funds, limitations on holding customer funds outside of the United States, limitations on the use of customer funds, and recordkeeping requirements relating to customer funds.

122 CFTC Regulation 1.3 defines a futures commission merchant to be "[a]ny individual, association, partnership, corporation, or trust [. . .] Who, in connection with any of the[] activities [identified in the regulation] *accepts* any money, securities, or property [. . . .] That regulation also defines futures customer funds to mean "all money, securities, and property *received by* a futures commission merchant or by a derivatives clearing organization from, for, or on behalf of, futures customers [for the purposes identified in the regulation]. 17 CFR 1.3 (emphasis added).

123 Alternatively, a custodian may return the asset to the customer.

investor protections to those assets held with U.S. financial institutions.[124] Since FFIs are subject to a broad range of regulatory regimes, we believe that this requirement, together with the account statement contract requirement discussed below, would formalize and make more uniform the assets reported on account statements produced by an FFI, thereby better informing clients regarding their holdings and transactions.

a. Application with respect to crypto assets

As discussed above, we believe that under their existing regulatory regimes, qualified custodians are generally considered to have "possession or control" of assets that are in their exclusive or physical possession or control. We understand, however, that proving exclusive control of a crypto asset may be more challenging than for assets such as stocks and bonds. For example, while we understand that it is possible for a custodian to implement processes that seek to create exclusive possession or control of crypto assets (*e.g.*, private key creation, maintenance, etc.), it may be difficult actually to *demonstrate* exclusive possession or control of crypto assets due to their specific characteristics (*e.g.,* being transferable by anyone in possession of a private key). Moreover, we are mindful of crypto asset custody models in which an advisory client and a qualified custodian might simultaneously hold copies of the advisory client's private key material to access the associated wallet with the client's crypto assets, and thus both have authority to change beneficial ownership of those assets.[125]

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124 *See e.g.*, the Undertaking for Collective Investment in Transferable Securities Regulations 2016 (UCITS V) (enhancing the rules on the responsibilities of UCITS custodians including making the UCITS custodian liable for the avoidable loss of a financial instrument held in its custody).

125 Letter from Anchorage Digital Bank NA re Custody Rule and Digital Assets (Apr. 13, 2021) ("Proof of exclusive control can be securely achieved through a combination of software, hardware, and operational processes. However, custody models that rely on private key redundancy (maintaining multiple physical or electronic copies) and physical security as a proxy for digital asset security can't ever truly prove this.").

As discussed above, the proposed rule's definition of possession or control turns on whether the qualified custodian is required to participate in a change in beneficial ownership of a particular asset. While demonstrating that a qualified custodian has exclusive possession or control of an asset would be one way to demonstrate that the qualified custodian is required to participate a change of beneficial ownership, it is not the only way. For example, under the proposed rule, a qualified custodian would have possession or control of a crypto asset if it generates and maintains private keys for the wallets holding advisory client crypto assets in a manner such that an adviser is unable to change beneficial ownership of the crypto asset without the custodian's involvement.[126]

Importantly, however, to comply with the proposed rule, an adviser with custody of client crypto assets would generally need to ensure those assets are maintained with a qualified custodian that has possession or control of the assets at all times in which the adviser has custody.[127] While this is true for most client assets over which an adviser has custody, it is particularly relevant with respect to crypto assets because, as we understand, much of the crypto asset trading volume occurs on crypto asset trading platforms that often directly settle the trades placed on their platforms. As a result, many crypto trading platforms require investors to pre-

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126 We note that, in the context of crypto asset securities, the Commission has stated that, "a broker-dealer that maintains custody of a fully paid or excess margin digital asset security for a customer must hold it in a manner that complies with Rule 15c3-3, including that *the digital asset security must be in the exclusive possession or control of the broker-dealer*. A digital asset security that is not in the exclusive possession or control of the broker-dealer because, for example, an unauthorized person knows or has access to the associated private key (and therefore has the ability to transfer it without the authorization of the broker-dealer) would not be held in a manner that complies with the possession or control requirement of Rule 15c3-3 . . . .]" Commission Statement, *supra* footnote 25 at 11629 (emphasis added).

127 This is not only true for crypto assets, but any client asset for which an adviser has custody, subject to the exceptions in the proposed rule. *See* proposed rule 223-1(b)(1) (Shares of Mutual Funds), (2) (Certain Assets Unable to be Maintained with a Qualified Custodian), and (5) (Registered Investment Companies).

fund trades, a process in which investors transfer their crypto assets, including crypto asset securities, or fiat currency to such an exchange prior to the execution of any trade. Because we understand that most crypto assets, including crypto asset securities, trade on platforms that are not qualified custodians, this practice would generally result in an adviser with custody of a crypto asset security being in violation of the current custody rule because custody of the crypto asset security would not be maintained by a qualified custodian from the time the crypto asset security was moved to the trading platform through the settlement of the trade.[128] In light of our proposal to expand the rule's application from "funds or securities"[129] to "assets,"[130] this practice would also constitute a violation of the proposed rule for an adviser with custody of client crypto assets if the adviser trades those assets on a crypto asset trading platform that does not satisfy the definition of "qualified custodian." Alternative Trading Systems that do not require pre-funding of trades and that trade crypto asset securities following a process that does not involve the broker-dealer operator of the Alternative Trading System providing custodial services for the crypto asset securities are discussed further below.[131]

We request comment on all aspects of the proposed possession or control requirement, including the following items.

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128 This differs from the approach with a U.S. national securities exchange, which does not routinely exercise possession or control of the securities listed on a national securities exchange. In this scenario, trades are executed on a national securities exchange, establishing the contract between buyer and seller. The national securities exchange then passes transaction details on to a clearing agency or depository, which steps in to facilitate and complete settlement between each party's custodian, specifically the exchange of cash and securities per the trade's contracted terms agreed on the national securities exchange on a delivery versus payment basis.

129 *See* rule 206(4)-2(a).

130 *See* proposed rule 223-1(a).

131 *See infra* footnotes 456-57 and accompanying text.

41. Should the rule include the possession or control requirement, as proposed? Would the proposed requirement provide additional protections for clients? Possession or control would be defined to mean holding assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets. Do commenters agree with our view that the term "participation" would mean that the qualified custodian would effectuate the transaction and its involvement would be a condition precedent to the change in beneficial ownership? How else would commenters describe a qualified custodian's participation? Should we instead define possession or control to mean holding assets such that the qualified custodian is required to effectuate any change in beneficial ownership of those assets? Do commenters agree with our understanding that a qualified custodian's participation in a change in beneficial ownership may take different forms depending on the type of asset involved? Do commenters agree with our view that participation by a qualified custodian would require the qualified custodian be willing to attest to the transaction on an account statement? Do commenters agree with our understanding that a qualified custodian will customarily take custodial liability for client assets for which it participates in beneficial changes of ownership?
42. Do the types of financial institutions serving as qualified custodians under the current rule maintain client assets in a manner that would satisfy the proposed definition of "possession or control"? Do commenters agree with our view that the proposed definition of possession or control (*i.e.*, being required to participate in any change of beneficial ownership) is consistent with how the concept of possession or

control is understood currently by most qualified custodians and does not conflict with the requirements of qualified custodians' respective regulatory regimes?

43. Is our understanding correct that qualified custodians hold client assets for safekeeping until directed by the client or the client's duly authorized agent to enter into a transaction with a counterparty resulting in a change of the client's beneficial ownership or until directed to return the assets to the client, subject to duly authorized custodial charges? Is our understanding correct that this is crucial to safeguarding client assets and reflective of a fundamental underlying principle of the custody industry?
44. Should we have different possession or control requirements for different qualified custodians? If so, what should they be, and why?
45. Are we correct in our understanding that a custodian will assume custodial liability for a custodial customer's avoidable loss only if the custodian has possession or control (*i.e.*, is required to participate in any change in beneficial ownership) of the asset that is lost?
46. Unlike as proposed, should the rule explicitly state that the qualified custodian maintain "physical" or "exclusive" possession or control of the client's assets? Do commenters agree with our understanding qualified custodians may face greater challenges in their ability to demonstrate exclusivity with respect to crypto assets as compared their ability to demonstrate exclusive possession or control with respect to stocks and bonds? Do custodians for crypto assets routinely consider the crypto assets they service to be in their exclusive possession or control? If so, how would exclusivity be demonstrated? Are there particular safeguarding practices with

respect to crypto assets that are better suited to demonstrating exclusivity than others? What kind of evidence would be necessary to demonstrate proof of exclusive possession or control of crypto assets? What type of procedures would a crypto asset custodian need to have to demonstrate exclusive possession or control of crypto assets?[132] Would requiring exclusive possession or control improve safeguarding of crypto assets? Given the nature of crypto assets, is it possible to demonstrate the exclusive possession or control of a particular crypto asset? How important do custodians view "exclusive" possession or control of a client asset, including a crypto asset, to be for liability reasons? How do existing custodians of crypto assets address the risk of liability for theft, fraud, or misappropriation of crypto assets when a client (and potentially others with whom the client has shared the private key material) retains the ability to effect a change in beneficial ownership of the asset without the involvement of the custodian?

47. Would a custodian for crypto assets be able to satisfy the proposed possession or control requirement? Would such a custodian be able to participate in a change of beneficial ownership for a client's crypto asset? What does it mean for a custodian to "participate" in a change of beneficial ownership for a client's crypto asset transaction? Does this involve only the deployment of the private key or keys associated with the public address where the client's crypto assets are recorded to transfer, as instructed, the client's crypto assets to another person with a public key?

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[132] *See* Commission Statement, *supra* footnote 25, at 11629 ("A digital asset security that is not in the exclusive physical possession or control of the broker-dealer because, for example, an unauthorized person knows or has access to the associated private key (and therefore has the ability to transfer it without the authorization of the broker-dealer) would not be held in a manner that complies with the possession or control requirement of Rule 15c3-3 and thus would be vulnerable to the risks the rule seeks to mitigate.").

Does this also include recording or communicating a change in beneficial ownership?

48. To what extent does a custodian for crypto assets take custodial liability for a beneficial change in ownership of a client's crypto assets?
49. Is our understanding of how many crypto asset trading platforms require investors to pre-fund trades correct? How many of these trading platforms require pre-funding trades? How many rely on other custodial arrangements and how do those crypto asset trading platforms operate with such custodial arrangements? How would the proposed rule impact advisers who trade on such trading platforms currently? What, if any, impacts would the proposed rule have on the availability of crypto asset trading platforms that may be able to serve as qualified custodians? Would the proposed definition of "possession or control" enhance or inhibit investor protections with respect to client assets traded on crypto asset trading platforms?
50. Do custodians for crypto assets permit the customer (and potentially others with whom the customer has shared a private key) to retain the ability to effect a change in beneficial ownership of the asset without the involvement of the custodian? In these cases, do commenters believe that advisory clients would receive the benefits of the protections of the proposed rule if they contractually required a qualified custodian to be involved in any beneficial change of ownership of the crypto asset? Would crypto asset advisory clients and custodians be willing to enter into contractual agreements of that type? Would requiring that a qualified custodian have exclusive possession or control over the crypto asset have an impact on the crypto asset custody industry? How big of an impact?

51. Are there asset types other than crypto assets over which a qualified custodian may not be able to obtain "exclusive" possession or control? Please indicate which asset types and explain why exclusivity may not be possible.

52. Is our understanding correct that beneficial ownership change may occur at different points in the transaction lifecycle based on asset type? Is there a customary reference to when a change in beneficial ownership occurs for each asset type? For crypto assets, does the change in beneficial ownership occur when the transaction is recorded on the blockchain or when the transaction is settled off-chain on the internal ledger system of a crypto asset trading platform? Are there differences if the transaction is recorded on a private or permissioned ledger than on a public or un-permissioned ledger? Are there differences if the transaction is settled on a centralized crypto asset trading platform versus a so-called decentralized crypto asset trading platform?

53. Many market participants refer today to "atomic settlement" of crypto asset trades.[133] Is this is commonly understood and used term? Does it mean that both legs of the trade settle simultaneously (similar to a delivery vs. payment transaction), or that the trade settles instantly, or both? Which aspect of crypto asset settlement (simultaneous settlement or instantaneous settlement) is preferable from an investor protection standpoint? Are there drawbacks to either? Should the Commission require particular protections related to crypto asset trades or custody? What about other crypto asset transactions?

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[133] *See* Michael Lee, Antoine Martin, and Benjamin Müller, What Is Atomic Settlement? (Nov. 7, 2022), available at https://libertystreeteconomics.newyorkfed.org/2022/11/what-is-atomic-settlement/.

54. Is it possible for an adviser to execute any trade that settles instantly and while maintaining the assets at a qualified custodian throughout the lifecycle of that trade? If so, how? Could the adviser do so and still have the ability to trade with counterparties other than the qualified custodian? How would that work?

3. Minimum Custodial Protections

The proposed rule would promote minimum standard custodial protections for advisory clients whose advisers have custody of client assets. It generally would require that the investment adviser maintain client assets with a qualified custodian pursuant to a written agreement between the qualified custodian and the investment adviser (or between the adviser and client if the adviser is also the qualified custodian).[134] It would further require the adviser to obtain reasonable assurances in writing from the custodian regarding certain vital protections for the safeguarding of client assets. We understand that under existing market practices, advisers are rarely parties to the custodial agreement, which is generally between an advisory client and a qualified custodian, resulting in an adviser having limited visibility into the custodial arrangements of its clients. This presents several issues under the current rule and can result in an adviser being subject to the rule due to what has become known as inadvertent custody, which can occur, for example, when the custodial agreement between a client and custodian grants an adviser broader access to client funds or securities than contemplated by the adviser's own agreement with the client and the adviser did not intend to have such access to client assets.[135]

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134 Proposed rule 223-1(a)(1)(i).

135 *See* Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority, Division of Investment Management Guidance Update No. 2017-01 (Feb. 2017) (in which our staff discussed its views on the application of the current custody rule to various types of custodial agreements between a client and a custodian that grant an adviser broader access to client funds or securities than the adviser's own agreement with the client contemplates).

We understand that inadvertent custody often arises because a custodial agreement grants an adviser expansive authority to transact in or transfer assets held in its client custodial accounts (*e.g.*, the ability to initiate wire transfers) that are often superfluous to the advisory services being provided. However, because advisers are rarely a party to these agreements, their ability to repudiate unwanted authority is limited.

In addition, custodial market practices have evolved and expanded since the rule was last amended, as have the types of assets qualified custodians hold.[136] Some bank qualified custodians have developed custodial practices for crypto assets. However, federal banking regulators have stated more broadly regarding crypto asset-related activities that "[b]ased on the agencies' current understanding and experience to date [. . .] the agencies have significant safety and soundness concerns with business models that are concentrated in crypto-asset-related activities or have concentrated exposures to the crypto-asset sector."[137] The regulatory framework to which these institutions are subject is evolving, in part, to accommodate new entrants to the market for custodial services, including newly launched state-chartered trust companies that focus on providing crypto asset custody services.[138] In light of this evolution, we

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136 *See*, *e.g.*, Fiduciary Capacity; Non-Fiduciary Custody Activities, 84 Fed. Reg. 17967 (Apr. 29, 2019) (the Office of the Comptroller of Currency estimating that the size of non-fiduciary custody assets held at national banks and Federal savings associations has increased, since it last updated its fiduciary regulation in 1996, to approximately $41.7 trillion as of December 21, 2018); Olga Kharif, Fidelity Says a Third of Big Institutions Own Crypto Assets BNN Bloomberg (June 9, 2020), *available at* https://www.bnnbloomberg.ca/fidelity-says-a-third-of-big-institutions-own-crypto-assets-1.1447708 (reporting that, according to a survey by Fidelity Investments, 36 percent of institutional investors in the U.S. and Europe report holding crypto assets).

137 *See* Joint Statement on Crypto-Asset Risks to Banking Organizations, *supra* footnote 27.

138 *See*, *e.g.*, Application by Anchorage Trust Company, Sioux Falls, South Dakota to Convert to a National Trust Bank; Application for Residency Waiver (Jan. 13, 2021), available at https://www.occ.treas.gov/news-issuances/news-releases/2021/nr-occ-2021-6a.pdf; Application by Protego Trust Company, Seattle, Washington, to Convert to a National Trust Bank; Application for Director

must be mindful of the extent to which many of these new entrants to the custodial marketplace offer, and are regulated to provide, the types of protections we believe a qualified custodian should provide under the rule.[139]

At the same time, we understand that some existing qualified custodians have modified their practices to remain profitable amid these changes, such as by contractually limiting their liability to their customers in a variety of ways. Others have turned to outsourcing less profitable parts of their custodial services.[140] Our staff has observed that the clients who are least likely to have bargaining power are often afforded the fewest protections. These changes in the custodial industry have caused us to reconsider the minimum protections we believe an adviser who uses a qualified custodian to maintain possession or control of client assets should provide.

Residency Waiver (Feb. 4, 2021), available at https://www.occ.treas.gov/news-issuances/news-releases/2021/nr-occ-2021-19a.pdf; Application to charter Paxos National Trust, New York, New York, OCC Control Number: 2020-NE-Charter-318305, OCC Charter Number: 25252 (Apr. 23, 2021), available at https://www.occ.treas.gov/news-issuances/news-releases/2021/nr-occ-2021-49a.pdf; New York Department of Financial Services, Financial Services Superintendent Linda A. Lacewell Announces Grant of DFS Trust Charter to Bitgo to Engage in New York's Growing Virtual Currency Market (Mar. 4, 2021), *available at* https://www.dfs.ny.gov/reports_and_publications/press_releases/pr202103041. *See also*, New York Department of Financial Services, *Guidance on Custodial Structures for Customer Protection in the Event of Insolvency* (Jan 23, 2023), https://www.dfs.ny.gov/industry_guidance/industry_letters/il20230123_guidance_custodial_structures (issuing guidance focusing on customer protection relating to segregation of and separate accounting for customer virtual currency, custodian's use of customer virtual currency, sub-custody arrangements, and customer disclosure).

139 *See, e.g.*, Financial Stability Oversight Council, Report on Digital Asset Financial Stability Risks and Regulation (2022), available at https://home.treasury.gov/system/files/261/FSOC-Digital-Assets-Report-2022.pdf ("[S]ome platforms emphasize that they are regulated through MSB laws. These laws generally are intended to address consumer protection related to money transmission and to combat illicit finance. They are not intended to address funding mismatches outside of money transmission or risks posed by platforms custodying crypto-assets internally within omnibus accounts, particularly when commingled with platform assets.").

140 *See* Deloitte (2019), The Evolution of a Core Financial Service: Custodian & Depository Banks, available at https://www2.deloitte.com/content/dam/Deloitte/lu/Documents/financial-services/lu-the-evolution-of-a-core-financial-service.pdf, at 42-43 (noting the trend with custodians and depositories outsourcing operational departments to low cost labor regions in order to lower costs and increase margins on core services that have experienced the largest margin pressures).

Consequently, the proposed rule would require a written agreement between a qualified custodian and the investment adviser that incorporates certain minimum investor protection elements for advisory clients. Additionally, for certain protections in which the qualified custodian's duty runs primarily or exclusively to the advisory client, it would require the adviser to obtain reasonable assurances of certain minimum investor protection elements for advisory clients. We believe that this approach would have direct benefits for advisory clients and investment advisers. We acknowledge that an agreement between the custodian and the adviser would be a substantial departure from current industry practice. We also understand that certain of the protections that the rule text would promote are not *universally* provided to all custodial customers today. Nonetheless, we believe it is necessary to help protect client assets from the harms the custody rule is designed to address and would help ensure that they receive certain standard custodial protections under the rule.

The proposed requirements do not prescribe specific safeguarding procedures or require that client assets be maintained in a particular manner. Rather, they are designed to serve as guardrails that would apply irrespective of the type of asset or the type of financial institution acting as a qualified custodian. The requirements are also designed to remain evergreen as methods for safekeeping continue to evolve to reflect changes in technology, investment products, and custodial service best practices. For example, technical requirements for transacting and safeguarding crypto assets are likely to be different from those for traditional assets, such as stocks, bonds, and options. Furthermore, the design of blockchains and other distributed ledgers that require irreversibility of crypto asset transactions (without the consent of all parties to reverse), and the bearer nature of private keys make it challenging to recover assets that have been lost or stolen or to reverse benign trading errors even if an owner of a crypto asset

wallet may be identified. This is unlike the traditional securities infrastructure, which has well-developed protocols allowing for the reversal and cancellation of mistaken or unauthorized transactions.

These additional risks and nuanced challenges of safeguarding emerging assets, such as crypto assets, have caused us to consider alternatives to the current rule's more asset-neutral approach. In 2020, our staff issued a statement requesting input on, among other things, the types of qualities an adviser seeks when entrusting a client's assets to a particular custodian and whether there are qualities that would be important for safeguarding crypto assets that might not be important for safeguarding other types of assets.[141] Several commenters shared with the staff their views, advocating for such things as specifically tailoring the rule based on how changes in ownership of the asset are effectuated, including setting particular standards for qualified custodians of crypto assets.[142] While we agree that custodial activities may differ between traditional assets and crypto assets, we believe that the asset neutral approach of the current rule has been and will continue to be more effective because it relies on the expertise of the various types of qualified custodians and allows the rule to remain evergreen as the types of assets held by custodians evolve.

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141 *See* Staff Statement on WY Division of Banking's "NAL on Custody of Digital Assets and Qualified Custodian Status" (Nov. 9, 2020), available at https://www.sec.gov/news/public-statement/statement-im-finhub-wyoming-nal-custody-digital-assets (the Staff Statement used the term "digital" assets rather than the term "crypto" assets as used in this release).

142 *See e.g.,* Letter from Coinbase re Custody Rule and Digital Assets (May 25, 2021) (stating that qualified custodians for digital assets should, at a minimum have: institutional technical expertise; personnel with technical expertise; minimum size; authority to custody digital assets; robust staffing; audited control environment; and annual certified audits); Letter from Anchorage re Custody Rule and Digital Assets (Apr. 13, 2021) (advocating for standard requirements for a qualified custodian that maintains digital assets including proof of exclusive control, proof of existence of digital assets in custody, hardware security, and blockchain monitoring).

Although crypto assets are a relatively recent and emerging type of asset, this is not the first time custodians have had to adapt their practices to safeguard different types of assets.[143] The proposed rule relies on the expertise of custodians with a long history of developing different procedures for safeguarding a variety of assets. It is also not the first time custodians have grappled with a new method of transacting in or holding assets.[144] These custodians also have a long history of innovating and modernizing their practices as methods of transacting in or holding client assets have evolved. Rather, the proposed rule recognizes that there are certain fundamental protections that should be provided to a custodial customer when the adviser has custody:

- A qualified custodian should exercise due care and implement appropriate measures to safeguard the advisory client's assets;
- A qualified custodian should indemnify an advisory client when its negligence, recklessness, or willful misconduct results in that client's loss;

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143 For example, bank custodians have traditionally provided safekeeping to a variety of physical objects, such as valuable papers, rare coins, and jewelry. *See,* OCC, Comptroller's Handbook on Asset Management Operations and Control (Jan. 2011), *available at* https://www.occ.gov/publications-and-resources/publications/comptrollers-handbook/files/asset-mgmt-ops-controls/index-asset-mgmt-ops-controls.html, at 15. *See also* Thevenoz, Luc, Intermediated Securities, Legal Risk, and the International Harmonization of Commercial Law, 13 STAN. J.L. BUS. & FIN. 384, 386 (Spring 2008) ("Intermediated Securities") ("Immobilization and dematerialization of securities have made the physical delivery of certificates nearly irrelevant. In just a few decades, the issuance of securities has shifted from the physical to a virtual world, to which financial intermediaries hold the key.").

144 *See,* James Rogers, *Policy Perspectives on Revised UCC Article 8,* 43 UCLA L. Rev. 1431 (1996) (discussing the role large broker-dealers or banks acting as dealers or custodians played during the evolution from a manual securities settlement process focused on the processing of physical securities certificates to highly automated electronic settlement centered on processing and transfer of electronic book-entry securities); Adam Back, *Lien on Me, Uniformity Is Coming to Crypto-Backed Transactions*, 41-12 AM. BANKR. INST. J. 16 (Dec. 1, 2022) (discussing proposed UCC Article 12 governing property rights in a "controllable electronic record").

- A qualified custodian should not be relieved of its responsibilities to an advisory client as a result of sub-custodial arrangements;
- A qualified custodian should clearly identify an advisory client's assets and segregate an advisory client's assets from its proprietary assets;
- The client's assets should remain free of liens in favor of a qualified custodian unless authorized in writing by the client;
- A qualified custodian should keep certain records relating to those assets;
- A qualified custodian should cooperate with an independent public accountant's efforts to assess its safeguarding efforts;
- Advisory clients should receive periodic custodial account statements directly from the qualified custodian;
- A qualified custodian's internal controls relating to its custodial practices should be evaluated periodically for effectiveness; and
- A custodial agreement should reflect an investment adviser's agreed-upon level of authority to effect transactions in the advisory client's account.

We believe that financial institutions that act as qualified custodians under the current rule already provide some of the protections that would be required under the proposed rule's requirements, either to satisfy regulatory requirements, or pursuant to their existing contracts with their clients. For example, we understand that some qualified custodians usually provide quarterly account statements to their custodial customers. We also understand that qualified custodians often obtain periodic reports of their internal controls. Further, we understand that qualified custodians may currently indemnify their custodial customers against the risk of loss, but we understand that the indemnification standard—for example, ordinary negligence or gross

negligence—often varies by institution and by customer. To the extent an element is not typical for a particular custodian, it may create practical difficulties (*e.g.,* higher costs of compliance, or market contraction for custodial services). On balance, however, we believe the proposed rule promotes key protections to which every custodial customer should be entitled when the adviser has custody.

Some of these protections are best promoted via written agreement between the adviser and custodian; others are best promoted via the adviser obtaining reasonable assurances in writing from the qualified custodian that the protections will be provided to the advisory client. We view the safekeeping protections that would be required in the proposed written agreement to be duties owed to both the client and adviser, while we view the safekeeping protections in the proposed reasonable assurances requirements to be duties owed primarily to the client and, therefore, are proposing these protections in a manner that we believe appropriately reflects the respective obligations. We are also proposing to require that the adviser reasonably believe that the contractual provisions and reasonable assurances obtained by the adviser have been implemented by the qualified custodian.[145] We understand that many of the obligations under the contractual provisions and reasonable assurances obtained by the adviser rest on the qualified custodian, and that implementation for each requirement may vary widely depending on the facts and circumstances of the parties in interest and assets in interest. Nonetheless, advisers should enter into a written agreement with a qualified custodian based upon a reasonable belief that the qualified custodian is capable of, and intends to, comply with the contractual provisions. The adviser should have the same reasonable belief regarding the reasonable assurances obtained

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[145] *See* proposed rule 223-1(a)(1)(i), (ii).

from the qualified custodian. Further, during the term of the written agreement and related advisory relationship, advisers should have a reasonable belief that the qualified custodian is complying with the contractual obligations of the agreement and continuing to provide the protections to client assets for which the adviser obtained reasonable assurances from the qualified custodian. For example, if the qualified custodian fails to properly provide the adviser with the required quarterly account statement or the required annual internal control report discussed below, the adviser could not reasonably believe that the qualified custodian is complying with the contractual obligations of the written agreement.

Finally, as under the custody rule, the safeguarding rule would continue to permit an adviser or its related person to serve as a qualified custodian for client assets. We continue to believe that self-custody and related person safeguarding arrangements provide practical benefits for advisory clients; however, we remain wary of the potential risks of such arrangements that do not have an independent party involved in safeguarding client assets.[146] Accordingly, heightened protections similar to those required under the custody rule would continue to be required in such an arrangement.[147] Moreover, the following elements would all be required to be part of a written agreement with the client.[148]

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146 *See* 2009 Adopting Release, *supra* footnote 11, at section II.C.1 (discussing the benefits and associated risks of maintaining client investments with advisers or their related persons and suggesting that the use of an independent custodian would be an impractical requirement for many types of advisory accounts).

147 The proposed rule would require a qualified custodian that is a related person to the adviser to enter into a written agreement with the adviser.

148 A rulemaking petition submitted to the Commission requested that we adopt a rule prohibiting related person custody. We have considered the petition and share certain of the petition's concerns regarding custody arrangements not involving independent parties. However, we believe that the protections proposed in the rule appropriately limit those risks. Kaswell, Stuart J *Re: Petition for Rulemaking; Custody Rule 206(4)(2)*, Oct. 30, 2020 [File No. 4-767, Nov. 9, 2020], available at https://www.sec.gov/rules/petitions/2020/petn4-767.pdf ("[I]t is my view that the SEC should take the next

a. Reasonable Assurances

We believe that requiring an adviser to obtain the reasonable assurances in writing[149] that the custodian will comply with the client protections required in the proposed rule and discussed below would improve safekeeping of client assets. Similarly, we believe that requiring the adviser to maintain an ongoing reasonable belief that the custodian is complying with such client protection requirements will improve safekeeping of client assets.[150] It is our understanding that many current custodial agreements address these issues and, therefore, custodians are already familiar with these concepts. For example, we understand that many custodial agreements address the attachment of a lien on, or security interest in, client assets, in some cases for the protection of the qualified custodian for nonpayment of fees by a custodial client. Similarly, many custodial agreements address indemnification between the advisory client and the custodian, but we understand that the indemnification standard—for example, ordinary negligence or gross negligence—often varies by institution and by customer. The proposed reasonable assurances requirements—and the requirement for the adviser to maintain the ongoing reasonable belief that the reasonable assurances provided by the qualified custodian are being implemented—in the rule are important protections for client assets that, together with the client protections contained in the written agreement, are designed to expand and formalize the

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step and require the adviser to use a custodian that is unaffiliated in any way with the adviser."); and see Kaswell, Stuart J. *Supplement to Petition for Rulemaking; Custody Rule 206(4)(2); File No. 4-767* (Apr. 19, 2021), available at https://www.sec.gov/comments/4-767/4767-8685524-235622.pdf ("As indicated in my rule petition, I respectfully suggest that the Commission should amend the Custody Rule to require that each investment adviser use a custodian that is independent of that adviser.").

149 Exchange Act Section 13(b)(7) defines "reasonable assurance" and "reasonable detail" as "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs." 15 U.S.C. 78m(b)(7). *See* Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (Jun. 27, 2007) [72 FR 35323] (discussing meaning of "reasonable assurance").

150 *See* proposed rule 223-1(a)(1)(ii).

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 our proposed rule.

i. Due Care

The proposed rule would require that the adviser obtain reasonable assurances in writing from the qualified custodian that the qualified custodian will exercise due care in accordance with reasonable commercial standards in discharging its duty as custodian and will implement appropriate measures to safeguard client assets from theft, misuse, misappropriation, or other similar types of loss.[151] The requirement that the adviser obtain reasonable assurances that a qualified custodian will exercise due care in accordance with reasonable commercial standards is similar to the standard required of certain custodians under Investment Company Act rules.[152] The Commission has had experience with the standard of care under rule 17f-4 under the Investment Company Act and believes that advisory clients should receive protections similar to those afforded under that rule. In addition, we believe that this investor protection element would provide an important standard for evaluating the qualified custodian's custodial practices.

We also believe that it is crucial for a qualified custodian to implement appropriate measures to safeguard assets from theft, misuse, misappropriation, or other similar types of loss based on the asset type and manner in which ownership is evidenced.[153] We recognize that the

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151 Proposed rule 223-1(a)(1)(ii)(A).

152 *See e.g.,* rule 17f-4 of the Investment Company Act.

153 *See e.g.,* Customer Protection Rules 17 CFR 240.15c3-3 (requiring appropriate measures to protect and preserve customer property held at broker-dealers).

appropriateness of the measures required to safeguard assets varies depending on the asset.[154] For instance, the exercise of due care may require that a bearer instrument, such as a physical coupon bond, a physical security certificate, or a commodity such as gold, be kept in a vault. Likewise, an investment that is evidenced in electronic book-entry form, such as an exchange-traded note, could be maintained in line with robust cybersecurity standards. And the exercise of due care may require, in many cases, that crypto assets be stored in a cold wallet, but depending on the facts and circumstances, such as when a client seeks to buy and sell crypto assets very frequently, due care may mean the use of hot wallets in combination with robust policies and

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[154] We also recognize that while the understanding of appropriate safeguarding measures is generally expected to be within the expertise of the qualified custodian, advisers also generally should seek to become sufficiently familiar with safeguarding practices to identify concerns or red flags in order to, among other things, form an opinion as to whether the assurance that they receive from the qualified custodian that the qualified custodian is acting with due care is reasonable. More broadly, identifying concerns and red flags is an important factor in the adviser forming a reasonable belief that the protections in the proposed written agreement have been implemented.

procedures.[155] Other facts and circumstances may require a hybrid of the two.[156] Further, because crypto assets and distributed ledger technology are still evolving, we expect the methods used to safeguard crypto assets will likewise evolve, which may lead to reevaluation of best practices in the future.

The proposed standard of care is not uncommon in the custodial market and we believe that financial institutions acting as qualified custodians are familiar with it.[157] We believe, however, that the standard of care is not universal in the custodial market, and that this requirement may result in some qualified custodians changing the terms of their custodial agreements with advisory clients to incorporate this standard. We believe that this provision would promote this important protection in a consistent manner across all advisory client

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155 *See, e.g.*, R. Travis Leppky and Guy Sadeh, Matthew Bender and Co., Blockchain and Smart Contract Law: U.S. and International Perspectives; Ch. 7, Sec. 7 (Security and Custody: Security Issues for Cryptographic Asset Wallets) (2022) ("[T]he difference between a hot and cold wallet is whether or not they are connected to the Internet. Generally speaking, hot wallets are less secure because of threats that come with being connected to the Internet and additional indirect threats if the cryptocurrency wallets are held by an external provider (*i.e.*, hacks, phishing, external provider stability issues, etc.). Hot wallets are generally better for day-to-day transactions and trading, since near instant access is provided. Cold wallets, meanwhile, are stored offline, which provides additional security. They are generally better for holding crypto assets for the long term."); Deborah A. Sabalot & Madeleine Yates, *Cryptoassets and custody: an elephant in the room?,* 9 Journal of International Banking and Financial Law 580 (Sept. 24, 2019) ("Hot storage means devices connected with the internet and generally means that the asset can be transferred quickly but will also be at greater risk of loss through hacking. Cold storage devices are physically offline and disconnected from the internet but are generally considered less accessible although are arguably more secure in that they cannot be attacked in the way that online systems can. Other arrangements include hybrid systems which allow the temporary storage of cryptoassets in a hot facility before being moved to cold storage."); *see generally* Cryptopedia Staff, Hot Wallets vs. Cold Wallets, GEMINI (July 4, 2021), available at https://www.gemini.com/cryptopedia/crypto-wallets-hot-cold ("A hot wallet is connected to the internet and could be vulnerable to online attacks — which could lead to stolen funds — but it's faster and makes it easier to trade or spend crypto. A cold wallet is typically not connected to the internet, so while it may be more secure, it's less convenient.").

156 *See id*.

157 The proposed contractual requirement is the same as the standard that automatically applies to custodians under Article 8 of the Uniform Commercial Code. *See* UCC §8-504(c)(2) and 8-509 (a) and (b).

assets[158] and would discourage the qualified custodian from establishing contractual performance standards that are less stringent.[159]

ii. Indemnification

The proposed rule would require that the adviser obtain reasonable assurances in writing from the qualified custodian that the qualified custodian will indemnify the client (and will have insurance arrangements in place that will adequately protect the client) against the risk of loss in the event of the qualified custodian's own negligence, recklessness, or willful misconduct.[160] The goal of this proposed requirement would be for the client to be compensated in the event of a loss for which the qualified custodian is responsible.

Our staff has observed that custodians often include indemnification clauses in their custodial agreements with customers. Generally, the provisions indemnify custodial customers from losses arising out of or in connection with the custodian's execution or performance under the agreement to the extent the loss is caused by, among other things, the custodian's negligence, gross negligence, bad-faith, recklessness, or willful misconduct. Our staff has observed that the contractual limitations on custodial liability vary widely in the marketplace. Our staff has also observed that the negotiating power of the investor appears to play an outsized role in the type of misconduct for which a custodian will provide indemnity and that retail investors appear to have limited ability to negotiate these terms effectively.

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158 The requirement of due care, of course, may impose on a qualified custodian a number of practices not expressly addressed in this release.

159 *See, e.g.*, UCC §8-504(c)(2) (allowing alteration of the standard of care by agreement).

160 Proposed rule 223-1(a)(1)(ii)(B).

Custodial misconduct is one of the primary risks that can undercut or eliminate the protections of a custody account.[161] The proposed rule seeks to create a minimum floor of custodial protection for investors—including those investors that have little or no power to negotiate for those protections—in the event of custodial misconduct. We question the extent to which investors, and particularly retail investors, understand that they may have limited recourse against the financial institution that was hired to safeguard their assets in the event they suffer a loss because of that institution's misconduct.[162] As such, we believe that it is reasonable to require an adviser to obtain reasonable assurances from a qualified custodian that it will provide the required indemnification for advisory clients.

The current practice in the custodial marketplace reflects a broad range of contractual limitations on the qualified custodian's liability to its customers to reduce exposure and may result in sub-optimal safeguarding protections for client assets. While we understand that custodians, as a gesture of goodwill or to avoid headline exposure, may cover losses caused by their own misconduct even if the customer is ineligible for indemnification under the custodial agreement, such gestures are at the sole discretion and ability of the custodian and we believe that this does not provide sufficient, consistent, reliable investor protection.[163] Custodians may not always be willing to extend such goodwill, such as in the event of an extremely large loss caused by, for example, custodial negligence under a custodial contract providing for indemnification of the custodial client only in the event that the custodian's misconduct

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161 Klees Article, *supra* footnote 24, at 106.

162 *See, e.g.*, Klees Article, *supra* footnote 24, at 103 ("clients bear several significant legal and operational risks that could limit recovery of their custodied assets").

163 We also do not know whether the willingness of custodians to cover losses for which they may not be contractually liable depends on whether the advisory client is retail or institutional.

constitutes gross negligence, during a general downturn in the economy, or at a time that the custodian is otherwise not sufficiently capitalized to easily absorb the loss. Requiring an adviser to obtain reasonable assurances from the qualified custodian that the qualified custodian will indemnify the client (and will have insurance arrangements in place that will adequately protect the client) against the risk of loss in the event of the qualified custodian's own negligence, recklessness, or willful misconduct, as proposed, will help protect clients from custodial misconduct and reduce the need to rely on the goodwill of a custodian to make a client whole in the event of the custodian's misconduct.

In our view, the proposed indemnification requirement would likely operate as a substantial expansion in the protections provided by qualified custodians to advisory clients, in particular because it would result in some custodians holding advisory client assets subject to a simple negligence standard rather than a gross negligence standard. We believe that this requirement is justified because of the important investor protection benefits it will provide.

iii. Sub-custodian or Other Similar Arrangements

The proposed rule would require that the adviser obtain reasonable assurances in writing from the qualified custodian that the existence of any sub-custodial, securities depository, or other similar arrangements with regard to the client's assets will not excuse any of the qualified custodian's obligations to the client.[164] This requirement is designed to help ensure that the qualified custodian would remain responsible in circumstances where a loss or other failure to satisfy its obligations to the client, whether contractual or otherwise, can be attributed to a sub-custodian or other third party selected by the qualified custodian.

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[164] Proposed rule 223-1(a)(1)(ii)(C).

As discussed above, outsourcing has become increasingly common in the custodial space, whether outsourcing of back-office functions or the core function of holding a custodial client's assets.[165] Additionally, we understand that the delegation of safeguarding to sub-custodians can result in opaque structures, for example involving several FFI sub-custodians in different countries.[166] Further, our staff has observed that custodial agreements addressing the use of sub-custodians seek to limit contractually the custodian's liability for acts or omissions of the sub-custodian in a variety of ways, including expressly limiting the contractual liability of the custodian for acts of the sub-custodian, as well as limiting the affirmative steps the custodian may be required to take in connection with any loss of client assets as a result of the sub-custodian's willful default or insolvency. We view the increase in use of sub-custodians to similarly increase the risk to client assets because, among other things, an adviser and a client are not likely to have a direct contractual relationship with the sub-custodian and are not likely to be able to have decision-making authority with respect to which sub-custodian a qualified custodian uses. The client and adviser, therefore, are more likely to experience challenges in recovering

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165 *See, e.g.*, Deloitte Outsourcing Article, *supra* footnote 140; U.S. Bank, 5 questions you should ask your custodian about outsourcing (May 19, 2022), available at https://www.usbank.com/financialiq/plan-your-growth/find-partners/outsourcing-questions-ask-custodian.html ("It's fairly common for custody banks to outsource day-to-day securities processing work to external vendors – both domestically and overseas."); Avantage Reply, Outsourcing in the Asset Servicing Industry: Custodian and Depositary Banks, Evolving regulatory requirements and industry practices in the Eurozone and the UK (Nov. 2015), available at https://www.reply.com/en/topics/risk-regulation-and-reporting/Shared%20Documents/Outsourcing%20Working%20Paper.pdf ("Custodian banks have traditionally outsourced high-volume operational tasks. While these still form the bulk of outsourcing, activities that contribute to the running of banks themselves are now also being routinely outsourced, including significant chunks of Customer Services, Human Resources, Risk and Finance."); Geis, George S., *Traceable Shares and Corporate Law*, 113 Nw. U.L. Rev. 227 (2018), at 233-234 (discussing the largest custodial banks performing recordkeeping and information dissemination functions for smaller custodian banks).

166 *See* Thomas Droll, Natalia Podlich, and, Michael Wedow (2015) *Out of Sight, Out of Mind? On the Risk of Sub-Custodian Structure*s. Bundesbank Discussion Paper No. 31/2015, available at SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2797055.

losses caused by the sub-custodian in the event of a loss of client assets. We similarly believe that this is true for a securities depository or other third-party arrangement implemented by the custodian with respect to client assets over which the advisory client has no control.

We believe that requiring the proposed reasonable assurances requirement would help reduce the ability of a qualified custodian to avoid responsibility for the other important safeguarding obligations it has to the advisory client by delegating custodial responsibility to a sub-custodian, securities depository, or other similar arrangements. We believe these requirements are justified because a qualified custodian should not be able to disclaim liability for a third-party it hires.

iv. Segregation of Client Assets

The proposed rule would require the adviser to obtain reasonable assurances in writing from the qualified custodian that the qualified custodian will clearly identify the client's assets as such, hold them in a custodial account, and segregate them from the qualified custodian's proprietary assets and liabilities.[167] We are proposing this requirement because we continue to believe that segregation is a fundamental element of safeguarding client assets.[168] We believe that some financial institutions that serve as qualified custodians, particularly FFIs, are not

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[167] Proposed rule 223-1(a)(1)(ii)(D). In contrast to the requirements we are proposing to include in the written agreement, and as with the other reasonable assurances requirements, we believe this safekeeping obligation runs primarily to the client.

[168] Segregation of client investments has been a fundamental element of the custody rule since its inception. *See e.g.,* 1962 Adopting Release, *supra* footnote 2 (requiring advisers to segregate and identify securities beneficially owned by each client, and to hold them in a "reasonably safe" place). *See also*, Klees Article, *supra* footnote 24 (describing segregation as a pillar of custody that has generally been recognized in the United States).

required to segregate and identify their client assets.[169] In addition, for those qualified custodians that are required to segregate and identify their client assets, the extent of those activities varies.[170] The proposed requirement is designed to help ensure that client assets are at all times readily identifiable as client property and remain available to the client even if the qualified custodian becomes financially insolvent or if the financial institution's creditors assert a lien against the qualified custodian's proprietary assets (or liabilities).[171] We believe this proposed requirement would help protect client assets from claims by a third party looking to secure or satisfy an obligation of the qualified custodian, including in cases of insolvency or bankruptcy.[172] We believe that the proposed requirement would help to identify clearly client assets as belonging to the appropriate client and, in the context of an FFI, we believe these actions would help to preserve the client's interests in the event of a government taking.

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169 The custody rule requires a foreign financial institution to segregate client assets in order to meet the definition of qualified custodian. As discussed above and below, we propose to replace and strengthen the segregation requirement for FFIs in the custody rule that would complement the proposed segregation requirements of the safeguarding rule.

170 *See*, *e.g.,* 12 U.S.C. 92(c) and 12 U.S.C. 1464(n)(2) (requiring national banks and federal savings associations to segregate all assets held in any fiduciary capacity from their general assets and to keep a separate set of books and records showing all transactions in these accounts); section 4d(a)(2) of the Commodity Exchange Act (requiring FCMs to segregate from their own assets all money, securities and other property deposited by futures customers to margin, secure, or guarantee futures contracts and options on futures contracts traded on designated contract markets).

171 The proposed segregation requirements are drawn from rule 15c3-3 of the Exchange Act, which requires broker-dealers to safeguard their customer assets and keep customer assets separate from the firm's assets, to prevent investor loss or harm in the event of the broker-dealer's failure. *See* Financial Responsibility Rules of Broker-Dealers*,* Exchange Act Release No. 70072 (Jul. 30, 2013) [78 FR 51824 (Aug. 21, 2013)] ("Financial Responsibility Adopting Release"). In addition, other regulatory regimes have adopted similar requirements. *See, e.g.*, rule 1.20 [17 CFR 1.20] under the Commodity Exchange Act, which requires a futures commission merchant to segregate customer assets from its own assets.

172 *See, e.g.,* Report of the Trustee's Investigation and Recommendations, In re MF Global Inc., No. 11-2790 (MG) SIPA (Bankr. S.D.N.Y. June 4, 2012) (noting that about $1.6 billion in customer funds were found to be missing after the financial institution's bankruptcy). Crypto asset trading platforms have also experienced failures resulting in bankruptcy, raising questions as to whether investors' funds will be returned. *See, e.g., In re Celsius Network LLC,* 2023 Bankr. LEXIS 2, at *60 (Bankr. S.D.N.Y., Jan 4, 2023) (holding that customer crypto assets in "Earn Accounts" were property of the bankruptcy estate).

We also understand that for administrative convenience and other reasons qualified custodians often hold client assets in omnibus accounts containing assets of more than one client or similar commingled-style accounts. We understand that practice may be even more common when a qualified custodian uses a sub-custodian to hold client assets. We do not intend the segregation requirement to preclude traditional operational practices in which client assets are held in omnibus accounts or otherwise commingled with assets of other clients because we recognize that custodians regularly maintain assets in a manner that allows such assets to be identified as held for a particular client, distinct from assets of other clients, and not subject to increased risk of loss arising from a custodian's insolvency.

We understand that the current rule's account requirements in 206(4)-2(a)(1) pose certain compliance challenges when client assets are commingled, including in the context of sweep accounts, escrow accounts, and loan servicing accounts. We believe the proposed segregation requirements[173] along with the proposed written agreement and other reasonable assurances requirements more directly and comprehensively achieve our policy goal than the custody rule's account requirements in rule 206(4)-2(a)(1). In light of the proposed segregation requirements, the safeguarding rule would not include the custody rule's requirement to maintain client funds and securities with a qualified custodian (1) in a separate account for each client under the client's name; or (2) in accounts that contain only client funds and securities under an adviser's name as agent or trustee for the clients.[174]

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173 The safeguarding rule would also require certain additional segregation requirements related to, among other things, segregating client assets from the adviser's assets, discussed in more detail in Section D, below. *See* proposed rule 223-1(a)(3).

174 Custody rule 206(4)-2(a)(1).

We believe that proper identification of client assets, as required by the segregation requirement of the proposed rule, would mitigate concerns regarding the safety of a client's assets. Sub-accounting of commingled accounts allows qualified custodians to identify readily an owner's commingled assets at any point in time. Eliminating the custody rule's requirement to maintain accounts that contain only clients' funds and securities also should alleviate certain compliance challenges when client and non-client assets are commingled for administrative convenience and efficiency purposes, such as in the context of sweep accounts, escrow accounts, and loan servicing accounts.[175] We understand that some custodial agreements between advisory clients and qualified custodians contain a contractual provision requiring segregation of client assets from the custodian's proprietary assets and liabilities. We believe that the reasonable assurances requirement in the proposed rule may result in qualified custodians adding such a contractual provision to custodial agreements that do not contain this language. However, we believe that some custodial agreements already contain language addressing the requirement. Moreover, because we understand that many qualified custodians are required by their functional regulator to segregate assets, we believe that an adviser obtaining reasonable assurances regarding segregation as required under the proposed rule would not result in a substantial change in the operational practices of many custodians. More importantly, we believe that the proposed rule's requirement that an adviser obtain reasonable assurances from the qualified custodian regarding the segregation requirement provides vital protections.

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175 *See* 2014 IM Guidance, *supra* footnote 17; Madison Capital Funding, Inc., SEC Staff No-Action Letter (Dec. 20, 2018) ("Madison Capital No-Action Letter").

v. No Liens Unless Authorized in Writing

The proposed rule would require the adviser to obtain reasonable assurances in writing from the qualified custodian that the qualified custodian will not subject client assets to any right, charge, security interest, lien, or claim in favor of the qualified custodian or its related persons or creditors, except to the extent agreed to or authorized in writing by the client.[176] This requirement is designed to protect client assets by discouraging qualified custodians from using those assets in a manner not authorized by the client. This provision would help ensure that client assets maintained with the qualified custodian are protected and are free of any claims by the qualified custodian, or a third party looking to secure or satisfy an obligation of the qualified custodian, including in cases of the qualified custodian's insolvency or bankruptcy.

Liens and the other claims addressed in the proposed rule can arise in favor of a qualified custodian in a variety of circumstances. For example, in a margin account, a type of brokerage account, a qualified custodian may lend cash to a client to allow the client to purchase securities. The qualified custodian's loan is typically collateralized by the securities purchased by the client, other assets in a client account, and cash, all of which are typically subject to a security interest in favor of the qualified custodian.[177] Similarly, qualified custodians often have contractual or other rights to liens or similar claims arising from unpaid client fees. The rule would not prohibit arrangements like these. Rather, the rule would require that the adviser obtain reasonable assurances from the qualified custodian that the client has authorized in writing any right, charge, security interest, lien, or claim in favor of the qualified custodian or its related persons or

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176 *See* proposed rule 223-1(a)(1)(ii)(E).

177 *See* Uniform Commercial Code, § 8-504 and cmt. 2 ("Margin accounts are common examples of arrangements in which an entitlement holder authorizes the securities intermediary to grant security interests in the positions held for the entitlement holder.").

creditors that would arise in connection with these arrangements or others. While we recognize that these and similar arrangements involve some level of risk to client assets, we recognize that they can also be beneficial, and should be permitted when authorized.

We believe that many qualified custodians maintain their custodial customer assets free of liens and similar claims, other than those agreed to or authorized in writing by the client. Further, we understand that some custodial agreements contain contractual language addressing when a lien or similar claim will attach to client assets. Therefore, we believe requiring an adviser to obtain this reasonable assurance from the qualified custodian would provide important client protections.

b. Written Agreement

As discussed above, the proposed rule would require an adviser to enter into a written agreement with a qualified custodian containing certain terms that we view as critical to safeguarding client assets.[178] The rule would require that the written agreement contain the terms described in more detail below.

i. Provision of Records

The proposed rule would require that the written agreement with the qualified custodian include a provision requiring the qualified custodian promptly, upon request, to provide records relating to client assets to the Commission[179] or an independent public accountant for purposes

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178 Proposed rule 223-1(a)(1)(i).

179 All custodians, including foreign custodians, must provide records of custody and use of the securities, deposits, and credits related to an investment adviser's client to representatives of the Commission upon request. Advisers Act Section 204(d)(1). The Commission believes that formalizing this requirement in the written agreement between a qualified custodian and an investment adviser will ensure qualified custodians are aware of the requirements of the Advisers Act.

of compliance with the rule.[180] Custodial account records provide information that is critical to an independent public accountant's ability to perform its role under the current rule, and would be similarly critical under the proposed rule. We understand, however, that accountants often struggle to obtain – or to obtain timely – information from qualified custodians when performing surprise examinations under the current rule unless the advisory client requests that the qualified custodian share the information. We realize this is likely because the qualified custodian has no contractual agreement with the adviser or the accountant that has been hired by the adviser. We believe the proposed contractual requirement would substantially mitigate these complications.

We understand that qualified custodians do not often provide third parties access to custodial account records in light of privacy concerns for their customers, unless there is contractual privity with those third parties or their customers request they do so. We believe that the proposed contractual requirement would mitigate these record access challenges because the qualified custodian would be in direct contractual privity with the adviser and would have a contractual obligation to provide the records required by the rule.

ii. Account Statements

The proposed rule would require that the written agreement with the qualified custodian provide that the qualified custodian will send account statements (unless the client is an entity whose investors will receive audited financial statements as part of the financial statement audit process pursuant to the audit provision of the proposed rule),[181] at least quarterly, to the client and the investment adviser, identifying the amount of each client asset in the custodial account at

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180 Proposed rule 223-1(a)(1)(i)(A).

181 *See* proposed rule 223-1(b)(4).

the end of the period as well as all transactions in the account during that period, including advisory fees.[182]

The custody rule requires an adviser to have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement, at least quarterly, to each of the adviser's clients for which it maintains funds or securities, identifying the amount of funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period.[183] We continue to believe that qualified custodians' delivery of account statements *directly* to advisory clients—without involvement of the adviser—helps provide clients with confidence that any erroneous or unauthorized transactions by an adviser would be reflected in the account statement and, as a result, would deter advisers from fraudulent activities. In a change from the current custody rule, the qualified custodian would also now be required to send account statements, at least quarterly, to the investment adviser, which would allow the adviser to more easily perform account reconciliations. We also believe that, because of custody rule 206(4)-2(a)(3), the account statement contract provision is consistent with longstanding custodial practices and would easily be incorporated by qualified custodians into the written agreement. The account statements could also be delivered to the client's (or pooled investment vehicle investor's) independent representative.

In circumstances where an investor is itself a pooled vehicle that is controlling, controlled by, or under common control with the adviser or its related persons (a "control relationship"), the contract with the qualified custodian must require the quarterly account statement to be delivered

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[182] Proposed rule 223-1(a)(1)(ii)(B). The proposed requirement is similar to the approach in the current rule with regard to the investment adviser forming a reasonable belief after due inquiry that the qualified custodian sends account statements, at least quarterly, to the client. *See* rule 206(4)-2(a)(3).

[183] Custody rule 206(4)-2(a)(3).

by the qualified custodian to all of the investors in each pooled investment vehicle client, which includes investors in the underlying pools by looking through that pooled vehicle (and any pools in a control relationship with the adviser or its related persons, such as in a master-feeder fund structure).[184] Advisers to pooled investment vehicles may from time to time establish special purpose vehicles ("SPVs") or other pooled vehicles for a variety of reasons, including facilitating investments by one or more private funds that the advisers manage. If a qualified custodian did not look through each pool in a control relationship with the adviser, the qualified custodian would be essentially delivering the quarterly statement to the adviser rather than to the parties the quarterly statement is designed to inform. Outside of a control relationship, such as if a private fund investor is an unaffiliated fund of funds, this same concern is not present, and the qualified custodian would not need to look through the structure to make meaningful delivery. The qualified custodian would just distribute the quarterly statement to the unaffiliated fund of funds' adviser or other designated party. We believe that this approach would lead to meaningful delivery of the quarterly statement to advisory clients. Also in a change from the current custody rule, the proposed rule would require the written agreement to contain a provision prohibiting the qualified custodian from identifying assets on account statements for which the qualified custodian lacks possession or control, unless requested by the client. If a client requests such assets be included on its account statement, the account statement may identify the assets, but only if the account statement clearly indicates that the custodian does not have possession or

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184 *See* proposed rule 223-1(c).

control of the assets.[185] Advisers have, at times, requested a qualified custodian to include particular holdings and transactions on the custodial account statements for a variety of reasons, including in an attempt to demonstrate compliance with the custody rule. For example, it is our understanding that custodians have been unwilling or unable to take possession or control of certain investments, such as a variety of privately issued securities. Advisers sometimes request that custodians report these securities as an "accommodation" on a custodial account statement so that the client is aware of their existence.

We recognize that account statements provided by a qualified custodian on a so-called "accommodation basis" may offer a client the ability to review all of its investments in a single consolidated account statement and potentially alert a client or an auditor to the existence of an investment.[186] We are concerned, however, that the practice of a qualified custodian including investments that it is not safeguarding on an account statement may be misleading and confusing to clients. To evaluate the holdings and transactions reported on an account statement, a client must have confidence in the statement's integrity and accuracy. Accordingly, we would prohibit an adviser from participating in a practice that we believe undermines that integrity and utility.[187]

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185 To the extent that a *client* requests that a qualified custodian report in account statements holdings and transactions to which the custodian is not attesting as a custodian and for which the custodian is disclaiming liability, the proposed rule would not disrupt this practice, though it would require them to be clearly identified as such.

186 The rule proposes a process and protections for certain assets unable to be maintained with a qualified custodian, thereby making accommodation reporting unnecessary. *See* section II.C, *infra*.

187 Other regulatory regimes have raised concerns about this practice including the potential for communicating inaccurate, confusing or misleading information to customers, lapses in supervisory controls, and the use of these reports for fraudulent or unethical purposes. *See e.g.*, FINRA's Regulatory Notice 10-19 (reminding broker-dealer firms of their responsibilities to ensure that they comply with all applicable rules when engaging in providing customers with consolidated financial account reporting).

iii. Internal Control Report

The proposed rule would require that the written agreement with the qualified custodian provide that the qualified custodian, at least annually, will obtain, and provide to the investment adviser a written internal control report that includes an opinion of an independent public accountant as to whether controls have been placed in operation as of a specific date, are suitably designed, and are operating effectively to meet control objectives relating to custodial services (including the safeguarding of the client assets held by that qualified custodian during the year).[188] Consistent with an adviser's fiduciary duty, an adviser should review the report for control exceptions and take appropriate action where necessary.[189]

Although the custody rule requires an internal control report only when the adviser or its related person acts as a qualified custodian,[190] we believe expanding this requirement to all qualified custodians under the proposed rule would mitigate risks to client assets regardless of the affiliation of the qualified custodian.[191] We believe the proposed requirement would help protect client assets by ensuring that the qualified custodian's controls with respect to its safeguarding practices are routinely evaluated by a third party that is independent of the

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188 This requirement would apply as a control objective of the internal control report rather than a requirement in the rule, thereby expanding the requirement to all qualified custodians, not just a qualified custodian that is the adviser or its related person. *See* generally, Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940, Advisers Act Release No. 2969 (Dec. 30, 2009) [75 FR 1492 (Jan. 11, 2010)] ("Accounting Guidance").

189 *See supra* footnote 142 and accompanying text.

190 Current rule 206(4)-2(a)(6).

191 An introducing broker that is also an adviser or the adviser's related person would not be considered as acting as a qualified custodian under the proposed rule if all client investments are maintained with a carrying broker (which is not a related person of the adviser) and thus the introducing broker would not be subject to the internal control report requirement.

custodian. We drew the proposed requirement from our experience with the internal control report requirement under the custody rule, understanding of requirements currently applicable to some types of qualified custodians, as well as best practices.[192]

The objective of the examination supporting the internal control report is to obtain reasonable assurance that the qualified custodian's controls have been placed in operation as of a specific date, and are suitably designed and operating effectively to meet control objectives related to safeguarding of client assets during the period specified.[193] Based on our experience with the custody rule, we believe that the benefits and protections that we initially believed were warranted for a more limited group of qualified custodians should be expanded to include all qualified custodians.[194]

We understand that not all qualified custodians obtain internal control reports, although we believe many do. We also understand that for those qualified custodians that currently obtain internal control reports, the scope of those reports may not cover the financial institutions' safeguarding activities that this proposed requirement is designed to cover. Nonetheless, we believe this requirement is justified because the proposed internal control report requirement would provide meaningful investor protection benefits by, among other things, providing

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192 Rule 206(4)-2(a)(6)(ii). *See* 2009 Proposing Release, *supra* footnote 11, at n.88 (noting that custodians often provide internal control reports to clients who demand a rigorous evaluation of internal controls as a condition of obtaining their business and that obtaining such report is an "industry best practice."). *See also* United States Government Accountability Office, Investment Advisers; Requirements and Costs Associated with the Custody Rule (July 2013), *available at* https://www.gao.gov/assets/gao-13-569.pdf (stating that representatives from two industry associations discussed that institutional investors commonly require custodians to obtain internal control reports).

193 *See* Accounting Guidance, *supra* footnote 183, at section III.

194 *See* rule 206(4)-2(a)(6)(ii).

advisers with information regarding the control practices of the qualified custodian that would enable advisers to assist advisory clients in making more informed decisions concerning holding assets with particular qualified custodians.

We are not requiring the provision of a specific type of internal control report as long as the required objectives are addressed.[195] This flexibility would permit qualified custodians to leverage existing audit work to satisfy regulatory requirements, or work currently performed as part of internal control reports prepared to meet client demand.

The proposed rule would define "independent public accountant" to mean a public accountant that meets the standards of independence described in rule 2-01 of Regulation S-X (17 CFR 210.2-01).[196] The Commission has long recognized that an audit by an objective, impartial, and skilled professional contributes to both investor protection and investor

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[195] For example, we believe that a report on the description of controls placed in operation and tests of operation effectiveness, commonly referred to as a "SOC 1 Type 2 Report," would be sufficient to satisfy the requirements of the internal control report, provided that the report covers whether the controls have been placed in operation as of a specific date, are suitably designed, and are operating effectively in order to meet control objectives as required by the rule. A report that simply provides a report of procedures or controls a qualified custodian has put in place as of a point in time, commonly referred to as a "SOC 1 Type 1 Report," would not satisfy the requirements of the internal control report because it does not test operation effectiveness of the controls. In addition, a report issued in connection with an examination of internal control conducted in accordance with AT-C Section 315: Compliance Attestation ("AT-C Section 315") or AT-C Section 320: Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control over Financial Reporting ("AT-C Section 320") under the standards of the American Institute of Certified Public Accountants would also be sufficient provided that the report covers whether the controls have been placed in operation as of a specific date, are suitably designed, and are operating effectively in order to meet control objectives as required by the rule. *See* 2009 Adopting Release, *supra* footnote 11, at section II.C.1. Similarly, a report based on an examination in accordance with PCAOB AT-1 of a broker-dealer's compliance report prepared pursuant to rule 17a-5 of the Exchange Act would be sufficient to satisfy the internal control requirement. *See* 17 CFR 240.17a-*5;* Broker-Dealer Reports*,* Exchange Act Release No. 34-70073 (July 30, 2013) [78 FR 51910 (Aug. 21, 2013)].

[196] *See* proposed rule 223-1(d)(5). The definition in the proposed rule would be amended to reference Rule 2-01 in its entirety rather than the more limited reference in the current custody rule (see rule 206(4)-2(d)(3), referencing 2-01(b) and (c)), which amendment is designed to clarify that the entirety of the auditor qualification and independence requirements in Rule 2-01 apply.

confidence.[197] We understand that qualified custodians currently obtaining internal control reports voluntarily or pursuant to requirements of the qualified custodian's functional regulator may need to engage a new accountant if the qualified custodian's current accountant is not independent as defined by the proposed rule.[198] We believe that adherence to the bedrock principle that auditors must be independent in fact and in appearance[199] contributes to investor protection and investor confidence in connection with the relationship between an auditor and the qualified custodian. We therefore believe that this requirement is appropriate.

In connection with our concerns noted above regarding circumstances in which an adviser or related person is the qualified custodian, we are proposing to retain the current rule's approach that if the qualified custodian is a related person or the adviser, the independent public accountant that prepares the internal control report must verify that client assets are reconciled to a custodian other than you or your related person. In addition, we would continue to require that if the qualified custodian is a related person or the adviser, the independent public accountant is registered with and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the Public Company Accounting Oversight Board ("PCAOB"), in accordance with the rules of the PCAOB.[200] We believe that qualified custodians routinely retain accountants that satisfy this requirement because of this requirement under the custody rule. In light of our experience with this requirement of the

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197 *See* Revision of the Commission's Auditor Independence Requirements, Release No. 33-7919 (Nov. 21, 2000) [65 FR 76008 (Dec. 5, 2000)].

198 *See* proposed rule 223-1(a)(1)(i)(C); 223-1(d)(5).

199 *See* Qualifications of Accountants, Release No. 33-10876 (Oct. 16, 2020) [85 FR 80508 (Dec. 11, 2020) (discussing bedrock principles).

200 Proposed rule 223-1(a)(1)(i)(C)(1).

current rule, we believe that registration and the periodic PCAOB inspection of an independent public accountant's overall quality control system will provide us greater confidence in the quality of the internal control report in the context of an affiliated adviser and custodian.

iv. Adviser's Level of Authority

The proposed rule would require that the written agreement with the qualified custodian specify the investment adviser's agreed-upon level of authority to effect transactions in the custodial account as well as any applicable terms or limitations.[201] We are also proposing that this contract provision permit the adviser and the client to reduce the specified level of authority. Our understanding is that investment advisers often are given authority over the custodial account in the custodial agreement between the custodian and the client that is broader than what the adviser and client agreed to in the advisory agreement. For example, an adviser may not have authority under its advisory agreement with a client to instruct the client's custodian to disburse client assets. If, however, the client's agreement with its qualified custodian grants the adviser broad authority over the client's account, including to disburse or transfer assets, the adviser would be able to effect a change in beneficial ownership of the client's assets.[202] In these circumstances, from the qualified custodian's perspective, the client has authorized the adviser to withdraw the client's assets and, while there may be constraints contained in the advisory agreement between the adviser and a client, the custodian may not be aware of these constraints

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201 Proposed rule 223-1(a)(1)(i)(D).

202 *See, e.g.,* Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority, Division of Investment Management Guidance Update No. 2017-01 (Feb. 2017) ("2017 IM Guidance") in which our staff discussed its views on the application of the current custody rule to various types of custodial agreements between a client and a custodian that grant an adviser broader access to client funds or securities than the adviser's own agreement with the client contemplates.

or may be unwilling or unable to treat the terms of the advisory agreement as controlling.[203] In this scenario, believing the adviser to have authority over the client's assets, the custodian could accept the adviser's instructions to direct the disposition of the client's assets.[204] We are concerned this puts clients at risk, such as in the event a rogue advisory employee misuses the authority to direct the disposition of a client's assets held by the custodian. We understand that advisers have had little success in modifying or eliminating their unwanted authority either because a custodian is reluctant to accept the adviser's request to modify its agreement with its client, or the client may lack the bargaining power to negotiate more limited terms on the adviser's authority over the client's assets because the custodian may refuse to modify its standard forms.[205] This contractual requirement of the proposed rule is designed to mitigate these concerns and empower advisers to modify this aspect of the custodial agreement to better reflect client intentions and to be consistent with the adviser's contractual obligations to its clients.

Our staff has observed that qualified custodians have been reluctant to modify or customize the level of authority investment advisers have with respect to customer accounts. It increases their need to monitor customer accounts, and to accept liability, for unauthorized transactions by an adviser and its personnel. We believe that the risks of inadvertent custody, the related risk that a custodian may follow an instruction with respect to client assets presuming

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203 Our staff took a similar view. *See id.*

204 While the advisory agreement between the adviser and its client may constrain the adviser's authority, the custodian may not be aware of such constraints. A separate bilateral restriction between the adviser and the client is insufficient to prevent the adviser from having custody where the custodial agreement enables the adviser to withdraw or transfer client funds, securities or similar investments upon instruction to the custodian. Our staff took a similar view. *See* 2017 IM Guidance, *supra* footnote 202.

205 *See supra* footnote 116 and accompanying text.

authority that the adviser does not have under its advisory contract with the client, and our staff's observation of the reluctance of qualified custodians to modify adviser authority, warrant the proposed requirement. Ultimately, we believe this requirement would better protect advisory clients than the current default broad authority provisions in current contracts.

We request comment on all aspects of the proposed reasonable assurances and written agreement requirement, including the following:

55. Is our understanding correct that custodians are familiar with the concepts addressed by the reasonable assurances and written agreement requirements?
56. Should the rule include the due care reasonable assurances requirement? Is this standard of care common practice in the custodial marketplace and, if so, would custodians be willing to provide information to an adviser sufficient to satisfy the proposed rule? Instead of the proposed approach, should the rule require generally that an adviser obtain reasonable assurances that a qualified custodian meets certain minimum commercial standards and then specify some but not all applicable standards? Would the proposed requirement provide additional protections for clients when an adviser has custody of client assets and further the policy goals of the rule?
57. Should the rule include the reasonable assurances requirement that the qualified custodian will indemnify the client (and will have insurance arrangements in place that will adequately protect the client) against the risk of loss in the event of the qualified custodian's own negligence, recklessness, or willful misconduct? Would this requirement provide additional protections for clients when an adviser has custody of client assets and further the policy goals of the rule? Alternatively,

should we require reasonable assurances of a different indemnification standard? If so, what standard and how would that standard protect investors consistent with the policy goals of the rule?

58. Would the proposed indemnification standard be a substantial departure from current industry practice? Would it be expensive for qualified custodians and would those costs be passed on to custodial clients? If so, are there less expensive ways of achieving the policy goals of the rule? Would this requirement result in custodians ceasing operations in the custody business? If so, what proportion of custodians would commenters expect to stop providing custody services as a result of this proposed rule? Should the safeguarding rule, instead, require disclosure to clients that they could lose their assets in the event of custodian misconduct? We understand that retail clients were often afforded the fewest protections. If we were to require disclosure, instead of indemnification, would such retail clients be able to negotiate with custodians for better protection?

59. Do commenters agree with our understanding that custodians may cover losses caused by their own misconduct even if the customer is ineligible for indemnification under the custodial agreement to avoid headline exposure or as a gesture of goodwill to their custodial customers? Do insurers contribute compensation as part of these payouts? If so, how frequently? Do advisers step in to compensate customers in these circumstances? If so, how frequently?

60. Should the proposed rule include the reasonable assurances requirement requiring the qualified custodian to provide indemnity and have insurance arrangements in place to adequately protect its clients? Should the rule include additional safeguards

regarding the indemnification requirement, such as stating that insurance proceeds will be solely for the benefit of the client, and will not be considered an asset of anyone other than the client? Should the rule include any safeguards around the type of insurance a qualified custodian could maintain for those indemnification purposes? If yes, what types of safeguards should be imposed? For example, should the insurance company be of a certain type or hold a certain qualification or rating? What alternatives should we require to achieve our policy goals? Are there any particular challenges for FFIs meeting this requirement? If so, what are they?

61. Should the proposed rule include the reasonable assurances requirement that the existence of any sub-custodial, securities depository, or other similar arrangements with regard to the client's assets will not excuse any of the qualified custodian's obligations to the client? Would that requirement help ensure that a qualified custodian could not avoid responsibility for the other important safeguarding obligations it owes to the client by delegating custodial responsibility to a sub-custodian or other responsibilities to other third parties? Would the requirement provide additional protections for clients when an adviser has custody of client assets and further the policy goals of the rule?
62. Should the rule include the proposed reasonable assurances of segregation of client assets requirements? Are these requirements sufficiently clear?
63. Would the proposed reasonable assurances of segregation of client assets requirements impose appropriate limitations to safeguard client assets? Should we eliminate or modify any of them? Alternatively, are there other limitations that would be appropriate?

64. Would the proposed reasonable assurance of segregation of client assets requirement increase the likelihood that client assets will be available to be returned to clients if a qualified custodian experiences financial events such as insolvency or bankruptcy? For example, do commenters believe the requirements would help ensure that client assets are more readily identifiable as client property?
65. Should certain assets be excluded from these reasonable assurances of segregation of client assets requirements? If so, which assets and why? Would limiting these requirements to certain types of assets present compliance challenges? If so, which assets and why?
66. In particular, would the proposed reasonable assurances of segregation of client assets requirement present challenges with respect to crypto assets? Should we address crypto asset segregation and/or custody with separate requirements? Do crypto assets raise specific segregation issues not presented by other assets? If so, what are they and why? Would the proposed requirements offer substantial protections in the event of a bankruptcy or financial losses involving a custodian with custody of crypto assets? Would the proposed reasonable assurances of segregation of client assets requirement present challenges with respect to other types of assets?
67. Does the proposed reasonable assurance of segregation requirement guard against loss, misappropriation, misuse, theft, and the risk of client assets being subject to creditor claims in the insolvency or bankruptcy of the qualified custodian, while permitting the flexibility that would address some of the compliance challenges that the current rule presents (*e.g.*, commingling of client and non-client assets)?

68. Should we instead retain the custody rule's requirement to maintain client funds and securities with a qualified custodian in a separate account for each client under the client's name or in accounts that contain client funds and securities under the adviser's name as agent or trustee? If so, should any of the custody rule's requirements be modified in any way? If we were to retain the custody rule's requirement, should we expand the scope of the separate account requirement to assets from funds and securities?

69. Is our understanding correct that, for administrative convenience and other reasons, qualified custodians often hold client assets in omnibus accounts containing assets of more than one client or similar commingled-style accounts? Do commenters agree that this practice may be even more common when a qualified custodian uses a sub-custodian to hold client assets?

70. Should the rule require that an adviser obtain reasonable assurances that the qualified custodian will not commingle client and non-client assets, similar to the custody rule?[206] Alternatively, should the rule be modified to permit the commingling of client and non-client assets for administrative convenience and efficiency? If so, what should be considered "administrative convenience and efficiency"? Does allowing client and non-client assets to be commingled (*e.g.*, in the same omnibus account) increase the risk that client assets will be lost, misused, stolen, or misappropriated? Could an advisory client's assets be used to satisfy the debts of someone else in a bankruptcy event if client and non-client assets are commingled?

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206 *See* rule 206(4)-2(a)(1)(i).

71. Do commenters agree that there are circumstances when qualified custodians' services require them to commingle advisory client assets and assets of non-advisory customers? For example, when a qualified custodian uses sweep accounts, escrow accounts, and loan servicing accounts? In these circumstances, should the rule require additional protections? Which protections and why and would they differ depending on the type of commingled account?
72. Should the rule require that an adviser obtain reasonable assurances from the qualified custodian regarding the sub-accounting of commingled accounts? Would such a requirement provide additional protection to client assets?
73. Are there instances where commingling or pooling of certain assets by qualified custodians may occur via certain omnibus and sub-accounting arrangements that may present compliance challenges under the reasonable assurances of segregation of client assets requirement? What are those instances and what are the challenges?
74. Do commenters think that qualified custodians will include contractual segregation provisions in their custodial agreements with advisory clients if they do not already do so? Should the rule require an express contractual requirement between the adviser and custodian to identify and segregate client investments? Would a contractual requirement help ensure that advisory client assets are protected?
75. Do commenters agree with our belief that not all financial institutions that serve as qualified custodians, particularly FFIs, are currently required to segregate and identify their client investments? Do commenters agree that requiring an adviser to obtain reasonable assurances that a qualified custodian will segregate client assets from the custodian's proprietary assets and liabilities would be critical to protecting

client investments in the event of a qualified custodian's insolvency as well as in the event of a taking by a foreign government? Do commenters believe there may be reluctance by some financial institutions to segregate client assets? Are there circumstances in which segregation might not be important? If so, which circumstances?

76. Would this segregation provision present practical challenges? For example, would it present practical challenges in the context of omnibus accounts or temporary sweep accounts? Would financial institutions be able to satisfy the segregation provision? For example, we know that national banks and federal savings associations are required to segregate all assets held in any fiduciary capacity from their general assets. Is this also true of national banks and federal savings associations that hold custodial assets in a non-fiduciary capacity? Are there other compliance challenges that this proposed segregation requirement would pose? Are there circumstances in which qualified custodians' services require them to commingle advisory client assets with other assets?

77. In the context of requiring an FFI to segregate client investments, do commenters believe that the reasonable assurances segregation requirement would help to preserve the client's interests in the event of a government taking?

78. In the event of the insolvency or bankruptcy of a qualified custodian, do commenters agree with our understanding that the sub-accounting of commingled accounts allows a qualified custodian to readily identify the rightful owner of any investment at any point in time? Are there any particular assets or services for which such

identification via sub-accounting is difficult or burdensome? If so, what are the reasons for these difficulties?

79. Is our approach in requiring a qualified custodian to maintain client assets pursuant to a written agreement between the qualified custodian and the investment adviser appropriate? Would the proposed approach provide additional protections for clients when advisers have custody of client assets and further the policy goals of the rule? Would this requirement increase costs to maintain client assets with a qualified custodian? Would this approach limit the pool of financial institutions that are able to serve as qualified custodians? Would financial institutions currently acting as qualified custodians exit the business as a result of the written agreement requirement? Do commenters agree that custodial practices, types of instruments custodians hold, and the regulatory framework to which these financial institutions are subject have evolved, in part to accommodate new entrants to the market for custodial services? Do commenters agree that this evolution, including new custodians and new custodial practices, has resulted, in at least some cases, in a general reduction in the level of protections offered by custodians, often resulting in advisory clients with the least amount of bargaining power (*i.e.*, retail investors) receiving the most limited protections? Are there other reasons that commenters believe custodial practices have evolved to result in a general reduction in the level of protections offered by custodians? Would the proposed approach mitigate some of our concerns with regard to these custodial market changes?

80. Is our belief correct that financial institutions that act as qualified custodians under the current rule already provide some of the protections that would be required under

the proposed rule's contractual requirements, either to satisfy regulatory requirements or pursuant to their existing contracts with their clients? Do these qualified custodians already provide the protections that would be required in the proposed written agreement to every customer? Are some protections provided to customers more often than others? If so, which protections and why?

81. Should the rule permit an adviser or its related person to be a qualified custodian, as under the custody rule, or should we prohibit the adviser or its related person from being the qualified custodian? Do commenters agree that an adviser or related person acting as the qualified custodian presents risks to client assets that are not present when a qualified custodian is not the adviser or a related person of the adviser? Do commenters agree that the proposed requirements in the rule, including the proposed internal control report requirements applicable to qualified custodians that are the advisers or a related person, would help to reduce those risks? If the rule prohibits the adviser or its related person from being the qualified custodian, would it result in additional costs or operational burdens on advisory clients? For example, would the requirement cause advisory clients to lose access to services or other efficiencies they currently receive? Would the requirement result in higher costs for advisory clients?

82. Given that the written agreement and reasonable assurances approach would be applicable equally to the different types of qualified custodians, should the rule identify other financial institutions such as securities depositories, transfer agents, credit unions, insurance companies, or other intermediaries as qualified custodians?

83. Are the contractual requirements and reasonable assurances requirements sufficiently clear? Are there additional contractual requirements or reasonable assurances related to the safeguarding of client investments that should be included in the written agreement or obtained by the adviser? If so, what are they, and why? Should we eliminate any of the contractual requirements or reasonable assurances requirements? If so, which ones, and why? Should all of the requirements be contractual or reasonable assurances, rather than a mix of these two categories as we proposed? Should any be re-categorized?

84. Are there alternatives to all or any of the contractual requirements or reasonable assurances requirements that would support the policy goals of the proposed requirements while obviating the need for one or more specific contractual provisions or reasonable assurances? If so, what are the alternatives? Specifically, would we be able to achieve the same policy goals by requiring that an adviser adopt and implement policies and procedures reasonably designed to ensure that a qualified custodian was providing certain protections to client assets, rather than requiring a contractual clause for the protection? For example, would requiring advisers to adopt and implement a policy and procedure reasonably designed to ensure that a qualified custodian would promptly, upon request, provide records relating to the adviser's clients' assets held in the account at the qualified custodian to the Commission or to an independent public accountant provide protection equivalent to the proposed contractual obligation to provide these records? What about the proposed internal control report contractual obligation? Would a client be able to obtain equivalent protection provided by an adviser's adoption and

implementation of a policy and procedure reasonably designed to ensure that the qualified custodian will provide the internal control report required in the proposed contractual requirement? Are there other alternatives to any of the contractual requirements, such as requiring that an adviser obtain reasonable assurances from the qualified custodian that the qualified custodian has contractually agreed to provide account statements, internal control reports, or any of the other requirements we are proposing to be included in the written agreement? Are there any other alternatives that we should require?

85. Are there circumstances in which the written agreement and reasonable assurances requirements should not be required? For example, should the written agreement and reasonable assurances requirements not apply in instances where an advisory client has a custodial relationship with a qualified custodian that precedes the client's engagement of the adviser? If so, how long should the custodial relationship precede the advisory relationship in order for an exception of this type to apply?

86. Should the proposed rule include the contractual provision that the qualified custodian will promptly, upon request, provide records relating to client investments to an independent public accountant for purposes of compliance with the rule? Are we correct in our belief that this proposed provision would facilitate the public accountant's ability to obtain custodial account records? Would this requirement provide additional protections when the adviser has custody of client assets and further the policy goals of the rule?

87. Should we require a more specific time period in which a qualified custodian would be required to provide records? For example, should we require that a qualified custodian provide records within three days of a request?

88. Is our understanding correct that qualified custodians do not often provide third parties access to custodial account records in light of privacy concerns for their customers, unless there is contractual privity with those third parties or their customers request they do so? If so, would the proposed contractual requirement mitigate these record access challenges because the qualified custodian would be in direct contractual privity with the adviser and would have a contractual obligation to provide records?

89. Should the proposed rule include the contractual requirement that the qualified custodian will send account statements, at least quarterly, to the client and the investment adviser? The current rule requires an investment adviser to have a reasonable basis, after due inquiry, for believing that the qualified custodian maintaining client investments sends an account statement, at least quarterly, to the client. Is the proposed requirement regarding sending account statements to the adviser necessary or helpful? Would that requirement have a significant cost impact on qualified custodians and would those costs be passed on to advisory clients? Are there alternatives to the proposed contractual provision that we should require? For example, would the client have sufficient protection when an adviser has custody of its assets if we were to require that an adviser must have reasonable assurance that the qualified custodian maintaining client assets sends an account statement, at least quarterly, to the client?

90. To what extent would the proposed requirement to provide custodial account statements to advisers increase costs to advisory clients?

91. To what extent do commenters believe that the requirement to provide custodial account statements to advisers would have an impact on an adviser's duty to monitor? Do commenters believe that it would increase the frequency at which some advisers would be required to monitor activity in client accounts? Would this enhance protection of client assets? Could it increase advisory costs?

92. Do commenters agree that custodians regularly send account statements to their custodial customers attesting to the holdings and transactions in the account during a particular period? Do commenters agree that advisory clients use these account statements to identify erroneous or unauthorized transactions or withdrawals in their accounts*?*

93. Many advisers or their related persons serve as advisers to pooled investment vehicles or to other similar entities (*e.g.,* general partner of a limited partnership). The proposed rule would continue to except these advisers from the requirement to have a qualified custodian send account statements with respect to pooled investment vehicles that are audited annually and distribute their audited financial statements to the investors in the pool. Should we continue to except these advisers from the account statement requirement? Would the investors in those pools find the account statement useful to monitor the pool's account activity? Should we extend this exception to all entities that are audited annually and distribute audited financial statements to investors in the entities pursuant to the audit provision, as proposed,

provided the entity complies with all of the requirements in the proposed audit provision?[207] Are there other persons that we should except from this requirement?

94. In circumstances where an investor is itself a pooled vehicle that is controlling, controlled by, or under common control with the adviser or its related persons (a "control relationship"), should the contract with the qualified custodian require the quarterly account statement to be delivered by the qualified custodian to investors in the underlying pools by looking through that pooled vehicle (and any pools in a control relationship with the adviser or its related persons, such as in a master-feeder fund structure)? Do commenters agree with our understanding that if a qualified custodian did not look through each pool in a control relationship with the adviser, the qualified custodian would be essentially delivering the quarterly statement to the adviser rather than to the parties the quarterly statement is designed to inform? Do commenters agree with our view that requiring the qualified custodian to "look through" in these instances would lead to meaningful delivery of the quarterly statement to advisory clients?
95. Is our understanding correct with respect to current practices of reporting certain custodial customer holdings for which the qualified custodian lacks possession or control on an accommodation basis?
96. Should the proposed rule prohibit account statements from identifying clients' investments for which the qualified custodian lacks possession or control unless the client requests otherwise? Do commenters agree that the practice of a qualified

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[207] *See* proposed rule 223-1(b)(4) and Section II.G.1, *infra*.

custodian including on an account statement assets that it is not safeguarding may be misleading to clients? Are there challenging practical implications of this proposed prohibition? For instance, our staff has previously taken the view that, under some arrangements, an adviser that is a qualified custodian may send its advisory clients account statements that include assets maintained with a sub-custodian that is also a qualified custodian.[208] Would the proposed contract provision preclude this type of arrangement? Similarly, some qualified custodians (regardless of whether they are related persons of the adviser) send consolidated account statements that include the holdings of sub-custodians. Would the proposed contract provision disrupt this practice? Are there ways of improving account statement integrity without eliminating qualified custodians' ability to send consolidated account statements in these circumstances? For example, should we permit an adviser to request that these assets be included on the account statement but require that such request instruct a qualified custodian to include disclosure on the statement explaining that the qualified custodian does not have custodial liability for those investments? Are there are other disclosures that would appropriately distinguish how the qualified custodian maintains investments?

97. Should we include the contractual requirement that the qualified custodian, at least annually, obtain, and provide to the investment adviser a written internal control report? Would the proposed internal control requirement provide additional protections where the adviser has custody? Would the proposed internal control

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208 *See* Custody Rule FAQs, *supra* footnote 17, at Question IX.1.

requirement raise costs for advisory clients? Should the contractual requirement require some additional notification of any material discrepancies identified in an examination supporting the internal control report? For example, should the contractual requirement require that the accountant performing the examination notify the Commission of any material discrepancies by submitting a form such as Form ADV-E to the Commission? Should the contractual requirement require the accountant to notify the clients of the material discrepancies? Should the contractual requirement include any other provisions with respect to the written internal control report?

98. Should we prescribe particular steps an adviser should take to review internal control reports for control exceptions? For example, should we require an annual review of these reports by the adviser's Chief Compliance Officer or an adviser personnel with the skill set to review such reports?

99. Should we specify the internal control report to be obtained at least annually, as proposed? Alternatively, should the internal control report be obtained more or less frequently?

100. Should the proposed internal control report be based on an assessment of the same control objectives outlined in the 2009 Accounting Guidance?[209] Are these control objectives applicable to all qualified custodians? Should certain of the control objectives be required only when the adviser uses a related party qualified custodian? Have custodial practices changed since the 2009 Accounting Guidance

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[209] *See* Accounting Guidance, *supra* footnote 183, at section III.

was published which would necessitate the addition or removal of control objectives in order to meet the policy goals of the proposed rule? Would additional control objectives be necessary in order to appropriately safeguard all client assets as required under the proposed rule, compared to funds and securities as required under the current custody rule?

101. When preparing an internal control report for a related party qualified custodian, should an accountant continue to be required to verify that client assets are reconciled to a custodian other than the adviser or its related person? Should this required reconciliation be limited to only securities? Are there custodians (like a securities depository) unaffiliated with the adviser that can hold all client assets when a related party qualified custodian is utilized? Is further guidance needed on this reconciliation requirement?

102. Should the contractual provision require that the independent public accountant that prepares or issues the report be registered with the PCAOB when the adviser serves as, or is a related person of, the qualified custodian, as proposed? If so, should the independent public accountant also be subject to regular inspection by the PCAOB, as proposed? Would using independent public accountants registered with, and subject to regular inspection by, the PCAOB increase the costs to obtain these reports or make it too difficult to obtain a qualified accounting firm to provide an internal control report? Should there be a different independence standard for accountants performing the engagement? Rather than the independence standard

proposed, should the rule require an accountant to not be a related person of the qualified custodian as that term is defined under the safeguarding rule?[210]

103. The current rule[211] and proposed rule[212] define an independent public accountant as a public accountant that meets the standards of independence described in rule 2–01 of Regulation S–X (17 CFR 210.2–01). Do custodians that voluntarily obtain internal control reports or obtain them to satisfy other requirements often obtain them from independent public accountants that are independent according to this standard? If not, do they have another standard for determining independence? For example, do custodians require auditors to meet the independence standard set by the Association of International Certified Professional Accountants? Do custodians require an independent public accountant to be unaffiliated from the custodian?

104. Rather than the contractual provision requiring that the independent public accountant that prepares or issues the report be registered with the PCAOB when the adviser serves as, or is a related person of, the qualified custodian, as proposed, should this requirement apply to all qualified custodians, regardless of whether the qualified custodian is the adviser or a related person? If so, should the rule contain different requirements for a qualified custodian that is the adviser or a related person?

105. Is it appropriate, as proposed, to require that an adviser that is also the qualified custodian include all of the proposed reasonable assurances protections in the written

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210 Proposed rule 223-1(d)(11).

211 Current rule 206(4)-2(d)(3).

212 Proposed rule 223-1(d)(5).

agreement with the client? Should we require similar protections for any related person qualified custodian? For example, should the rule require the written agreement of any related person that is the qualified custodian to include all of the proposed reasonable assurances requirements? Would doing so provide enhanced protections for client assets? Would it result in any additional burdens on advisers, related persons, or clients?

106. Do commenters agree with our proposed requirement that the accountant who prepares the internal control report should be "independent" from the qualified custodian? Should it, instead, require independence from adviser?

107. Would obtaining or receiving an internal control report present additional issues if the qualified custodian for client assets is located outside of the United States? Would the requirement that the independent public accountant be registered with, and subject to regular inspection by, the PCAOB in affiliated or self-custody situations make it more difficult to obtain such an internal control report?

108. Instead of making it a term of the required written agreement, should we permit an adviser to rely on the representations of a qualified custodian that it has obtained the required internal control report?

109. Should the proposed rule include the contractual requirement that the qualified custodian will specify the investment adviser's agreed-upon level of authority to effect transactions in the custodial account as well as any applicable terms or limitations? Are there other ways in which we could accomplish our objective to help empower advisers to modify or eliminate their unwanted ability in a custodial agreement to better reflect their client intentions? Would the requirement provide

additional protections where the adviser has custody of client assets and further the policy goals of the rule?

110. Is it difficult for advisers that have custody, including inadvertent custody, pursuant to a client's custodial agreement with a qualified custodian, to reduce or eliminate their authority over the client's custodial account? Would the proposed qualified custodian contractual requirement make it easier for advisers to reduce or repudiate this authority? Do qualified custodians often reject an adviser's request to modify its agreement with its client to reduce or eliminate the adviser's authority?

111. Do qualified custodians sometimes lend, invest, or otherwise use their custodial customers' investments? Do advisers with custody of client assets have knowledge of these transactions? Do these transactions present risk to custodial customers? Do advisers consider whether a custodian engages in these transactions, or has sufficient insurance coverage to cover the risk of loss arising from these transactions when involved in selecting a qualified custodian for an advisory client? Should we include in the final rule a contractual requirement requiring qualified custodians to record a liability and maintain sufficient capital and/or insurance when lending, investing, or otherwise using their custodial customers' investments? Would qualified custodians be able to satisfy the requirement? If not, what type of financial institutions would be unable to satisfy it? Are there other ways of protecting custodial customers when an adviser has custody from risk of loss when those financial institutions lend, invest, or otherwise use client investments?

112. Should the proposed rule include other contractual provisions or reasonable assurances? For example, should we require the written agreement to contain a

contractual provision requiring the qualified custodian to make and keep adequate records? Would that provision facilitate compliance with the contractual provision requiring that the qualified custodian provide records to the Commission or independent public accountant? Would this requirement provide additional protections for clients where the adviser has custody and further the policy goals of the rule?

113. Are there other risks that the rule should require the written agreement to address? For example, should the rule require that the written agreement expressly address the transfer of custodial assets in the event of the custodian's bankruptcy or insolvency? Should the written agreement be required to state, or should the adviser be required to obtain reasonable assurances, that the intent of parties is to enter into a custodial relationship, and under no circumstances should the relationship be considered a debtor-creditor relationship?

114. Investment companies registered under the Investment Company Act ("RICs") are subject to a comprehensive regime for the custody of their assets under the Investment Company Act and Commission rules thereunder, with specific requirements that vary based on the type of custodian. Should we continue to except accounts of RICs under proposed rule 223-1 in light of this regime for RICs? Should we apply any of the provisions of proposed rule 223-1 to RIC custodial arrangements, particularly the proposed contractual provisions for the qualified custodian agreement? Should the required contractual provisions depend on the type of custodian involved? For example, should RICs be required to include some or all

of the proposed contractual provisions in agreements with bank custodians because the Commission has not adopted a rule related to bank custodians specifically?

115. Does the custody rule contain any safeguards that the safeguarding rule retains that are not necessary and which we should not require?

C. Certain Assets that are Unable to be Maintained with a Qualified Custodian

We believe that the bulk of advisory client assets are able to be maintained by qualified custodians; however, we understand that is not universally the case, particularly for two types of assets: certain physical assets and certain privately offered securities.

It is not uncommon for physical assets, such as precious metals, physical commodities, and real estate, to be held in client portfolios, and thus there are likely circumstances in which advisers would have custody of these physical assets as a result of the expanded scope of the safeguarding rule. We understand that these assets are sometimes unable to be maintained by qualified custodians, and that some qualified custodians may refuse to custody such assets, in part, because the inherent physical characteristics of the items increase the expenses associated with their maintenance and safekeeping. Some of these assets by their very nature or size may not easily be subject to theft or loss, and that may reduce the need for the safeguarding protections offered by a qualified custodian, but when an adviser has an ability or authority to change beneficial ownership of these assets, there is still a risk of misuse, misappropriation, or loss associated with the adviser's insolvency or bankruptcy.

Similarly, it is increasingly common for advisory clients to have privately offered securities in their portfolio.[213] We understand that advisers with trading authority of privately offered securities that do not settle DVP often have custody of these securities because of the broad, general power of attorney-like authority required to trade these securities.[214] There are certain impediments to transferability typically associated with certain privately offered securities—specifically, the need to obtain the consent of the issuer or other securities holders prior to any transfer of ownership—that make certain of these assets less susceptible to some of the risks the rule is designed to address. In particular, they would be less likely to be stolen by a third party or simply lost. These characteristics reduce the need for the safeguarding protections offered by a qualified custodian. These characteristics, however, do little, if anything, to protect a client against misuse, misappropriation, or losses that may result from the adviser's insolvency or bankruptcy.

We understand that the current market for custodial services of privately offered securities is fairly thin. We also understand that, although some custodians will custody these

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213 *See, e.g.*, Form ADV data current as of [Nov. 30, 2021] (showing that there are currently 5,037 registered private fund advisers with over $18 trillion in private fund assets under management); *See also*, Vanguard, The role of private equity in strategic portfolios (Oct. 2020), available at https://corporate.vanguard.com/content/dam/corp/research/pdf/Role-of-private-equity-in-strategic-portfolios-US-ISGRPE_102020_US_F_online.pdf ("[T]he asset size of the private equity market has been gradually growing on an absolute basis and relative to the public equity market over the last 20 years. Private equity has risen from 2% to 7% of total investable global equity assets."); *see also* Scott Bauguess et al., Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017 (2018), available at https://www.sec.gov/files/dera-white-paper_regulation-d_082018.pdf (noting that an analysis of issuer self-reported data through electronic Form D filings indicates that the number of unregistered offerings and corresponding amounts raised have been increasing over the years 2009-2017); Concept Release on Harmonization of Securities Offering Exemptions, Release No. 33-10649 (June 18, 2019) [84 FR 30460 (June 26, 2019)], at n.37 (stating that the amounts raised in exempt markets have increased both absolutely and relative to public markets).

214 See *supra* footnote 71 and accompanying text.

securities by holding them in nominee form, many do not custody them. We similarly understand that demand for these services may also be thin. Moreover, we understand that many advisers with custody of these assets do not seek to maintain them with a qualified custodian—at least in part—because the custody rule contains the "privately offered securities exception"[215] from the qualified custodian requirement.

To qualify for the privately offered securities exception today, the security must meet the exception's description of "privately offered securities." This definition includes securities acquired from the issuer in a transaction or chain of transactions not involving any public offering; uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client; and transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer. This custody rule exception contains one additional condition: for an adviser to a limited partnership or similar pooled investment vehicle to rely on this exception, the adviser must also comply with the custody rule's audit provision. In adopting this exception, the Commission had expressed its concern that these safeguards may be ineffective in the case of limited partnerships (or other pooled investment vehicles), noting that because the private securities are held in the name of the limited partnership and the adviser acts for the partnership, the adviser has apparent authority to arrange transfers that would be recognized by the issuer of the securities.[216]

However, the Commission adopted this exception in 2003, following concerns raised by commenters that a requirement to maintain certain privately offered securities with qualified custodians could pose difficulties; particularly given that ownership of such assets generally was

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215 *See* rule 206(4)-2(b)(2).

216 *See* 2003 Adopting Release, *supra* footnote 1.

recorded only on the books of the issuer (*e.g.,* investments in limited partnerships where clients receive only a copy of the partnership agreement as evidence of their investment or assignment agreements for debt or equity interests in a private company).[217] In support of its decision to adopt the exception, the Commission stated that some of the impediments to transferability typically associated with certain privately offered securities provide some external safeguards against the kinds of abuse the rule seeks to prevent.[218]

When this exception was adopted, the size of the privately held securities market was much smaller than it is now on an absolute basis as well as in relation to the size of the publicly traded securities market.[219] In addition, the type, nature, structure, and prevalence of private issues have also changed and expanded in recent years, all of which have led the Commission to reconsider the current rule's exception.[220] We have become concerned over the years since its

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217 *See* 2003 Adopting Release, *supra* footnote 2, at section II.B. ("Commenters [] pointed out that, *on occasion*, a client may purchase privately-offered securities and that maintaining certain of these assets in accounts with qualified custodians poses difficulties because the client's ownership of the security is recorded only on the books of the issuer.") (emphasis added).

218 *Id.* The 2003 Adopting Release identified a specific and limited range of securities to which commenters referred. *See* 2003 Adopting Release, *supra* footnote 2, at n.26 ("Commenters specifically mentioned clients' investments in limited partnerships, where clients receive only a copy of the partnership agreement as evidence of their investment. Commenters also mentioned assignment agreements for debt or equity interests in a private company, or other types of customized agreements.").

219 *See* Vanguard, The role of private equity in strategic portfolios (Oct. 2020), available at https://corporate.vanguard.com/content/dam/corp/research/pdf/Role-of-private-equity-in-strategic-portfolios-US-ISGRPE_102020_US_F_online.pdf ("[T]he asset size of the private equity market has been gradually growing on an absolute basis and relative to the public equity market over the last 20 years. Private equity has risen from 2% to 7% of total investable global equity assets."); *see also* Scott Bauguess et al., Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017 (2018), available at https://www.sec.gov/files/dera-white-paper_regulation-d_082018.pdf (noting that an analysis of issuer self-reported data through electronic Form D filings indicates that the number of unregistered offerings and corresponding amounts raised have been increasing over the years 2009-2017); Concept Release on Harmonization of Securities Offering Exemptions, Release No. 33-10649 (June 18, 2019) [84 FR 30460 (June 26, 2019)], at n.37 (stating that the amounts raised in exempt markets have increased both absolutely and relative to public markets).

220 For example, our staff has received several questions over the years about whether certain securities would still qualify for the exception if the securities were not acquired from the issuer but were transferred, for

adoption that this exception may not adequately protect an advisory client from the broad types of risks the custody rule is intended to address: chiefly, misappropriation.[221]

When an asset cannot be maintained with a qualified custodian, a client may not have a full understanding of its holdings or receive periodic account statements reflecting transactions in those assets. This reduces the likelihood that a client will be able to identify suspicious activity in its account or notice that its assets are gone. Moreover, these assets may not be included in the sample of assets subject to verification procedures during a surprise examination or meet the materiality threshold for verification during a financial statement audit. As a result, a loss could similarly go undetected by an independent public accountant for a substantial period.

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instance, in a subsequent private offering, from one owner to the next. Our staff has also responded to other questions concerning the application of the exception. *See, e.g.*, 2013 IM Guidance, *supra* footnote 17 (providing staff views regarding security evidenced by a private stock certificate).

[221] *See* 2009 Adopting Release, *supra* footnote 11, at section II.B.3 (noting the difficulty for advisory clients to verify that assets actually exist because ownership is recorded only on the issuers' books). In the 2009 Adopting Release, the Commission expanded the protections of the surprise examination to privately offered securities. *See id.* The growth of the privately offered securities market since our 2009 amendments to the custody rule has increased our concerns regarding the risks we identified in the 2009 Adopting Release to these client assets. We have also taken into account concerns expressed by others. *See, e.g.*, Dodd Frank Regulating Hedge Funds and other Private Investment Pools Testimony of James S. Chanos, *supra* footnote 14, at 50 ("These instruments are privately issued uncertificated securities, bank deposits, real estate assets, swaps, and interests in other private investment funds, as well as shares of mutual funds, which, under current law, can simply be titled in the name of the private investment fund care of the manager, and the evidence of ownership held in a file drawer at the manager of the private investment fund. The issuers of those assets are permitted to accept instructions from the manager to transfer cash or other value to the manager. This gaping hole in current Advisers Act custody requirements can allow SEC-registered advisers easily to abscond with money or other assets and falsify documentation of ownership of certain categories of assets, and makes it difficult for auditors, investors and counterparties to verify the financial condition of advisory accounts and private investment funds. Requiring independence between the function of managing a private investment fund and controlling its assets, by requiring that all assets be titled in the name of a custodian bank or broker-dealer for the benefit of the private fund and requiring all cash flows to move through the independent custodian, would be an important control. Similarly, requiring an independent check on the records of ownership of the interests in the private investment fund, as well as imposing standards for the qualification of private investment fund auditors — neither of which currently is required by the Advisers Act — would also greatly reduce opportunities for mischief.").

Ideally, a robust market for custodial services would develop for physical assets and privately offered securities. Absent such a development and the exception, however, advisers would be faced with the inability to comply with a Commission requirement or a need to transition to providing nondiscretionary advice or take certain other actions in order to avoid a violation of Commission rules, which could be disruptive or result in client harm. We are therefore proposing to reform the privately offered securities exception to address our concerns about the lack of protections and transparency that could result when privately offered securities and physical assets cannot be maintained by a qualified custodian and to reduce the likelihood that a loss of these assets could be undetected for an indeterminate amount of time. The safeguarding rule would provide an exception to the requirement to maintain client assets with a qualified custodian where an adviser has custody of privately offered securities or physical assets, provided it meets the following conditions:[222]

- The adviser reasonably determines and documents in writing ownership cannot be recorded and maintained (book-entry, digital, or otherwise) in a manner in which a qualified custodian can maintain possession, or control transfers of beneficial ownership, of such assets;
- The adviser reasonably safeguards the assets from loss, theft, misuse, misappropriation, or the adviser's financial reverses, including the adviser's insolvency;
- An independent public accountant, pursuant to a written agreement between the adviser and the accountant,

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222 *See* proposed rule 223-1(b)(2).

- Verifies any purchase, sale, or other transfer of beneficial ownership of such assets promptly upon receiving notice from the adviser of any purchase, sale, or other transfer of beneficial ownership of such assets; and
- Notifies the Commission within one business day upon finding any material discrepancies during the course of performing its procedures;

- The adviser notifies the independent public accountant engaged to perform the verification of any purchase, sale, or other transfer of beneficial ownership of such assets within one business day; and
- The existence and ownership of each of the client's privately offered securities or physical assets that is not maintained with a qualified custodian are verified during the annual surprise examination or as part of a financial statement audit.

1. Definition of Privately Offered Security and Physical Assets

The proposed rule's definition of privately offered securities would retain the elements from the custody rule's description that require the securities to be acquired from the issuer in a transaction or chain of transactions not involving any public offering, and transferable only with prior consent of the issuer or holders of other outstanding securities of the issuer.[223] Like the custody rule, the safeguarding rule would also require the securities to be uncertificated and would require ownership to be recorded only on the books of the issuer or its transfer agent in the name of the client. However, the safeguarding rule would also require that the securities be capable of only being recorded on the non-public books of the issuer or its transfer agent in the

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223 Rule 206(4)-2(b)(2)(i). "Privately offered securities" are defined by rule 206(4)-2(b)(2) as securities that are (1) acquired from the issuer in a transaction or chain of transactions not involving any public offering, (2) uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client, and (3) transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer. *See also* proposed rule 223-1(d)(9).

name of the client as it appears in the records the adviser is required to keep under Rule 204-2. This definitional requirement would enhance the assurance of the existence of the client asset provided by the verification required by proposed 223-1(b)(2)(iii)(A) and will make the verification process more efficient. The term "uncertificated" would generally have the same meaning as set forth in article 8 of the Uniform Commercial Code.[224] Additionally, we would not view a security to be certificated where the certificate cannot be used to redeem, transfer, purchase, or otherwise effect a change in beneficial ownership of the security for which the certificate is issued.[225] We understand that transactions and ownership involving crypto asset securities on public, permissionless blockchains are generally evidenced through public keys or wallet addresses.[226] As proposed, in order for a security to be a privately offered security under the proposed safeguarding rule, among other conditions, it must be uncertificated, and the ownership can only be recorded on the non-public books of the issuer or its transfer agent in the name of the client as it appears in the adviser's required records. As a result, we believe that such crypto asset securities issued on public, permissionless blockchains would not satisfy the conditions of privately offered securities under the proposed safeguarding rule.[227]

We are not providing a definition of the term "physical asset" or including specific types of assets in the proposed rule. Rather, we believe that the plain language of the phrase, along

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224 *See* UCC Sec. 8-102(a)(18) ("'Uncertificated security' means a security that is not represented by a certificate.").

225 Our staff took a similar view. *See* 2013 IM Guidance, *supra* footnote 17.

226 *See generally*, PwC, Demystifying cryptocurrency and digital assets (accessed Dec. 5, 2022), available at https://www.pwc.com/us/en/tech-effect/emerging-tech/understanding-cryptocurrency-digital-assets.html (describing storage, ownership, and transactions, of crypto assets).

227 Crypto assets that are not crypto asset securities would not qualify for the exception because they do not satisfy the definition of privately offered security under proposed 223-1(d)(9).

with a principles-based facts and circumstances approach that requires an adviser to look to the characteristics and nature of a particular physical asset is more appropriate. We believe that what constitutes a "physical asset" is often self-evident, particularly when compared to other assets that are certificated, maintained digitally, or in book-entry form. For example, real estate and physical commodities[228] such as, corn, oil, and lumber are physical assets, while assets like cash, stocks, bonds, options, futures and funds are not, even if they provide exposure to physical assets. Physical evidence of ownership of non-physical assets that can be used to transfer beneficial ownership, like stock certificates, private keys, and bearer or registered instruments do not, themselves, qualify as physical assets and would not qualify for the exception from the qualified custodian requirement. Similarly, certain physical evidence of physical assets such as a warehouse receipt for certain commodities would not qualify for the exception if they can be used to transfer beneficial ownership even though the commodities documented by the warehouse receipt may qualify for the exception. Or in the real estate context, a deed or similar indicia of ownership that could be used to transfer beneficial ownership of a property would not qualify for the exception, but the physical buildings or land would qualify.

2. Adviser's Reasonable Determination

In order to be eligible for the exception, the rule would require an adviser to determine, and document in writing, that ownership cannot be recorded and maintained (book-entry, digital, or otherwise) in a manner in which a qualified custodian can maintain possession or control of such assets. Such a determination necessarily depends on the facts and circumstances in issue.

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228 *See, e.g.*, International Organization of Securities Commissions, Principles for the Regulation and Supervision of Commodity Derivatives Markets—Consultation Report at 82 (Nov. 2021), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD689.pdf (defining physical commodity as "[a] tangible product or raw material, as opposed to an instrument which references a physical commodity.").

Moreover, these determinations would necessarily evolve over time as assets and the custodial industry change, allowing the proposed rule to remain evergreen.

An adviser's reasonable determination of whether a qualified custodian is able to maintain possession or control of a particular asset would generally involve an analysis of the asset and the available custodial market. An adviser's reasonable determination generally would not require the identification of every conceivable qualified custodian and an evaluation of its custodial services. Fundamentally, to determine whether an asset can or cannot be maintained by a qualified custodian under the proposed rule, an adviser generally should obtain a reasonable understanding of the marketplace of custody services available for each client asset for which it has custody. The adviser's written documentation of its determination would generally contain material facts concerning its understanding of the custodial marketplace and a description of the client asset in issue.

The proposed rule does not specify the frequency with which an adviser must make this determination. What frequency would be reasonable for any determination would depend on the particular assets and the facts and circumstances. For example, an adviser might develop policies and procedures for conducting this analysis, and those policies and procedures might reasonably call for an annual assessment of one type of asset for which there have been no indicators of a developing custodial market. On the other hand, it would likely be unreasonable for an adviser to annually assess the custodial market for an asset for which developing custodial services are well publicized as imminent.

As discussed above, we believe that many privately offered securities are not currently maintained by qualified custodians. However, we understand that a substantial portion of securities—privately and publicly held—are uncertificated (*i.e.,* paper stock certificates are

largely a relic from a prior era, replaced by more modern methods of recording ownership).[229] Particularly as a result of the growth of uncertificated publicly traded securities, we understand that custodians have refined safeguarding and reporting practices with respect to uncertificated securities. Therefore, we believe that this experience has made it increasingly possible for qualified custodians to provide custody services for privately offered securities. Accordingly, while today it may be reasonable under appropriate circumstances for an adviser to determine that a qualified custodian cannot maintain possession or control of a particular privately offered security, we believe that determination may be more difficult to support as the custodial industry continues to evolve.

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[229] *See* Paech, Philipp, *Securities, Intermediation and the Blockchain: An Inevitable Choice Between Liquidity and Legal Certainty?* 21(4) UNIF. L. REV. 612 (Dec. 1, 2016) ("The practice of securities holding, transfer, and collateral has changed significantly over the past 200 years-moving from paper certificates and issuer registers, to an intermediated environment, and from there to computerization and globalization."); Intermediated Securities, *supra* footnote 144, at 386 ("Immobilization and dematerialization of securities have made the physical delivery of certificates nearly irrelevant. In just a few decades, the issuance of securities has shifted from the physical to a virtual world, to which financial intermediaries hold the key."); DTCC, From Physical to Digital: Advancing the Dematerialization of U.S. Securities (Sept. 2020), available at https://www.dtcc.com/~/media/Files/PDFs/DTCC-Dematerialization-Whitepaper-092020.pdf ("the crushing mountain of paper of the paperwork crisis in the 1960s and 1970s was addressed by the two-pronged approach of immobilization and dematerialization"). While the terminology is sometimes used interchangeably, "dematerialized securities" generally refer to securities, sometimes certificated, that are represented by entries in securities accounts maintained by financial intermediaries for investors, while "uncertificated securities" refer to securities that are not represented by a certificate but are registered on an issuer's books. *See generally*, Thevenoz, Intermediated Securities, at 386 ("Certificated securities do not need to move if they are immobilized in the custody of reliable depositories and represented by entries in securities accounts maintained by financial intermediaries for investors. When needed, immobilized securities can be transferred by way of book-entries in investors' accounts, which substitute for their physical delivery. Where corporate law and investor preferences allow, physical individual securities can become wholly unnecessary. A whole issue can be replaced by one global certificate, or it can even be recorded in an 'issue account' without the need for any certificate, against which the dematerialized securities can be credited to the securities accounts of market participants and, here again, be transferred by way of book-entries. Immobilization and dematerialization of securities have made the physical delivery of certificates nearly irrelevant. In just a few decades, the issuance of securities has shifted from the physical to a virtual world, to which financial intermediaries hold the key."); *and see* UCC § 8-102(18) ("'Uncertificated security' means a security that is not represented by a certificate.").

Whether an adviser can make the reasonable determination regarding a particular physical asset necessarily depends on the asset type and the availability of custody services. For example, an adviser could likely conclude that qualified custodian services are unavailable for unharvested wheat or a shopping center. Similarly, custody of certain tangible agricultural commodities may be impossible to insure at a qualified custodian.[230] In these circumstances, an adviser may reasonably determine that ownership cannot be recorded and maintained (book-entry, digital, or otherwise) in a manner in which a qualified custodian can maintain possession or control of such asset. Conversely, it is likely that a qualified custodian can hold gold bullion,[231] and it would therefore be difficult for an adviser to make the determination required to invoke the proposed exception.

3. Adviser Reasonably Safeguards Assets

To rely on the exception, the adviser would be required to reasonably safeguard any privately offered securities or physical assets that are not maintained with a qualified custodian from loss, theft, misuse, misappropriation, or the adviser's financial reverses, including the adviser's insolvency. While the specific procedures implemented to safeguard assets may vary

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230 Though such physical assets may be unable to be held with a qualified custodian as defined under the proposed rule, we understand that agricultural commodities and other physical commodities do have certain non-qualified custodians, exchange-approved warehouses or clearing houses that provide substantial record keeping and safeguarding protections for such assets. These often include secure storage facilities, internal control procedures, and relevant insurance coverages.

231 It is our understanding that banks are able to custody gold bullion and other precious metals, but that other non-bank custodians provide secure storage and transportation services for gold bullion and other precious metals, including vault custody and related transportation services. *See, e.g.,* The Brinks Company, SEC Staff No-Action Letter (Feb. 3, 2014). We also understand that, from time to time, bank custodians or others may exit the precious metals custody business, but that other custodians may become available to perform those custody services. *See*, *e.g.*, Depository Trust Company of Delaware, LLC, SEC Staff No-Action Letter (Sept. 12, 2016).

depending on the asset, advisers must satisfy their fiduciary duty in safeguarding any particular asset.[232]

With respect to privately offered securities, an adviser might "reasonably safeguard" an asset by looking to reasonable commercial standards, which we understand presently may draw from a variety of protections such as enhanced recordkeeping, additional change of control terms in governance agreements, designation of an agent required to be involved in transfers of beneficial ownership, among others. For example, one critical safeguard that advisers should consider is the types of internal controls that they can implement to reasonably safeguard clients' privately offered securities. If possible, an adviser may consider separating duties of the person responsible for recording investments in privately offered securities from the person responsible for authorizing the buying and selling of privately offered securities from the person responsible for holding certificates or other legal records evidencing ownership of privately offered securities.[233] An adviser may also consider implementing procedures to regularly review and reconcile the following documents to the adviser's records: legal documents demonstrating evidence of ownership of privately offered securities, including any changes year over year; board meeting minutes, if available, for any activity that may evidence a change in a client's ownership of privately offered securities; and records of share ownership maintained by the issuer or its transfer agent in the name of the client. An adviser may also consider periodically reviewing and documenting that the privately offered securities are transferable only with the prior consent of the issuer or its shareholders. Importantly, the rule recognizes that the privately

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232 The principles-based requirement to reasonably safeguard a client's physical assets is drawn from an adviser's fiduciary duty including its duty of care or duty of loyalty under the Advisers Act, which extends to the entirety of the adviser-client relationship. *See supra* footnote 57.

233 We recognize in some smaller organizations it may be more challenging to separate these functions.

offered securities vary, as do the relationships between an adviser and its advisory clients, and the rule retains the flexibility necessary for advisers to make reasonable determinations concerning the safeguarding of those privately offered securities that are unable to be maintained with a qualified custodian.

With respect to physical assets, an adviser might "reasonably safeguard" such assets by looking to reasonable commercial standards, which may include storage in a secure facility or vault that adheres to exchange, clearing house, or other licensing requirements for participation in certain commodities markets; dual control procedures for access to assets in safekeeping; maintenance of records to evidence movement or transfer of assets (including details on depositor, beneficiary and/or the legal owner); periodic reconciliation of records with assets held (*e.g.,* vault counts); separation of duties for movement or transfer of assets, recordkeeping and reconciliation; periodic audits; smoke detection and fire suppression systems; and insurance coverage for any custody-related losses incurred by its clients. Advisers may need to tailor their standards for safeguarding to each particular physical asset depending on the relative common standards for its market.[234] For example, reasonable commercial standards for safeguarding and taking delivery of an agricultural commodity like a bushel of wheat[235] necessarily would be

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234 *See, e.g.*, The Board of the International Organization of Securities Commissions, *Commodity Storage and Delivery Infrastructures: Good or Sound Practices* (Feb. 2019), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD622.pdf (encouraging the adoption of "Good or Sound Practices" in member jurisdictions, but noting that "[n]ot all of the Practices described may be relevant to all market participants. It is for market participants to determine the applicability of any particular Practice and to apply it as their circumstances require.").

235 For example, in the agricultural context, clearing members and delivery facilities are subject to the various rules of the exchange or clearing house as well as inspection by the exchange and the Department of Agriculture. *See*, Chapter 7, Delivery Facilities and Procedures, Chicago Board of Trade Rule Book (2022) available at: https://www.cmegroup.com/rulebook/CBOT/.

different from the appropriate maintenance gold bullion[236] or of personal property like jewelry, antiques, or art.[237] We believe this approach will give advisers the flexibility to develop and implement safeguarding practices with respect to assets not maintained with a qualified custodian that are appropriately tailored, while helping to ensure client assets receive appropriate protections.

When an adviser has custody of client physical assets that are not maintained with a qualified custodian, the ultimate obligation to safeguard those assets falls to the adviser. In some circumstances, an adviser might conclude that it could safeguard the asset itself, provided it can do so in accordance with reasonable commercial standards. In other circumstances, the adviser could instead determine that it could permissibly maintain physical assets with a third party that the adviser concludes could safeguard the assets in accordance with reasonable commercial standards. The proposed rule does not require a particular approach.

More broadly, an adviser might demonstrate that it is reasonably safeguarding a client asset itself or through a third party, by adopting, implementing, and regularly reassessing policies and procedures that include robust due diligence and ongoing oversight designed to ensure the

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236 *See* Global Previous Metals Code Global Precious Metals Code available at https://www.lbma.org.uk/market-standards/global-precious-metals-code.

237 The OCC notes in its Handbook that miscellaneous assets (e.g., jewelry, art, coins) should be maintained in a vault consistent with applicable law and sound custodial management. Vault control procedures should ensure physical security, dual control procedures, maintenance of records evidencing access to the vault, proper asset transfer ticketing, and periodic vault counts. *See*, Custody Services, Comptrollers Handbook (Jan. 2002) available here: https://www.occ.treas.gov/publications-and-resources/publications/comptrollers-handbook/files/custody-services/pub-ch-custody-services.pdf ("OCC Custody Handbook"). See also Inland Marine Underwriters Association, Evaluating the Risk in the Storage and Shipping of Fine Art: Insights into the Art Service Industry at https://www.imua.org/Files/reports/2019reports/EvaluatingRiskinStorageandShippingofFineArtsUpdateFinal1_4_2019.pdf.

adviser has assessed and evaluated the safeguarding measures put in place by itself or the third party maintaining physical assets. Such policies and procedures might include procedures to assess whether the person maintaining the client asset has exercised and is likely to continue to be able to exercise due care in accordance with reasonable commercial standards in safeguarding the asset.

4. Notification and Prompt Independent Public Accountant Verification

The exception to the requirement to maintain assets with a qualified custodian would also require an adviser to enter into a written agreement with an independent public accountant.[238] The proposed rule would require the adviser to notify the independent public accountant of any purchase, sale, or other transfer of beneficial ownership of such assets within one business day.[239] The written agreement would require the independent public accountant to verify the purchase, sale, or other transfer promptly upon receiving the required transfer notice.[240] The written agreement would also require the accountant to notify the Commission by electronic means directed to the Division of Examinations within one business day upon finding any material discrepancies during the course of performing its procedures.[241] We believe that these requirements would provide advisory clients meaningful and much-needed protection when their advisers have custody of assets that are not maintained with a qualified custodian.

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238 *See* proposed rule 223-1(b)(2)(iii).

239 *See* proposed rule 223-1(b)(2)(iv).

240 *See* proposed rule 223-1(b)(2)(iii)(A).

241 *See* proposed rule 223-1(b)(2)(iii)(B).

It has been our longstanding view that the involvement of independent public accountants in the review and verification of client assets of which advisers have custody is an important safeguarding tool and reduces the risk of loss of client assets.[242] Consistent with that view, we believe that an independent public accountant's involvement in the verification and notification requirements in the proposed rule enhances the reliability and integrity of the verification and would help identify problems that clients may not, and thus would provide deterrence against fraudulent conduct by advisers.

We believe that the timing requirement for the notice—that the adviser would be required to provide notice to an independent public accountant within one business day of a transfer of beneficial ownership—is important to inform an independent public accountant as soon as practicable of a transfer of beneficial ownership of client assets that are not held with a qualified custodian. This timing will build a record for the accountant to review in connection with an annual surprise examination or financial statement audit and, therefore, would reduce the likelihood of loss or misappropriation of client assets. Moreover, we anticipate the timing of these requirements in close proximity to the timing of a transaction, coupled with the annual confirmation during a surprise examination or financial statement audit, would also reduce the likelihood that any loss would go undetected for an extensive time. Further, we believe that this notice would not be challenging for any adviser to provide to the independent public accountant, especially considering the limited nature of the requirement relative to the more involved aspects

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242 *See, e.g.*, Adoption of Rule 206(4)–2 under the Investment Advisers Act of 1940, IA Release No. 123 (Feb. 27, 1962) [27 FR 2149 (Mar. 6, 1962)] (requiring advisers with custody of client securities or funds to engage an independent public accountant to conduct an annual surprise examination); 2009 Adopting Release, *supra* footnote 11, at section II.B.1. ("Because advisers with custody often have authority to access, obtain and, potentially, misuse client funds or securities, we believed the additional review provided by an independent public accountant would help identify problems that clients may not, and thus would provide deterrence against fraudulent conduct by advisers.").

of many of the closings related to privately offered securities or physical assets such as the preparation or review of closing memos, confirmation of receipt of funds, execution of signature pages, and many other more time-consuming tasks related to closings for these types of assets.

Based on our experience with the audit provision in the current rule,[243] we understand that independent public accountants are familiar with a wide variety of transaction verification and tracing transaction activity as this is a normal audit procedure. We recognize, however, that the verification and transaction tracing process of any purchase, sale, or other transfer of beneficial ownership of the assets would necessarily vary depending on the type of asset. For example, for a privately offered security purchased or sold by an advisory client, the independent public accountant could contact the issuer of the security or its agent to verify the existence of the asset and relevant information concerning the transfer of beneficial ownership of the client asset. The independent public accountant may also take a wide array of additional steps depending on the nature of the security—and the transaction—along with other relevant facts and circumstances. For example, the independent public accountant may review a private placement memorandum, the issuer's Regulation D filings,[244] or take other steps to assist in verifying the existence and transfers of beneficial ownership of the asset.

For a physical asset purchased or sold by an advisory client, such as a commercial shopping center, the independent public accountant may confirm the existence of the asset through a variety of reliable means. To confirm the transfer of beneficial ownership of the asset, the independent public accountant may review deeds or other land recordation materials, or seek to obtain other reliable information concerning the transfer of the asset. The independent public

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243 Rule 206(4)-2(a)(4) and 206(4)-2(b)(4).

244 *See* Form D, Notice of Exempt Offering of Securities, available at https://www.sec.gov/files/formd.pdf.

accountant may use similar methodologies in connection with the verification of the existence, and purchase or sale, of physical commodities. For example, an independent public accountant may seek to confirm existence and the relevant transfers of beneficial ownership of grain by reviewing a warehouse receipt for the assets held in a grain elevator.

The written agreement required by the proposed rule would require the accountant to notify the Commission within one business day upon finding any material discrepancies during the course of its examination.[245] This requirement is effectively identical to the notification requirement for material discrepancies found during a surprise examination under the custody rule[246] and would require an effectively identical decision-making process by the independent public accountant: the independent public accountant may first take reasonable steps to establish the basis for believing a material discrepancy exists. The obligation to notify the Commission arises once the accountant has a basis for believing there is a material discrepancy. Ordinarily, an accountant should be able to determine promptly whether it has a basis for believing there is a material discrepancy.[247] The reporting by the independent public accountant of a material discrepancy would provide the staff with timely notice of a potential issue with the adviser's custodial practices, providing the staff with an earlier opportunity to examine an adviser or take other action against an adviser, as appropriate, in an effort to help safeguard client assets. This

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245 *See* proposed rule 223-1(b)(2)(iii).

246 *See* rule 206(4)-2(a)(4)(ii).

247 *See* 2003 Adopting Release, supra footnote 2, at note 34; 2009 Proposing Release, supra footnote 11, at note 10.

proposed requirement also bears similarities to the proposed notification requirement for an audit under the proposed safeguarding rule.[248]

5. Surprise Examination or Audit

Like the custody rule, the safeguarding rule would require advisers relying on the exception to undergo an annual surprise examination or rely on the audit provision.[249] In a change from the custody rule, however, the proposed rule would require each privately offered security or physical asset not maintained with a qualified custodian to be verified.[250] This change from the custody rule is designed to address our concerns that a loss of these assets could go undetected for an extended period of time as a result of a not being included within the accountant's sample to be tested during a surprise examination or verified during an audit if they do not meet the threshold for materiality. Moreover, this proposed requirement would supplement the proposed requirement to verify transactions promptly after they occur, operating similarly to an annual "bring down." This would help ensure the client has some comfort regarding the status and ultimate disposition of these assets over time despite the lack of ability to monitor quarterly custodial statements. We recognize that this proposed requirement likely constitutes a departure from current practice for most surprise examinations and audits, but believe that the protective benefits of the surprise examination and annual audit are critical to the

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248 *See infra*, section II.F.

249 *See* rule 206(4)-2(a)(4); 2009 Adopting Release, *supra* footnote 11, at section II.B.3. ("Because clients are more dependent on the adviser with respect to the safeguarding of these securities, advisory clients may be exposed to additional risks when their advisers acquire these securities on their behalf. To mitigate these risks and to provide assurance that privately offered securities are properly safeguarded, we believe that it is appropriate to require an independent third-party to verify client ownership with the issuers of the securities by requiring that these securities be subject to the surprise examination requirement under the amended rule.").

250 *See* proposed rule 223-1(b)(2)(v).

safeguarding of client assets, especially where these assets do not have the additional protections afforded by the oversight of a qualified custodian.

We request comment on all aspects of the proposed exception, including the following:

116. Should the rule retain the privately offered securities exception of the custody rule without any modifications?

117. Do commenters agree with our understanding that, today, the overwhelming majority of securities are uncertificated, that the volume of privately offered securities has vastly expanded since 2003, and that custodians have developed safeguarding and reporting practices, particularly with respect to publicly-traded securities? Are we correct that the custodial market for privately issued securities is less developed? Do commenters also agree that some custodians will presently custody privately issued securities and that new custodial services are being developed?

118. Should the rule eliminate the current rule's privately offered securities exception to the requirement to maintain securities with a qualified custodian, as proposed? Rather than eliminating the custody rule exception and creating the new safeguarding rule exception for privately offered securities and physical assets, should the custody rule exception be retained, but modified in a different way? For example, should it be made available solely to advisers whose clients' financial statements are audited and distributed to investors in accordance with the requirements of this rule? If so, what standard of independence should an auditor be required to satisfy?

119. Are we correct in our belief that the privately offered securities exception may not adequately protect an advisory client from the broad types of risks the rule is intended to address? If not, in what ways does the exception provide adequate protections? Are there alternatives to eliminating the exception and creating the new exception as proposed that would better serve the proposed rule's policy goals?

120. Is our understanding correct that advisers with trading authority of privately offered securities that do not settle DVP often have custody of these securities because of the broad general power of attorney-like authority required to trade these securities?

121. Are qualified custodians able to provide custody services for privately offered securities? If so, what services? Would maintaining these securities with qualified custodians be practically challenging and/or costly? If so, what are the challenges or cost constraints?

122. Do commenters agree that the custody rule exception's restrictions on transferability of privately offered securities do not provide comparable protections to those provided under the proposed rule? If commenters disagree, how do these restrictions protect against misappropriation by the adviser or theft by a third party? Do issuers and other holders of outstanding securities evaluate whether a transaction in the securities would result in misappropriation by the adviser or theft by a third party? Do they have an incentive to evaluate a transaction for misappropriation or any of the other policy goals of the rule?

123. We are proposing to retain the mutual fund shares exception because, in our experience, this exception has not raised similar types of investor protection

concerns that we are seeking to address in this proposal.[251] Do commenters believe that the mutual fund shares exception raises investor protection risks? Should we eliminate the exception for mutual fund shares? To what extent do advisory clients purchase mutual fund shares through qualified custodians such as broker-dealers such that the exception may not be necessary?

124. Our understanding is that certain assets cannot be maintained with a qualified custodian, but that the bulk of client assets that advisers service are able to be held by a qualified custodian. Do commenters agree with this understanding? What are some examples of assets that cannot be held by a qualified custodian? If an asset cannot be maintained with a qualified custodian, should an adviser be permitted to have custody of the asset, as that term is defined in the proposed rule? Should advisers, instead, be required to relinquish the authority that triggers the application of the definition of custody in the context of the asset that is unable to be maintained with a qualified custodian? Alternatively, should they be required to provide alternative safeguards for the asset, such as those proposed?

125. Are there currently assets that qualified custodians will maintain, but doing so would be cost-prohibitive for advisers or their clients? If so, what are some examples of these assets? At what point does it become cost-prohibitive? Is it measured based on a percentage of the value of the asset? Is it based on a percentage of the adviser's fee for providing advisory services with respect to that asset? Is it

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251 *See* rule 206(4)-2(b)(1) and proposed rule 223-1(b)(1).

the point at which it becomes unprofitable for the adviser to provide advice to the client?

126. Should the proposed rule permit an adviser to conclude that an asset is eligible for the exception if it would be prohibitively expensive to custody the asset with a qualified custodian? What would be considered prohibitively expensive?

127. Is the proposed definition of privately offered securities clear? Should it include any additional factors? Should any of the proposed factors be removed? For example, is the description of the meaning of uncertificated clear? Should it be revised? Are there securities that qualify for the custody rule's description of this term that would be unable to rely on the proposed exception as a result of the differences of the proposed definition? Please explain.

128. Do commenters agree with our belief that ownership of crypto asset securities that is evidenced through public keys or wallet addresses on public blockchains would not qualify for the proposed privately offered securities exception? If not, why? Could the rationale for the privately offered securities exception – namely, that impediments to transferability present with certain privately offered securities mitigate some of the risks and provide some external safeguards against the kinds of abuse the rule seeks to prevent (loss and third-party theft) when those assets cannot be maintained by a qualified custodian – also apply to the custody of crypto asset securities, the ownership of which is evidenced through public keys or wallet addresses on public, permissionless blockchains?[252] If so, how do the protections

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[252] *See* 2003 Adopting Release, *supra* footnote 2 at nn. 26-28 and accompanying text.

work? How do they mitigate some or all of the risks the rule is designed to address – loss, theft, misappropriation, misuse, and adviser insolvency or bankruptcy?

129. Should we provide a more prescriptive definition of physical asset? Do commenters believe that there are certain physical assets that are unable to be maintained with a qualified custodian? If so, do commenters believe that those assets will remain static as the custody industry evolves?

130. Is the term "physical assets" sufficiently clear such that advisers will be able to understand its application and appropriately utilize the exception? Should we define the term "physical assets" or use another term for this exception, such as "tangible assets?" If so, should such a definition include or exclude specific asset types? What assets are commonly considered to be physical assets that are unable to be held at a qualified custodian?

131. Should the proposed rule provide flexibility for advisers to make a reasonable determination that a privately offered security or physical asset is eligible for the exception? Are there concerns that providing advisers with the ability to make a reasonable determination as to whether a privately offered security or physical asset is eligible for the exception will allow some advisers to avoid using qualified custodians to protect client assets? Should the Commission take a different approach instead?

132. Should we limit the exception to privately offered securities and physical assets as proposed? Should we expand the scope of the exception to other types of assets? If we expanded the scope, which types of assets should we include and why? Specifically, are there impediments to transferability present with other types of

assets that mitigate some of the risks and provide some external safeguards against the kinds of abuse the rule seeks to prevent (loss, third-party theft, misuse, misappropriation, adviser insolvency/bankruptcy) when those assets cannot be maintained by a qualified custodian? Please explain your answer. Alternatively, should we not create an exception for privately offered securities and physical assets?

133. Is our understanding correct that the current market for custodial services of privately offered securities is limited? Is our understanding correct that demand for these services is also limited? Do commenters agree with our understanding of the market for custodial services for physical assets? Please explain.

134. To be "reasonable," how frequently should advisers determine whether a qualified custodian can maintain possession or control of an asset? Should the rule provide flexibility as proposed? Should it instead specify intervals, such as monthly, quarterly, semi-annually, or annually?

135. If we expanded the scope of the exception beyond privately offered securities and physical assets to other assets that an adviser reasonably determines cannot be held at a qualified custodian what requirements should we put in place to ensure the assets are properly safeguarded? Should such measures include some or all of the protections for qualified custodians that we discuss in section II.3.C above?

136. Rule 206(4)-7 requires advisers to adopt and implement policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules, which will include the safeguarding rule. Should we, nonetheless, prescribe specific written policies and procedures to be adopted and implemented for determining

when privately offered securities or physical assets would be eligible for the exception? For example, should any such written policies and procedures be designed to help ensure that any party involved in maintaining client assets be required to exercise due care in accordance with reasonable commercial standards to safeguard client assets? Would this requirement improve safeguarding of client assets not maintained with a qualified custodian?

137. How do advisers currently safeguard securities for which they rely on the privately offered securities exception under the custody rule? Do these practices differ from what would be required under the proposed rule? Please explain. Should these practices be prescribed under the final rule?

138. Should we define the term "reasonably safeguard" in the rule text? Do commenters believe that reasonable safeguards are generally within reasonable commercial standards for particular physical assets or privately offered securities? Are advisers able to ascertain what safeguards are within such reasonable commercial standards for particular physical assets or privately offered securities they may hold on behalf of clients?

139. How would an adviser document that it is satisfying its fiduciary duty to an advisory client when maintaining client assets not with a qualified custodian under the proposed exception? How frequently would it be required to provide this evidence?

140. Should we require a particular standard of care? Should we require particular safeguards or practices?

141. Should the rule require an independent public accountant, pursuant to a written agreement between the adviser and the accountant, to verify transfers of privately offered securities or physical assets promptly upon receiving notice from the adviser of any purchase, sale, or other transfer of beneficial ownership of such assets? Would the requirement enhance the safeguarding of client assets not maintained with a qualified custodian and reduce the risk of loss or misappropriation?

142. Is the proposed rule's timing requirement that the written agreement require an independent public accountant to "promptly" verify any purchase, sale, or other transfer of beneficial ownership of such assets sufficiently clear? Is the meaning of the term "promptly" in this context sufficiently understood in practice? Is additional guidance needed? In lieu of the "promptly" requirement proposed, should we require an independent public account to verify any purchase, sale, or other transfer of beneficial ownership within a set number of days? If so, how many days? For example, within 24 hours of the transfer of beneficial ownership? Within 24 hours of receipt of notice from adviser? Within two days of the transfer of beneficial ownership or notice from the adviser? Within one week of the transfer of beneficial ownership or notice from the adviser?

143. Are we correct in our understanding that independent public accountants are familiar with asset verification and transaction tracing procedures? Do commenters believe that there are alternative procedures that would achieve the policy goals of the rule? Should we require the independent public accountant to be the same as the independent public accountant hired to conduct the annual surprise examination or financial statement audit? Conversely, should we prohibit this? Would there be

benefits to using the same accountant, such as an ability to leverage work papers from the verification when performing annual surprise examination or audit procedures? Would there be benefits to using a different accountant?

144. Would the 2009 Accounting Guidance contain sufficient guidance for an accountant that is engaged to perform the proposed verification procedures around privately offered securities and physical assets that are not maintained with a qualified custodian? What changes, if any, do you believe would be necessary to provide adequate direction with respect to the proposed verification procedures?

145. Should we require the independent public accountant employed by the adviser under this exception to verify the transfers to be registered with and subject to inspection by the PCAOB?

146. Should the rule require the adviser to notify the accountant of a transaction within one business day as proposed? Should we require these notices to be in writing? Alternatively, should the rule require that the written agreement between the adviser and the accountant require the adviser to notify the accountant of a transaction within one business day?

147. Do commenters agree with our view that this notification should occur as soon as practicable after the closing of a transfer of beneficial ownership of assets not custodied with a qualified custodian? If not, what timeframe do commenters recommend that would achieve the policy goals of the proposed rule? For example, should we require the notice be no later than a certain number of hours after the transaction date? After the settlement date? After money or asset(s) are sent to a counterparty? After receipt of proceeds of a redemption?

148. Do commenters agree with our belief that it would not be challenging for advisers to provide the required notification, as proposed?

149. Is there a way to mitigate the risk that an adviser intending to misappropriate client assets does not comply with the notification requirement? Should we require other safeguards that limit the risk that an adviser intentionally or unintentionally fails to comply with the notification requirement?

150. Rather than requiring verification by an accountant promptly after each purchase, sale, or other transfer, as proposed, should we require timely notification to the auditor and require the auditor to reconcile each reported purchase, sale, or other transfer reported to the books and records subject to the annual audit or surprise examination? Would this provide the same level of protection for client assets not maintained with a qualified custodian as the prompt verification requirement proposed? If not, are there nonetheless good reasons to require annual verification rather than prompt verification? If we were to require only annual verification, are there other safeguards that we should require to mitigate the risk of misappropriation?

151. Rather than requiring verification by an accountant promptly after each transfer, as proposed, should the rule require, as part of the annual surprise examination or annual audit, an accountant to verify holdings of privately offered securities from one year to the next and evaluate discrepancies? For example, if a client's account held assets X, Y, and Z in one year, but only X the following year, the accountant would evaluate the disposition of assets Y and Z.

152. Should the rule require the written agreement between the adviser and the accountant to require the accountant to notify the Commission within one business day upon finding any material discrepancies during the course of its examination? Is the material discrepancy requirement clear or should we provide further guidance regarding how accountants should make the materiality determination? In light of the fact that the requirement is effectively identical to the notification requirement for material discrepancies found during a surprise examination under the current custody rule, do commenters believe that the requirement for the accountant to notify the Commission within one business day upon finding any material discrepancies would result in "false positives" or unnecessary notifications to the Commission as a result of the one-business-day reporting timeframe? If so, do commenters recommend a different timeframe?

153. Rather than the form of verification and asset tracing proposed, should the rule require verification procedures substantially in the form used by independent public accountants under custody rule 206(4)-2(a)(4)?

154. Should the rule require the independent public accountant to file a certificate on Form ADV-E stating that it has verified the transactions and describing the nature and extent of its verification? If so, when should the certificate be filed? Promptly upon completion of the verification? Within one business day? Within a certain period of time after being notified by the adviser? Would such a requirement enhance the safeguarding of client assets not maintained with a qualified custodian and reduce the risk of loss or misappropriation?

155. Should the rule permit other persons or entities to perform the verification that the rule proposes be performed by the independent public accountant? For example, should an independent representative be permitted to perform this function? If so, should the rule retain the independent representative definition from the current rule?[253] If not, what changes should be made? What, if any, procedures should we require to be performed to verify the transaction, especially for the broad array of physical assets that may be covered by the rule? Would an independent representative be equipped to perform verification? Would such an approach be more or less burdensome than the proposed approach?

156. If an independent representative should be permitted to perform the role we are proposing for an independent public accountant, should the rule require or prohibit certain parties from acting as an independent representative? What persons and entities do commenters believe might act as independent representatives? Do commenters believe that qualified custodians would be willing to act as independent representatives? Do commenters believe that a client could serve as its own independent representative? If so, would that further the policy goals of the rule? Should there be limits on which clients could serve as their own independent representative? For example, should those clients be required to be a qualified purchaser, accredited investor, or satisfy certain other tests (*e.g.,* net worth, education, licensing)? Would there be difficulties in locating a sufficient number of independent representatives to perform this function?

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[253] *See* rule 223-1(d)(4).

157. Should we require that the proposed verification procedures provide a certain level of assurance to investors? If so, what level of assurance should we require? Should we require the written agreement specify a required assurance framework that would be applied? Should we require a reporting mechanism requiring the auditor to communicate the results of the ongoing verification procedures to the adviser? If so, how frequently should we require reports and what information should we require to be included?

158. As an alternative to the notification and verification elements of the proposed rule, should we instead require periodic examinations for privately offered securities and physical assets that are not maintained with a qualified custodian? If so, should the procedures be substantially similar as those required for surprise examinations under current rule 206(4)-2(a)(4)? How frequently should these examinations occur? Would quarterly be sufficient to reduce the risk of misappropriation and loss of client assets? Would quarterly surprise examinations be more or less expensive than the notification and verification proposed rules?

159. Are there other challenges with these aspects of the rule, as proposed? Would this requirement be expensive for advisers, and would advisers pass those costs along to advisory clients?

160. Should the rule require asset verification of all client assets not maintained with a qualified custodian? Would this help reduce the risk of theft, loss, or misappropriation of client assets? How common is asset verification for privately held securities? For physical assets? Should the verification requirement permit sampling of client accounts, as opposed to verification of assets for all client

accounts? Should advisers with custody of assets not maintained with a qualified custodian be required to obtain more surprise examinations? If so, how frequently? Would quarterly or bi-annual asset verification be more appropriate? Is 100% asset verification of assets in all client accounts common in other contexts or performed for other purposes unrelated to the requirements of the custody rule?

161. Should the rule require that the audit verify all client assets not maintained with a qualified custodian, which would thus bar the accountant engaged by the adviser from performing asset sampling with respect to such assets? Would this help reduce the risk of theft, loss, or misappropriation of client assets? How common is 100% asset verification for audits of privately held securities? For physical assets? Should advisers with custody of assets not maintained with a qualified custodian be required to obtain more audits? If so, how frequently? Would quarterly or bi-annual asset audits be more appropriate? Is 100% asset verification of client assets common in other contexts or audits performed for other purposes unrelated to the requirements of the custody rule?

162. Do audits provide an appropriate level of protection for clients where an adviser is unable to keep certain assets with a qualified custodian? If not, why not? In addition to the requirement that all assets be verified during the annual audit, should we recommend any specific audit procedures to test that client assets not kept at a qualified custodian are appropriately safeguarded from loss or misappropriation?

163. If an adviser has any assets not maintained with a qualified custodian, should the rule require asset verification of all assets, including those assets that are maintained with a qualified custodian to ensure a complete accounting of all assets occurs as of

the audit date? Are there other controls that could be put in place to ensure assets are not transferred to satisfy an audit and then returned to their original location?

164. Are there risks not discussed above created when an adviser has custody of privately offered securities or physical assets that are not maintained with a qualified custodian? If so, what are those risks? Would the proposed rule sufficiently mitigate those risks? If not, what additional safeguards should be required?

165. As an alternative or in addition to any of the safeguards in the proposed exception, should we require advisers to promptly deliver a written notice to each client whose assets are not maintained with a qualified custodian (or the client's independent representative) containing certain specified information regarding the assets, such as to inform the client that the assets are not kept by a qualified custodian and to explain how the client can verify the existence and ownership of those holdings? Should the notice be required to be delivered within a certain time to allow an adviser to enter into an agreement with an entity to maintain the assets? If so, what should that timing be? Should it be similar to the timing the proposed exception would require for the adviser to provide notice to the accountant? Is there additional information that should be required to be included in the notice?

166. As an alternative or in addition to any of the safeguards in the proposed rule, should the rule require that an adviser provide a quarterly summary of a client's transactions involving assets that are not maintained with a qualified custodian? Should the summary be more or less frequent? Should the summary be in a prescribed format or should certain specific information be required? If the Commission adopts requirements to send quarterly statements to investors in private

funds as recently proposed,[254] should that satisfy the requirement to send these account statements? Should those quarterly statements be required to be audited as an additional or alternative condition of the proposed exception?

167. As an alternative or in addition to any of the safeguards in the proposed rule, should we require the adviser to obtain an internal control report for assets not maintained with a qualified custodian? If so, what type(s) of internal control report(s) should we require and why? For example, should it have similar control objectives to the internal control report we would require of qualified custodians? Who should prepare such internal control report(s)? For example, should it be an independent public accountant registered with and subject to inspection as of the commencement of the engagement period by the PCAOB? Should we require an adviser to obtain an internal control report covering all of its internal controls, not just internal controls relating to the safeguarding of assets not maintained with a qualified custodian, or is the proposed exception sufficient to address our policy goals? Would requiring an adviser to obtain an internal control report be sufficient to mitigate the risks created when an adviser has custody of client assets that are not maintained with a qualified custodian?

168. As an alternative or in addition to any of the elements of the proposed safeguarding rule, should we require advisers to maintain insurance to reimburse clients for losses as a result of the advisers' misconduct? For example, should we require fidelity bonds? Should the insurance policy limits correspond to the amount

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254 *See*, Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Release No. IA-5955 (Feb. 9, 2022) [87 FR 16886] (Mar. 24, 2022).

of assets not maintained with a qualified custodian? Should the insurance policy limits correspond to the amount of all of the assets of which the adviser has custody? Are policies of this nature common? What costs would be associated with this kind of insurance? Who would be the payee of any claims – the client who suffered the loss or the adviser? What would be the advantages or disadvantages of either approach to payee? Are these policies occurrence based (the policy that pays on a claim is the one that is in effect at the time the incident occurred) or based on when the claims are made (the policy that pays on a claim is the one that is in effect at the time the claim is made regardless of when the incident occurred)? What would be the advantages and disadvantages to occurrence-based or claims-made policies in this context? What are common exclusions under these policies? Do they cover simple/ordinary negligence? Does the underwriting process for these policies involve an evaluation of the adviser's internal controls? Does the underwriting process take place annually and if so, does it differ from the initial underwriting assessment? Should the insurance policy be obtained from an insurer with certain credentials or subject to certain regulatory or other standards? Please explain.

169. As an alternative or in addition to any of the elements of the proposed rule, should we require advisers to have certain capital requirements? Should capital requirements be required to correspond to the amount of assets not maintained with a qualified custodian? Should capital requirements correspond to the amount of all of the assets of which the adviser has custody? Do advisers often maintain capital reserves in the event of a client loss as a result of their misconduct? If yes, is the capital maintained in escrow? If we were to require financial reserves, should the

reserves be maintained in escrow? Who would be an appropriate escrow agent? And what would be appropriate terms of the escrow, particularly for release of funds? Should the capital be maintained in a particular type of bank account? If yes, what kind of account is commonly used or would be appropriate for these purposes? Should such a requirement be conditioned upon using a particular type of bank? What type? For example, should it be chartered by the OCC? Subject to Federal Deposit Insurance Corporation oversight? What costs are associated with escrow accounts and financial reserve/net capital requirements?

170. Are there compliance challenges to this proposed exception? If so, what are they?

D. Segregation of Client Assets

Though advisers must attain reasonable assurance of segregation of client assets at a qualified custodian,[255] the proposed rule also would require advisers to segregate client assets from the adviser's assets and its related persons' assets in circumstances where the adviser has custody. Specifically, the proposed rule would require that client assets over which an adviser has custody:

(1) Be titled or registered in the client's name or otherwise held for the benefit of that client;

(2) Not be commingled with the adviser's assets or its related persons' assets; and

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[255] *See* discussion of qualified custodian segregation requirements at supra section II.(C)(4).

(3) Not be subject to any right, charge, security interest, lien, or claim of any kind in favor of the adviser, its related persons, or its creditors, except to the extent agreed to or authorized in writing by the client. [256]

Segregation of client assets from the assets of others continues to be a fundamental element of safeguarding client assets.[257] This aspect of the proposed rule is designed to ensure the client's continued ownership and authorized use of its assets. This proposed requirement is intended to complement, but serves a slightly different purpose than the proposed requirement that the adviser obtain reasonable assurance from the qualified custodian that the client's assets are similarly segregated. This proposed adviser segregation provision is critical in light of the fact that some client assets are not maintained with a qualified custodian.[258] Moreover, we view it as essential not only for the custodian, but also for the adviser, to keep its own proprietary assets and liabilities segregated from client assets to prevent misuse or misappropriation of client assets.

The proposed requirement that a client's assets be titled or registered in the client's name is designed to ensure that the client's assets are clearly identified as belonging to the appropriate client, regardless of whether a qualified custodian is holding the assets. The proposed rule would also permit advisers to identify the assets "for the benefit of" a particular client where assets may not be "titled or registered" in the client's name. For example, an adviser acting as a trustee would generally maintain client assets in trust for the benefit of a particular client for estate

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256 Proposed rule 223-1(a)(1). *See also supra* footnote 171.

257 *See supra* footnote 168.

258 *See* proposed rule 223-1(a)(1)(ii)(D).

planning or other purposes.[259] "For the benefit of" is also meant to recognize various ways advisory clients can title or register their investments. For example, clients may hold securities in "street name" or "nominee name" through a book-entry account with a broker-dealer, and the broker-dealer will keep records showing the client as the real or "beneficial" owner.[260] This requirement would protect client assets even if the assets are maintained with a broker-dealer in such a manner that gives the broker-dealer legal ownership of, or access to, the assets.

Similarly, if an adviser purchases privately offered securities that are held on the books of the issuer or the issuer's transfer agent, the adviser should ensure that the issuer or transfer agent properly records and registers the adviser's client as owner. For example, if the adviser invests in a private fund or purchases private debt for a client, the records at the private fund's transfer agent or the private debt issuer should reflect the client as the owner of the investment. We believe this requirement would safeguard the client's assets from intentionally or inadvertently becoming someone else's property as well as prevent circumstances that could result in the misuse or misappropriation of client assets.

The proposed rule would also require that client assets not be commingled with the adviser's assets, or those of its related persons. The proposed requirement is designed to help ensure that client assets are isolated and more readily identifiable as client property.[261]

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259 The client would maintain the beneficial interest in the trust property and the trustee would hold only legal title without the benefits of ownership; the trust property is not subject to personal obligations of the trustee, even if the trustee becomes insolvent or bankrupt. *See* Section 507 of the Uniform Trust Code (Jan. 2013).

260 *See, e.g.*, Concept Release on the U.S. Proxy System, Investment Advisers Act Release No. 3052 (July 14, 2010) [75 FR 42981 (July 22, 2010)] ("Proxy Concept Release").

261 We have taken a similar approach in other contexts. *See*, *e.g.*, Financial Responsibility Adopting Release, *supra* footnote 171 (discussing similar requirements under Rule 15c3-3 that would cause a broker-dealer to keep customer securities and cash isolated and readily identifiable as "customer property" and,

Consequently, we believe the proposed prohibition on commingling would help protect client assets from claims by a third party looking to secure or satisfy an obligation of the adviser, including in cases of insolvency or bankruptcy of the adviser, or its related persons.[262] We do not intend the prohibition on commingling to preclude traditional operational practices in which client assets are held together with other clients' assets. We recognize that some advisers and custodians regularly service assets in a manner where such assets are reasonably identifiable from other clients' assets and not subject to increased risk of loss from adviser misuse or in the case of adviser insolvency. Accordingly, we request comment on some of these practices and the potential impact of this prohibition below.

Under the proposed rule, client assets would also be required to remain free from any right, charge, security interest, lien, or claim of any kind in favor of the adviser, its related persons, or their creditors. These requirements are designed to protect client assets by limiting the ability of an adviser, or its related persons, to use client assets for their own purposes or in a manner not authorized by the client. However, we do not intend this condition to limit or prohibit authorized actions by clients. We are therefore proposing an exception to these requirements to the extent a client agrees to or authorizes such arrangements in writing.[263] In our understanding, some clients authorize these types of arrangements depending on the types of assets, products, or strategies in which they invest resulting in the subject assets being

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consequently, available to be distributed to customers in the event that the broker-dealer is liquidated in a formal proceeding under the Securities Investor Protection Act of 1970).

262 *See, e.g., supra* footnote 172.

263 *See* proposed rule 223-1(b)(7)

commingled and potentially subject to certain claims. For example, such an authorization might allow assets to be subject to a securities lending arrangement authorized by the client.[264] In a typical securities lending transaction, the legal title to loaned securities passes to the borrower for the loan term. The lender regains title to the securities when the securities are returned, either upon demand or at the end of a specified term. Similarly, in a margin account, which is a type of brokerage account, a broker lends cash to a client to allow the client to purchase securities. The loan is collateralized by the securities purchased, other assets in a client account, and cash, and the broker charges a periodic interest rate.[265] This proposed exception would also allow arrangements in which an adviser deducts fees directly from client assets for the payment for services rendered by the investment adviser or its related persons, so long as the client authorizes such payments in writing.

To the extent a client agrees to or authorizes in writing one of these, or similar, arrangements, it would be excepted from the proposed prohibition against subjecting the client's assets to any right, charge, security interest, lien, or claim in favor of the investment adviser or a qualified custodian.[266] Although these activities may implicate the types of risks the proposed rule is designed to address, we believe the client is aware of, and consents to, the arrangement for ease or by necessity to effect a desired activity with respect to its assets.[267] Without the ability to

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264 *See* proposed rule 223-1(a)(1)(iii).

265 *See* Uniform Commercial Code, § 8-504 and cmt. 2 ("Margin accounts are common examples of arrangements in which an entitlement holder authorizes the securities intermediary to grant security interests in the positions held for the entitlement holder.").

266 Proposed rule 223-1(a)(3)(iii).

267 *See also*, Standard of Conduct for Investment Advisers Release, *supra* footnote 57, page 8 (noting that although all investment advisers owe each of their clients a fiduciary duty under the Advisers Act, that the fiduciary duty must be viewed in the context of the agreed-upon scope of the relationship and necessarily depend upon what functions the adviser, as agent, has agreed to assume for the client, its principal).

authorize such arrangements, clients would be unable to engage in these potentially beneficial, authorized activities.

We believe that proper segregation of client assets, as required by the three-part requirements of the proposed rule, would mitigate concerns regarding the safety of a client's assets, particularly when coupled with the requirement described above that the adviser obtain reasonable assurance from the qualified custodian that the custodian is similarly segregating the client's assets.

We request comment on all aspects of the proposed rule's requirements for the segregation of investments, including the following items.

171. Should the rule include the proposed segregation requirements? Are these requirements sufficiently clear?

172. Do the proposed segregation requirements properly align with the proposed qualified custodian contract provisions and the reasonable assurance requirements, especially those proposed in subsections 223-1(a)(2)(ii)(D) and (E)?

173. Is the scope of the proposed segregation requirement's application to the adviser and its related persons appropriate? Should this section also apply to the qualified custodian, or are the proposed reasonable assurance requirements in 223-1(a)(2)(ii) sufficient to ensure segregation and protection of assets in a custodial account?

174. Would advisers be able to ensure that assets are held in the client's name or for the client's benefit in situations that involve recording of interests at a transfer agent or in circumstances involving the custody of privately offered securities or physical assets?

175. Would the proposed segregation requirements impose appropriate limitations to safeguard client assets? Should we eliminate or modify any of them? Alternatively, are there other limitations that would be appropriate?

176. Would the proposed requirements increase the likelihood that client assets will be available to be returned to clients if an adviser or its related persons experience any financial reverses, such as insolvency or bankruptcy? For example, do commenters believe the requirements would help ensure that client assets are more readily identifiable as client property?

177. Should certain assets be excluded from these requirements? If so, which assets and why? Would limiting these requirements to certain types of assets present compliance challenges? If so, what assets and why?

178. In particular, would the proposed segregation requirements present challenges with respect to crypto assets? Should we address crypto asset segregation and/or custody with separate requirements? Do crypto assets raise specific segregation issues not presented by other assets? If so, what are they and why? Would the proposed requirements offer substantial protections in the event of a bankruptcy or financial losses involving an adviser or custodian with custody of crypto assets? Would the proposed segregation requirements present challenges with respect to other types of assets?

179. Would the proposed requirements ensure that a third party's lien against one client's assets would not be improperly attached to other clients' investments? Are there any other rights, charges or claims that should be expressly identified in the proposed segregation requirements?

180. The proposed requirements would provide an exception to the provision that client assets not be subject to right, charge, security interest, lien, or claim of any kind to the extent it is authorized by the client in writing. Is this exception appropriate? Is it sufficiently clear? Would it properly account for assets that are subject to a securities lending arrangement or margin trading agreement? Is the proposed exception too broad? For example, should the proposed exception apply to only certain types of assets or arrangements? Should we prescribe specific conditions that must be included in any client authorization?

181. Is it sufficiently clear from the rule text that client assets are not to be subject to any claim except claims for payment of services rendered by the investment adviser or related person that is agreed to or authorized by the client? Should we explicitly exempt such claims for certain types of fees?

182. Do the proposed segregation requirements to be titled in the client's name, not to be commingled, and not to be subject to any right, charge, security interest, lien or claim guard against loss, misappropriation, misuse, theft, and the financial reverses of the adviser, permit the adviser with reasonable operational flexibility to use omnibus and other similar accounts?

183. Should the rule prohibit commingling client and non-client assets, as does the current rule? Alternatively, should it permit the commingling of client and non-client assets for administrative convenience and efficiency? If so, what should be considered "administrative convenience and efficiency"? Does allowing client and non-client assets to be commingled (*e.g.*, in the same escrow account) increase the risk that client assets will be lost, misused, stolen, or misappropriated? Could an

advisory client's assets be used to satisfy the debts of someone else in a bankruptcy event if client and non-client assets are commingled?

184. Should the rule include express requirements regarding the sub-accounting of commingled accounts if the rule permits commingling of client and non-client assets?

185. We recognize there are some instances where commingling or pooling of certain assets may occur via certain omnibus and sub accounting arrangements that may present compliance challenges under the segregation requirements. We also understand that though such commingling may occur, the client assets may still be considered to be identifiable via omnibus recordkeeping though they sit among non-client assets. In what circumstances may such a requirement restricting commingling place burdens on advisers? Are there certain assets or transaction types for which such a requirement may be particularly burdensome? Should we include any exceptions to the prohibition on commingling?

186. Do commenters agree that there are circumstances when advisers' services require them to commingle client assets and non-client assets? For example, when an adviser uses sweep accounts, escrow accounts, or when an adviser serves as administrative agent to a loan syndicate where the lenders consist of advisory clients and non-advisory clients?[268] In these circumstances, should the rule require additional protections? Which protections and why and would they differ depending on the type of commingled account? For example, should the rule include specific

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[268] *See*, *e.g.*, Madison Capital No-Action Letter.

requirements to allow an adviser to hold a percentage of the proceeds from the sale or merger of a portfolio company owned by one or more client pooled investment vehicles (*e.g.*, private equity funds) and other non-clients for a limited period? If so, should we limit the types of proceeds that could be included in the escrow account or the period in which the escrow exists? Should we require the portion of the escrow attributable to the pooled investment vehicle client to be included on financial statements that are audited? Should we require any contract governing the escrow or other commingled account to include certain terms (such as requiring a seller's representative or administrative agent to distribute the funds in the escrow or commingled account promptly on a predetermined formula)?[269]

E. Investment Adviser Delivery of Notice to Clients

The proposed rule, like the custody rule, would require an investment adviser to notify its client in writing promptly upon opening an account with a qualified custodian on its behalf.[270] The notice is designed to alert a client to the existence of the qualified custodian that maintains possession or control of client assets and whom to contact regarding such assets. Based on our experience with the custody rule, we continue to believe it provides important client protections.

The notice would continue to include the qualified custodian's name, address, and the manner in which the investments are maintained. The proposed rule would also explicitly require that the notice include the custodial account number to improve the utility of the notice. If the client is a pooled investment vehicle, the notice must be sent to all of the investors in the

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269 *See* 2014 IM Guidance, *supra* footnote 17, in which our staff discussed its views on application of the current rule to various situations involving special purposes vehicles SPVs and escrows.

270 *See* proposed rule 223-1(a)(2).

pool, provided that, if an investor is a pooled investment vehicle that is in a control relationship with the adviser or the adviser's related persons, the sender must look through that pool (and any pools in a control relationship with the adviser or its related persons) in order to send the notice to investors in those pools.[271] As discussed above, this is intended to promote meaningful delivery of this important information. As is permitted under the current rule, the notice could also be delivered to the client's (or pooled investment vehicle investor's) independent representative and the adviser would continue to be required to provide the notice promptly when an account is opened and following any changes in the information contained in the notice. If adopted, this provision would require advisers to send account opening notices only to clients for which it has opened new client accounts with a qualified custodian after the effective date of the rule. Advisers would not have to provide new notices to existing clients for which it has already opened accounts as these clients are likely already aware of the location of their assets at the qualified custodian from prior notices.

We request comment on all aspects of the proposed rule's investment adviser notice requirement, including the following items.

187. Should the notice include the qualified custodian's account number? Should we require other types of information to be included in the notice? If so, what information, and why? Should we eliminate any of the proposed types of information from the notice? If so, why?

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[271] *See* proposed rule 223-1(c).

188. If an adviser uses several qualified custodians for one of its clients, should the proposed rule permit the adviser to provide the client a one-time notice for these qualified custodians rather than providing a new notice each time the assets move among the qualified custodians? [272] If yes, should the rule require the adviser also to provide the client a new notice promptly upon using a new qualified custodian to maintain the client's investments?

189. Should we require advisers to provide notice to clients when assets are not held at a qualified custodian? If yes, what form should these notices take? Should they be provided on a one-off or periodic basis?

F. Amendments to the Surprise Examination Requirement

We are proposing changes to the surprise examination requirement.[273] Under the current custody rule advisers with custody, subject to certain exceptions, must undergo an annual surprise verification by an independent public accountant to put "another set of eyes" on client assets.[274] In circumstances where the adviser or a related person maintain client assets as a qualified custodian, the independent public accountant must be registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by the PCAOB in accordance with its rules. Currently, the surprise examination requirement does not require the adviser explicitly to have a reasonable belief about the implementation of the written agreement between the adviser and the accountant. The surprise examination requirement would be amended to state that the adviser must reasonably

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272 Our staff has taken a similar view under the current custody rule. *See* Custody Rule FAQs, *supra* footnote 17, at Question V.1.

273 *See* proposed rule 223-1(a)(4).

274 2009 Adopting Release, *supra* footnote 11.

believe that a written agreement has been implemented (*i.e.*, that the accountant will perform the surprise examination pursuant to the agreement and comply with the section's ADV-E filing and notification requirements when required). We are also proposing to amend the language concerning notice upon the finding of any material discrepancies during the course of an examination that the notice be sent by electronic means to the newly designated Division of Examinations as opposed to the current rule's requirement to send to the Director of the Office of Compliance Inspections and Examinations.[275]

In a change from the current rule, we are proposing an amendment requiring that an adviser "must reasonably believe" that the written agreement has been implemented. We designed this to address circumstances where, in our experience, there is an adviser that has entered into the agreement with the accountant, but failed to ensure the surprise examination occurs and the requirements of the rule are met. Entering into the contract with the accountant alone would not satisfy the rule. Accordingly, advisers generally should enter into a written agreement with the accountant based upon a reasonable belief that the accountant is capable of, and intends to, comply with the agreement and the obligations the accountant is responsible for under the surprise examination requirement. For example, after securing a written agreement for the engagement, the adviser generally should ensure that the accountant is able to access the Commission's filing system so that it can perform its Form ADV-E filing functions properly under the rule.

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[275] *See* proposed rule 223-1(a)(4)(v)

It has been our longstanding view that the involvement of independent public accountants in the review and verification of client assets of which advisers have custody is an important safeguarding tool and reduces the risk of loss of client assets.[276] Consistent with that view, we believe that the adviser must ensure that the independent public accountant's involvement in the verification and notification requirements in the proposed rule are implemented effectively so as to ensure the reliability and integrity of the surprise exam.

We request comment on the proposed rule's modifications to the surprise exam requirement, including the following:

190. Should the rule require that an adviser must reasonably believe that the written agreement with the accountant has been implemented to satisfy the Form ADV-E and notice requirements of the provision? Are advisers able to ensure that an accountant fulfills the surprise examination requirements, or are there certain limitations that would make satisfaction of this requirement difficult?

191. What difficulties do accountants have when fulfilling their obligations on behalf of advisers under this section of the proposed rule? Should we make other amendments to this subsection of the rule to ensure that accountants are able to fulfill their duties under the rule? Does the expansion of the scope of the rule from funds and securities to assets raise any problems for advisers and auditors that would need to comply with the surprise examination requirement?

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276 *See,* 2009 Adopting Release, *supra* note 11.

G. Exceptions from the Surprise Examination

In light of the proposed changes to the rule's scope to cover all assets, the proposal seeks to balance better the costs associated with obtaining a surprise examination with the investor protections it offers by providing exceptions to the surprise examination requirement when the adviser's sole reason for having custody is because it has discretionary authority or because the adviser is acting according to a standing letter of authorization, each subject to certain conditions. We are also proposing modifications to the current rule's audit provision that we believe will expand the availability of its use, enhance investor protection, and facilitate compliance. These exceptions are discussed below.

1. Entities Subject to Audit ("Audit Provision")

a. Scope of the Audit Provision

Similar to the custody rule, an adviser that obtains an audit at least annually and upon an entity's liquidation under the proposed rule would be deemed to have complied with the surprise examination requirement and would eliminate the need for an adviser to comply with the client notice requirement.[277] Although the requirement to deliver account statements to clients would be different under the proposed rule than under the custody rule, the audit provision would still eliminate the adviser's need to comply with the account statement aspect under the proposed rule as well. Specifically, for the adviser to qualify for the audit provision under the proposed rule, its client that is a limited partnership (or limited liability company, or another type of pooled

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[277] *See* proposed rule 223-1(b)(4). As under the custody rule, an adviser that relies on an exception from the surprise examination requirement, such as the exception for fee deduction under proposed rule 223-1(b)(3) or the proposed exception for discretionary trading under proposed rule 223-1(b)(8) and *see* Discretionary Authority, *infra*, need not rely on the audit provision.

investment vehicle or any other entity) would need to undergo a financial statement audit that meets the terms of the rule at least annually and upon liquidation.[278] Under the proposed rule:

(1) The audit must be performed by an independent public accountant that meets the standards of independence 17 CFR 210.2-01 (in rule 2-01 of Regulation S-X) that is registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the PCAOB in accordance with its rules;

(2) The audit meets the definition in 17 CFR 210.1-02(d) (rule 1-02(d) of Regulation S-X),[279] the professional engagement period of which shall begin and end as indicated in Regulation S-X Rule 2-01(f)(5);[280]

(3) Audited financial statements must be prepared in accordance with U.S. Generally Accepted Accounting Principles ("U.S. GAAP") or, in the case of financial statements of entities organized under non-U.S. law or that have a general partner or

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278 *See* proposed rule 223-1(b)(4).

279 Under the definition in rule 1-02(d) of Regulation S-X, an "audit" of an entity (such as a private fund) that is not an issuer as defined in section 2(a)(7) of the Sarbanes-Oxley Act of 2002 means an examination of the financial statements by an independent accountant performed in accordance with either the generally accepted auditing standards of the United States ("U.S. GAAS") or the standards of the PCAOB. When conducting an audit of financial statements in accordance with the standards of the PCAOB, however, the auditor would also be required to conduct the audit in accordance with U.S. GAAS because the audit would not be within the jurisdiction of the PCAOB as defined by the Sarbanes-Oxley Act of 2002, as amended, (*i.e.*, not an issuer, broker, or dealer). *See* AICPA auditing standards, AU-C Section 700.46. We believe most advisers would choose to perform the audit in accordance with U.S. GAAS only rather than both standards, though it would be permissible under the proposed audit rule to perform the audit in accordance with both standards.

280 This provision reflects the existing process. Among other things, rule 2-01(f)(5) of Regulation S-X indicates that the professional engagement period begins at the earlier of when the accountant either signs an initial engagement letter (or other agreement to review or audit a client's financial statements) or begins audit, review, or attest procedures; and the period ends when the audit client or the accountant notifies the Commission that the client is no longer that accountant's audit client.

other manager with a principal place of business outside the United States, must contain information substantially similar to statements prepared in accordance with U.S. GAAP and material differences with U.S. GAAP must be reconciled;

(4) Within 120 days (or 180 days in the case of a fund of funds or 260 days in the case of a fund of funds of funds) of an entity's fiscal year end, the entity's audited financial statements, including any reconciliations to U.S. GAAP or supplementary U.S. GAAP disclosures, as applicable, are distributed to investors in the entity (or their independent representatives); and

(5) Pursuant to a written agreement between the auditor and the adviser or the entity, the auditor notifies the Commission upon certain events.[281]

Elements of the proposed rule's audit provision are largely unchanged from the audit provision of the custody rule.[282] Differences include: (1) expanded availability from "pooled investment vehicle" clients to "entities"; (2) a requirement for the financial statements of non-U.S. clients to contain information substantially similar to statements prepared in accordance with U.S. GAAP and material differences with U.S. GAAP to be reconciled; and (3) a requirement for there to be a written agreement between the adviser or the entity and the auditor requiring the auditor to notify the Commission upon the auditor's termination or issuance of a modified opinion.[283]

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281 Proposed rule 223-1(b)(4).

282 *Compare* rule 206(4)-2(b)(4) *with* proposed rule 223-1(b)(4).

283 *See* proposed rule 223-1(b)(4)(v). *See also* AICPA auditing standard, AU-C Section 705, which establishes three types of modified opinions: a qualified opinion, an adverse opinion, and a disclaimer of opinion.

We request comment on all aspects of the proposed rule's annual audit provision, including the following:

192. Should the rule continue to permit an adviser to satisfy certain elements of the rule by relying on the audit provision as proposed? Should the rule require an audit upon an entity's liquidation as proposed? Should we modify either or both of these requirements? If so, how should we modify these requirements, and why?

193. Should the rule require audits to cover a period of 12 months? Would investors derive value from audits that cover periods longer or shorter than 12 months? If so, what time periods, and why?

194. Should the proposed rule allow newly formed and liquidating entities to perform an audit less frequently than annually, provided that the audit period does not exceed 15 consecutive months, with no more than three months of such period occurring immediately before or after the entity's fiscal year end? Is 15 months the appropriate audit period limit for newly formed and/or liquidating entities? Should we increase or decrease this limit? If so, what time period should we require, and why? Should we include additional restrictions or requirements for newly formed entities and/or liquidating entities under the audit provision? If so, what restrictions or requirements, and why? Would allowing for less frequent auditing during liquidation—for example, requiring an audit every 18 months or two years in such circumstances—result in a meaningful cost reduction to advisers or investors?

195. Should the proposed rule require investment advisers to provide investors with a form of interim financial reporting when an entity's audit period will be in excess of

12 months? If so, what information should be included in this reporting and who should receive this reporting? Should the reporting be audited?

196. Should the rule permit advisers to satisfy the audit provision by relying on an audit on an interval other than annually when an entity is liquidating? For example, should we allow advisers to rely on an audit of an entity every two years during the liquidation process? If so, should we modify the proposed rule to require investment advisers to create and distribute alternative financial reporting for the entity to investors (*e.g.*, cash-flow audit or asset verification)? Alternatively, or in addition to alternative financial reporting, should the rule require investment advisers to obtain a third-party examination of the liquidating entity? If so, what should the examination consist of, and why? For example, an independent auditor could examine a liquidating entity to confirm existence of the entity and that cash flows were appropriate.

197. Would allowing investment advisers to satisfy the audit provision by relying on an audit less frequently than annually during a liquidation raise any investor protection concerns that additional requirements could address? If so, what additional requirements, and why? For example, should advisers be required to provide notice to investors of their intent to liquidate an entity in these circumstances? Should advisers be required to obtain investor consent prior to satisfying the audit requirement by relying on audits on less than annual basis?

198. The custody rule does not define liquidation or liquidating entity for purposes of the liquidation audit requirement. Should it? If so, how? For example, should the definition be based on (1) a certain percentage of assets under management of the

entity from or over previous fiscal period(s), (2) a stated threshold based on an absolute dollar amount of the entity's assets under management, (3) a calculation of the ratio of the management fees assessed on assets under management of the entity, (4) some combination of the foregoing, or (5) some other basis?

199. Are there risks posed to investors when an entity is liquidating that the proposed rule does not address? If so, please describe those risks and how the rule should be modified to address such risks.

200. Are there some types of investments that pose a greater risk of misappropriation or loss to investors during a liquidation that the rule should specifically address to provide greater investor protection? If so, please describe (1) the investment type; (2) the particular risk poses to investors by the investment type during liquidation; and (3) how to modify the proposed rule to address such investor risk.

201. Should we define "fund of funds"? [284] If so, how should we define "fund of funds"? For example, should we define a "fund of funds" as a pooled investment vehicle that invests 10 percent or more of its total assets in other pooled investment vehicles that are not, and are not advised by, a related person of the pool, its general partner, or its adviser? [285] Are there other circumstances in which the proposed 180-day deadline might be appropriate?

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284 For example, we have described funds that invest in other funds as a "fund of funds" arrangement under rule 12d1-4 under the Investment Company Act. *See* Fund of Funds Arrangements, Release Nos. 33-10871; IC-34045 (Oct. 7, 2020) (Adopting Release).

285 We note that our staff has expressed its views of what constitutes a fund of funds for purposes of the custody rule. *See* Custody Rule FAQs, *supra* footnote 17, at Question VI.7.

202. Should we define "fund of funds of funds"? If so, how should we define "fund of funds of funds"? For example, should we define fund of funds of funds as a fund of funds that invests 10 percent or more of its total assets in one or more fund of funds that are not, and are not advised by, a related person of the fund of funds, its general partner, or its adviser.[286] Are there other circumstances in which the proposed 260-day deadline might be appropriate?

b. The Expanded Availability of Audit Provision

The current audit provision is available only to advisers to a limited partnership (or limited liability company or another type of pooled investment vehicle).[287] Historically, we have relied on financial statement audits to verify the existence of pooled investment vehicle investments.[288] Based on our experience since introducing the custody rule's audit provision, we have come to believe that audits provide substantial benefits to pooled investment vehicles and their investors because audits test assertions associated with the investment portfolio (*e.g.*, completeness, existence, rights and obligations, valuation, presentation). Audits may also provide a check against adviser misrepresentations of performance, fees, and other information about the pool. We are thus proposing to expand the availability of the audit provision from limited partnerships, limited liability companies, and other types of pooled investment vehicle

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286 We note that our staff has expressed its views of what constitutes a fund of funds of funds for purposes of the custody rule. *See* Custody Rule FAQs, *supra* footnote 17, at Question VI.8B.

287 See rule 206(4)-2(b)(4).

288 *See*, *e.g.*, rule 206(4)-2(b)(4) under the Advisers Act; *see also* 2009 Adopting Release, *supra* footnote 11.

clients to any advisory client entity whose financial statements are able to be audited in accordance with the rule.[289]

This aspect of the proposed rule would also eliminate uncertainty about the entity types for which the audit provision is currently available and extend the investor protection benefits of an audit to a larger number of investors, such as pension plans, retirement plans, college saving plans (529 plans), and Achieving a Better Life Experience savings accounts (ABLE plans or 529 A accounts).[290] Because of uncertainty about the entity types eligible to use the audit provision, we believe that some investment advisers do not use the current rule's audit provision.

We believe that financial statement audits provide additional meaningful protections to investors as compared to a surprise examination by increasing the likelihood that fraudulent activity is uncovered, thereby providing deterrence against fraudulent conduct by advisers. In a financial statement audit, the accountant performs procedures beyond those procedures performed during a surprise examination. Similar to a surprise examination, a financial statement audit involves an accountant verifying the existence of an entity's assets. A financial statement audit, however, also typically involves an accountant addressing additional important matters that are not covered by a surprise examination, such as tests of valuations of entity

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289 *See* rule 206(4)-2(b)(4). This provision does not depend upon a minimum number of investors in the entity. *See also* Custody Rule FAQs, *supra* footnote 17, at Question X.1, in which our staff expressed a similar view.

Similar to the approach under the custody rule, under the proposed rule, if the investors or participants in the legal entity client that is being audited are also clients of the adviser, the adviser would have to evaluate separately whether it has the ability or authority to effect a change in beneficial ownership of that investor's or participant's investments and comply with the proposed rule as appropriate. The financial statement audit of the legal entity whose investors or participants have invested would not satisfy the adviser's obligations under the proposed rule with respect to the investors or participants. *See infra* footnote 307.

290 The staff has previously provided its position to certain entities that requested clarity about their eligibility to comply with the current rule's exception for audited entities. *See*, *e.g.*, *Investment Company Institute*, SEC Staff No-Action Letter (Sept. 5, 2012).

investments, income, operating expenses, and, if applicable, incentive fees and allocations that accrue to the adviser. Thus, an audit includes the evaluation of amounts and disclosures within the financial statements that may be particularly significant to entity investors.

Moreover, we believe many entities other than pooled investment vehicles already undergo financial statement audits. These financial statement audits of entities may be similar in scope and offer similar investor protection benefits as an audit of a pooled investment vehicle. The proposed expansion of the availability of the audit provision, therefore, may reduce costs for these entities if they no longer must additionally undergo a surprise examination.

The account notice and custodial account statement delivery requirements are designed to help ensure the integrity of account statements and permit clients to identify any erroneous or unauthorized transactions or withdrawals by an adviser.[291] A financial statement audit regularly involves an accountant confirming bank account balances and securities holdings as of a point in time and includes the testing of transactions that have occurred throughout the year. We believe that the common types of audit evidence procedures performed by accountants during a financial statement audit – physical examination or inspection, confirmation, documentation, inquiry, recalculation, re-performance, observation, and analytical procedures – act as an important check to identify erroneous or unauthorized transactions or withdrawals by the adviser, obviating the need for the account notice and delivery requirements for entities that are not pooled investment vehicles.

We request comment on all aspects of the expanded availability of the audit provision, including the following items:

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[291] *See generally* 2003 Adopting Release, *supra* footnote 2; *see also* discussion *supra* at Section II.B and II.E.

203. Should we expand the availability of the audit provision beyond limited partnerships, limited liability companies, or other types of pooled investment vehicle to entities as proposed? If not, explain why. If we expand the availability of the audit provision, in what circumstances would this likely be utilized? Should we impose any limits on the types of entities that can make use of the audit provision? If so, what limits, and why? It is our understanding that a separate account cannot be audited. Is our understanding correct? If not, are separate accounts currently being audited, and if so, for what purpose? To the extent separate accounts can be audited, should the audit provision be available for separate account clients in addition to entities?

204. Do commenters agree that expanding the scope of entities eligible for the audit provision, as proposed, is likely to result in a greater percentage of client audits?

205. Is the term "entity" the appropriate term to use to describe the audit provision client type, or is there another term we should use? For example, an adviser may manage a separate account for a corporate institutional client that undergoes a financial statement audit for reasons unrelated to the custody rule. Although the financial statements pertain to a much broader universe of transactions than just transactions in the account or the assets the adviser manages for that client, should the adviser be able to rely on this audit to comply with the proposed rule? Would the answer depend on whether the adviser manages a non-entity sleeve of the client corporation's assets or a subsidiary entity?

206. Should the proposed rule define the term "entity"? If so, how? Would using the term "entity" reduce or eliminate any existing confusion regarding which entities may make use of the audit provision?

207. Do other entity client types currently undergo the type of audit, i.e., a full scope audit that is required under the audit provision? If so, how do the audit procedures for these entity clients differ, if at all, from the audit procedures currently performed during audits of pooled investment vehicles? If the audit procedures for these entity clients differ, do they still offer substantially similar protections to investors as the audits currently performed of pooled investment vehicles? Why or why not?

208. We understand that certain entities may undergo audits that are limited in scope, *e.g.*, an ERISA Section 103(a)(3)(C) audit. We understand that these limited scope audits restrict the testing of certain investment information where a qualified institution has certified to both the completeness and accuracy of the required information. These limited scope audits may be more cost-effective, but they also do not involve all of the procedures of a full scope audit. What audit procedures are performed during these limited scope engagements? Do these procedures offer substantially similar protection to investors as full scope audits? Why or why not? Should these limited scope audits be sufficient to satisfy the requirements of the audit exception? If so, why?

209. Given the independent public accountant's involvement to address the risks around the existence of investments and the risk of misappropriation, should the safeguarding rule require full scope—rather than limited scope—audits as proposed? Or should the rule require full scope audits only in certain circumstances or with

respect to certain entities? If so, what are those circumstances and why should the proposed rule require full scope audits in those circumstances? Would requiring full scope audits prohibit certain entities from being able to use the audit provision? If the rule allowed limited scope audits in some or all circumstances, should it impose any additional requirements on the investment adviser relying on that audit, the accountant performing that audit, or both?

c. PCAOB Inspection

As is the case with the current custody rule, the proposed rule would continue to require accountants performing audits to be registered with and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by the PCAOB in accordance with its rules. We believe that registration and periodic inspection of an independent public accountant's system of quality control by the PCAOB provides investors with some additional level of confidence in the quality of audit produced under the proposed rule. Under the PCAOB's current inspection program, we understand that the PCAOB selects audit engagements of audits performed involving U.S. public companies, other issuers, and broker-dealers, so private fund and certain other entity audit engagements would not be selected for review. Even if private fund and other entity audit engagements are not selected for review under the PCAOB's current inspection program, we believe that accounting firms registered with and subject to the PCAOB's inspection program would implement their quality control systems throughout the accounting firm related to their assurance engagements.

In light of our proposal to expand the availability of the audit provision, we understand that this requirement may limit the pool of accountants that are eligible to perform these services because only those accountants that currently conduct public company issuer audits are subject to regular inspection by the PCAOB. Many of an adviser's clients are already undergoing a

financial statement audit; therefore, the increase in demand for these services may be limited.[292] Nonetheless, the resulting competition for these services as a result of our proposed expanded availability of the audit provision may result in a limited pool of accountants eligible to provide the auditing services, which may increase costs to investment advisers and investors.

We also understand that, as part of its interim inspection program, the PCAOB inspects accountants auditing brokers and dealers, and identifies and addresses with these firms any significant issues in those audits.[293] Similar to the inspection program for issuer audits, we believe that the interim inspection program for broker-dealers provides valuable oversight of these accountants, which may result in better quality audits. Although the PCAOB may not disclose which accounting firms have been inspected under the interim inspection program for broker-dealers, we believe that the PCAOB uses a varied approach for selecting a particular audit engagement for review focused on both risk-based selections and random selections.[294] Accordingly, we would also consider an accountant's compliance with the PCAOB's interim inspection program for auditors of brokers and dealers to satisfy the requirement for regular inspection by the PCAOB under the proposed audit provision until the effective date of a

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[292] For example, more than 90 percent of the total number of hedge funds and private equity funds currently undergo a financial statement audit.

[293] *See* PCAOB Adopts Interim Inspection Program for Broker-Dealer Audits and Broker and Dealer Funding Rules (June 14, 2011) ("interim inspection program"), *available at* https://pcaobus.org/News/Releases/Pages/06142011_OpenBoardMeeting.aspx. *See also* Dodd-Frank Act Section 982.

[294] *See*, e.g., Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers, PCAOB Release No. 2022-04 (Aug. 19, 2022) at 7.

permanent program for the inspection of broker and dealer auditors that is approved by the Commission.[295]

An independent public accounting firm would not be considered to be "subject to regular inspection," however, if it is included on the list of firms that is headquartered or has an office in a foreign jurisdiction that the PCAOB has determined it is unable to inspect or investigate completely because of a position taken by one or more authorities in that jurisdiction in accordance with PCAOB Rule 6100.[296] We recognize that there may be a limited number of PCAOB-registered and inspected independent public accountants in certain foreign jurisdictions. However, we do not believe that advisers would have significant difficulty in finding an accountant that is eligible under the proposed rule in most jurisdictions because many PCAOB-registered independent public accountants who are subject to regular inspection currently have practices in various jurisdictions, which may ease concerns regarding offshore availability.

We request comment on the all aspects of the proposed requirement that accountants be registered with, and subject to inspection by, the PCAOB, including the following items:

210. Should the rule require accountants performing audits under the rule to be registered with the PCAOB as proposed? Should the rule require accountants to be subject to regular inspection by the PCAOB as proposed? Do accounting firms registered with and subject to regular inspection by the PCAOB implement their

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295 We note that our staff took a similar position and has had several years to observe the impact on the availability of accountants to perform services and the quality of services produced by these accountants. *See* Robert Van Grover Esq., Seward & Kissel LLP, SEC Staff No-Action Letter (Dec. 11, 2019) (extending the no-action position taken in prior letters until the date that a PCAOB-adopted permanent program, having been approved by the Commission, takes effect).

296 *See*, *e.g.*, Reports of Board Determinations Pursuant to Rule 6100, *available at* https://pcaobus.org/oversight/international/board-determinations-holding-foreign-companies-accountable-act-hfcaa.

quality control systems throughout the accounting firm related to their assurance engagements? Why or why not?

211. If the rule did not include these requirements, should the rule impose any additional licensing, examination, or inspection requirements on such accountants? If so, describe these additional requirements and explain why they are necessary? For example, should the rule require accountants to have a CPA license in good standing?

212. The PCAOB has specific rules governing regular and special inspections under its inspection program.[297] We understand, however, that sometimes advisers may be unsure whether a registered public accounting firm is "subject to regular inspection" by the PCAOB. Rather than require the accountant to be "subject to regular inspection," should we instead require the accountant to be a registered public accounting firm with either an issuer or broker dealer audit client (or play a substantial role in the audit of an issuer or broker dealer) as of the start of the engagement period and as of each calendar year end? If we were to take this approach, would it significantly diminish the number of accountants available to perform audits? How would this approach affect the cost of audits? Would this have any potential unintended consequences, including, for example, adversely affecting smaller public accounting firms compared to larger public accounting firms?

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297 *See* PCAOB Rule 4000 - 4003, *available at* https://pcaobus.org/about/rules-rulemaking/rules/section_4.

213. The PCAOB has explained that it will inspect at least five percent of the number of registered public accounting firms reporting that they have "played a substantial role in the preparation or furnishing of an audit report with respect to an issuer without having issued an audit report with respect to an issuer in that reporting period." [298] Should we define "subject to regular inspection" for purposes of compliance with the safeguarding rule to exclude registered public accounting firms that "played a substantial role in the preparation or furnishing of audit report with respect to an issuer without having issued an audit report with respect to an issuer in that reporting period"? If not, explain why not? If we defined "subject to regular inspection" in this way, would this significantly diminish the number of accountants available to perform audits? If so, how would this affect the cost of audits?

214. By extending the availability of the audit provision and continuing to require that the independent accountants performing audits be registered with and subject to regular inspection by the PCAOB, the proposed rule may narrow the pool of auditors who would be able to perform services under the proposed rule. Should the proposed rule instead require only PCAOB-registered public accounting firms to be used to perform certain services under the proposed rule? If so, which services and why?

215. Do commenters agree that the availability of accountants to perform services for purposes of the proposed rule is sufficient? If not, please describe how the proposed rule could provide greater availability.

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298 *See* PCAOB Rule 4003(h), *available at* https://pcaobus.org/about/rules-rulemaking/rules/section_4.

216. Do commenters agree that advisers have reasonable access to public accountants that are registered with and subject to inspection by the PCAOB in the foreign jurisdictions in which they operate? If not, how should the proposed rule address this issue?

d. Accounting Standards for Financial Statements

As is the case with the current custody rule, the proposed rule would require audited financial statements to be prepared in accordance with the generally accepted accounting principles.[299] Entities that are organized outside of the United States, or that have a general partner or other manager with a principal place of business outside of the United States, may have their financial statements prepared in accordance with accounting standards other than U.S. GAAP.[300] We would consider these financial statements to meet the requirements of the proposed rule so long as they contain information substantially similar to financial statements prepared in accordance with U.S. GAAP, material differences with U.S. GAAP are reconciled, and the reconciliation, including supplementary U.S. GAAP disclosures, is distributed to U.S. investors as part of the audited financial statements. Requiring that financial statements comply with U.S. GAAP or standards substantially similar to U.S. GAAP along with a reconciliation to U.S. GAAP in the case of foreign entities would help assure that clients receive consistent and quality financial reporting on their assets from their adviser.

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299 *See* proposed rule 223-1(b)(4)(iii).

300 This proposed provision is intended to codify our current approach. For example, we have previously allowed an adviser to a foreign pooled investment vehicle to have its financial statements prepared in accordance with International Accounting Standards or some other comprehensive body of accounting standards provided that the financial statements contain information that is substantially similar to financial statements prepared in accordance with U.S. GAAP and contains a footnote reconciling any material variations between the comprehensive body of accounting standards and U.S. GAAP. *See* 2003 Adopting Release *supra* footnote 2 at n.41.

We believe that this approach balances the needs of users of the financial statements with the cost to prepare financial statements under separate accounting standards by allowing advisers the flexibility to provide clients with financial statements that are prepared in accordance with applicable local accounting standards. We also believe a reconciliation to U.S. GAAP is necessary for entity audits because U.S. GAAP has industry specific accounting principles for certain pooled vehicles, including private funds. For example, U.S. GAAP may require measurement of trades on trade date as opposed to settlement date, presentation of a schedule of investments, and certain financial highlights that may not be required under other accounting standards. Because these differences may be material, a reconciliation to U.S. GAAP would enhance investor protection.

We request comment on all aspects of the proposed requirements for preparing financial statements in accordance with generally accepted accounting principles, including the following items:

217. Should the rule continue to require accountants to prepare audited financial statements in accordance with generally accepted accounting principles as proposed? Should the rule include any additional requirements regarding the preparation of financial statements? If so, what requirements, and why? For example, should we, as proposed, consider financial statements of non-U.S. advisers and non-U.S. entities to meet the requirements of the rule provided that they contain information substantially similar to statements prepared in accordance with U.S. GAAP, material differences with U.S. GAAP are reconciled, and the reconciliation is distributed to U.S. clients along with the financial statements? If so, should we specify what "substantially similar" means? What standards should be viewed as "substantially

similar" to U.S. GAAP, and why? Is the requirement to reconcile financial statements of entities organized under non-U.S. law or that have a general partner or other manager with a principal place of business outside the U.S. with U.S. GAAP necessary? Would this reconciliation requirement present any difficulties?

218. In light of our proposal to make the audit provision available to advisers to additional entities (e.g., pension plans, retirement plans, 529 plans, and ABLE plans), would these additional entities be able to meet the proposed accounting standards? Would they present any challenges for such entities? Should we modify this aspect of the proposal to address these additional entities? If so, how?

219. It is our understanding that the financial statement presentation required under U.S. GAAP may be different for pooled investment vehicles, e.g., private funds, compared to other entities, e.g., 529 plans. Would these presentation differences have an impact on investor's ability to understand the financial statements?

e. Distribution of Audited Financial Statements

Under the custody rule, an adviser must annually distribute its audited financial statements to all limited partners (or members or other beneficial owners) within 120 days of the end of its fiscal year and promptly upon completion of the audit in the final year of liquidation.[301] The proposed audit provision would generally retain this approach, requiring an adviser to distribute an entity's audited financial statements to current investors within 120 days, but would extend the delivery deadline to 180 days in the case of a fund of funds or 260 days in the case of a fund of funds of funds of the entity's fiscal year end.[302] The audited financial

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301 *See* rule 206(4)-2(b)(4)(i) *and* rule 206(4)-2(b)(4)(iii).

302 *See* proposed rule 223-1(b)(4)(iv).

statements would consist of the applicable financial statements (including any required reconciliation to U.S. GAAP, including supplementary U.S. GAAP disclosures), related schedules, accompanying footnotes, and the audit report. Based on our experience administering the custody rule, we believe that a 120-day time period is appropriate to allow the financial statements of an entity to be audited and to provide investors with timely information. We understand, however, that preparing audited financial statements for some arrangements, such as sub-adviser or outsourced Chief Investment Officer (OCIO) arrangements, may require reliance on third parties, which could cause an adviser to fail to meet the current 120-day timing requirements for distributing audited financial statements regardless of actions it takes to meet the requirements. We also recognize there may be times when an adviser reasonably believes that an entity's audited financial statements would be distributed within the 120-day timeframe but fails to have them distributed within that timeframe because of unforeseeable circumstances. For example, during the COVID-19 pandemic, some advisers were unable to distribute audited financial statements in the timeframes required under the custody rule due to logistical disruptions. Accordingly, the Commission would take the position that, if an adviser is unable to deliver audited financial statements in the timeframe required under the proposed safeguarding rule due to reasonably unforeseeable circumstances, this would not provide a basis for enforcement action so long as the adviser reasonably believed that the audited financial statements would be distributed by the applicable deadline.[303] We similarly believe that a 180-day time period (subject to this position and its reasonable belief standard) is appropriate in the context of a fund of funds and that a 260-day time period (subject to this position and its

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[303] *Compare* proposed rule 223-1(b)(4)(iv) *to* rule 206(4)-2(b)(4)(i). Under the proposed rule, we would still continue to require liquidation audited financial statements to be distributed "promptly."

reasonable belief standard) is appropriate in the context of a fund of funds of funds because advisers to these types of pooled investment vehicles may face practical difficulties completing their audits before the completion of audits for the underlying funds in which they invest.[304]

Under the proposed audit provision, the audited financial statements (including any reconciliation to U.S. GAAP prepared for a foreign entity, as applicable) must be sent to all of the entity's investors.[305] Further, if an investor is a pooled investment vehicle that is in a control relationship with the adviser or the adviser's related persons, the sender must look through that pool (and any pools in a control relationship with the adviser or its related persons) in order to send the audited financial statements to investors in those pools.[306]

In addition, an adviser to a pooled investment vehicle client may utilize an SPV, organized as a limited liability company, trust, partnership, corporation or other similar vehicle, to facilitate investments for legal, tax, regulatory or other similar purposes. For example, the adviser's pooled investment vehicle client may invest a portion of its capital in an SPV, which in turn purchases a single investment for the pooled investment vehicle client ("single purpose vehicle"). Similarly, an adviser to multiple pooled investment vehicle clients may utilize an SPV to purchase a single investment for multiple pooled investment vehicle clients ("multi-fund single purpose vehicle"). In another variation, an adviser to one or more pooled investment vehicle clients may utilize an SPV to purchase multiple investments for one or more pooled

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304 *See also* Custody Rule FAQs, *supra* footnote 17, at Question VI.8A and VI.8B, in which we note that our staff expressed a similar view.

305 *See* proposed rule 223-1(b)(4)(iv).

306 *See* proposed rule 223-1(c); *see supra* Section II.B.3.b.ii.

investment vehicle clients ("multi-purpose vehicle"). Similar to under the custody rule,[307] an investment adviser could either treat an SPV as a separate client, in which case the adviser will have custody of the SPV's assets, or treat the SPV's assets as assets of the pooled investment vehicles of which it has custody indirectly under the safeguarding rule. If the adviser is relying on the audit provision and treats the SPV as a separate client, the safeguarding rule would require the adviser to comply separately with the safeguarding rule's audited financial statement distribution requirements like the custody rule.[308] Accordingly, the adviser would distribute the SPV's audited financial statements to the pooled investment vehicle's beneficial owners. If, however, the adviser is relying on the audit provision and treats the SPV's assets as the pooled investment vehicle's assets of which it has custody indirectly, the SPV's assets would be required to be considered within the scope of the pooled investment vehicle's financial statement audit.[309]

An adviser would have the choice of whether to treat the SPV as a separate client or treat the SPV's assets as the pooled investment vehicle's assets of which it has custody indirectly, regardless of whether the SPV is a single purpose vehicle, multi-fund single purpose vehicle, or a multi-purpose vehicle (as applicable), provided that the SPV's assets would be considered within the scope of the financial statement audit of the pooled investment vehicle client(s) and provided that the SPV has no owners other than the adviser, the adviser's related person(s) or the pooled

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307 Advisers Act Rule 206(4)-2(c) states that sending an account statement under paragraph (a)(5) of the custody rule or distributing audited financial statements under paragraph (b)(4) of the custody rule shall not satisfy the requirements of the custody rule if such account statements or financial statements are sent solely to limited partners (or members or other beneficial owners) that themselves are limited partnerships (or limited liability companies, or another type of pooled investment vehicle) and are the adviser's related persons.

308 *See* discussion *supra* at Section II.B.3.b.ii.

309 *See also* i*d.*

investment vehicle clients that are controlled by the adviser or the adviser's related person(s). If, however, the adviser uses an SPV to purchase one or more investments for one or more pooled investment vehicle clients *and third parties that are not pooled investment vehicles controlled by the adviser or the adviser's related person(s)*, the adviser may *not* treat the SPV's assets as assets of the pooled investment vehicle clients of which the adviser or the adviser's related person(s) has custody indirectly for purposes of the safeguarding rule. The adviser would, instead, be required to treat the SPV's assets as a separate client for purposes of the safeguarding rule because the SPV has owners other than the adviser, the adviser's related person(s) or pooled investment vehicles controlled by the adviser or the adviser's related person(s). [310]

We request comment on all aspects of the proposed rule's requirements for distributing audited financial statements, including the following items:

220. Should the safeguarding rule require audited financial statements of an entity to be distributed to all the entity's investors within 120 days (or 180 days in the case of a fund of funds or 260 days in the case of a fund of funds of funds) as proposed? Would a longer or shorter period be appropriate (*e.g.,* 180 days or 90 days)? Should the rule expressly allow the statements to be distributed beyond the prescribed period of 120 (or 180 or 260) days if a reasonably unforeseeable circumstance necessitates a longer period? If so, should such a longer period have an outer limit? If so, should other conditions apply such as requiring the adviser to retain documentation supporting the reasons for the delay? Should it require advisers to notify investors of

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[310] We note that our staff previously took a similar view. *See* 2014 IM Guidance *supra* footnote 17.

the delay and, if so, what information should be included in the notice and by when should it be distributed?

221. If the adviser is unable to deliver audited financial statements in the timeframe required under the proposed safeguarding rule because of reasonably unforeseeable circumstances but the adviser reasonably believed that the audited financial statements would be distributed by the applicable deadline, the Commission would take the position that this would not provide a basis for enforcement action. Do commenters believe that this position should be incorporated into rule text? If so, why?

222. Instead of requiring distribution of the audited financial statement to investors, should we require the statement to be distributed or made available to investors upon request?

223. For entities, we understand that audited financial statements are posted to the entity's website, *e.g.,* a 529 plan's website, along with a written notification sent to accountholders of the availability of the financial statements. The entity also provides a hardcopy of the financial statements by mail within three business days upon an accountholder's request. Should we continue to allow this type of electronic delivery to meet the distribution requirement? Should we expand the availability of electronic delivery of audited financial statements? If so, how?

224. Do commenters agree that funds of funds or certain funds in master-feeder structures (including those advised by related persons) may not be able to prepare and distribute financial statements within the current rule's 120-day requirement? Subject to the qualification above that the Commission would take the position that

an inability to deliver audited financial statements in the required timeframe under certain circumstances would not provide a basis for enforcement action, do commenters agree that distribution within 180 or 260 days of the fund's fiscal year end would be appropriate? With the proposed expansion of the audit exception to entities, are there any types of entities other than fund of funds that should be permitted additional time for distribution? If so, why and what should that limit be?

225. Where an investor is a pooled investment vehicle that is in a control relationship with the adviser or the adviser's related persons, should we require the sender to look through that pool (and any pools in a control relationship with the adviser or its related persons) to satisfy the distribution requirement? If not, why not?

226. We understand that some registered fund families have organized unregistered money market funds for investment exclusively by their registered investment companies, in compliance with rule 12d1-1 under the Investment Company Act. The financial statements of the unregistered money market funds are audited, but delivered to the registered investment companies, which may be related persons of the adviser. Should there be an exception to the distribution requirements of proposed rule 223-1(c) under these circumstances?[311] Are there other similar circumstances where an exception would be appropriate? Please explain.

f. Commission Notification

The proposed rule would require an adviser to enter into, or cause the entity to enter into, a written agreement with the independent public accountant performing the audit to notify the

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311 We note that our staff has stated that it would not recommend enforcement action to the Commission under similar circumstances. *See* Custody Rule FAQs, *supra* footnote 17, at Question VI.10.

Commission (i) within one business day upon issuing an audit report to the entity that contains a modified opinion and (ii) 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.[312] These proposed requirements are drawn from the current rule's Form ADV-E filing requirement for independent public accountants performing surprise examinations.[313] The accountant making such a notification would be required to provide its contact information and indicate its reason for sending the notification. The written agreement must require the independent public accountant to notify the Commission by electronic means directed to the Division of Examinations. Timely receipt of this information would enable our staff to evaluate the need for an examination of the adviser. We expect the Division of Examinations would establish a dedicated email address to receive these confidential transmissions and would make the address available on the Commission's website in an easily retrievable location.

Although there is a requirement on Form ADV for an adviser to a private fund to report to the Commission whether it received a qualified audit opinion and to provide, and update, its auditor's identifying information, there is not a similar obligation for an accountant to notify the Commission as there is for a surprise examination under the current rule.[314] Based on our experience in receiving notifications from accountants who perform surprise examinations under the custody rule, we believe that the timely receipt of this information – from an independent

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312 *See* proposed rule 223-1(b)(4)(v).

313 *See* rule 206(4)-2(a)(4).

314 *See* rule 206(4)-2(a)(4) *compare to* rule 206(4)-2(b)(4); *see also* Form ADV Part 1A, Schedule D, Section 7.B.1, Q.23.

third party – would more readily enable our staff to identify advisers potentially engaged in harmful misconduct and who have other compliance issues. This would bolster the Commission's efforts at preventing fraudulent, deceptive, and manipulative activity and would aid oversight of investment advisers.

We request comment on all aspects these notification requirements, including the following items:

227. Should independent public accountants completing financial statement audits under the proposed rule be required to provide these proposed notifications? Would the requirement for an accountant to comply with the notification requirement change the approach that an accountant would take regarding audits that normally are performed for purposes of satisfying the custody rule? If so, how?

228. Are there any privacy concerns or contractual obligations that could prohibit or restrict an accountant from providing this information? If so, what?

229. The regulations in 17 CFR 240.17a-5 (rule 17a-5) require a broker or dealer to self-report to the Commission within one business day and to provide a copy to the accountant. The accountant must report to the Commission about any aspects of the broker's or dealer's report with which the accountant does not agree. If the broker or dealer fails to self-report, the accountant must report to the Commission to describe any material weaknesses or any instances of non-compliance that triggered the notification requirement. Should the audit provision under the proposed rule contain a notification requirement similar to rule 17a-5? Why or why not?

230. The regulations in 17 CFR 240.17a-5 (rule 17a-5) also require a broker-dealer, pursuant to a statement filed with the Commission, to allow access to the audit

documentation associated with the reports of the independent public accountant and to allow the independent public accountant to discuss the findings associated with the reports with representatives of the Commission. Should the rule include a similar provision? Specifically, should the rule require that an investment adviser, pursuant to a written agreement between the adviser and the accountant, allow access to the audit or examination documentation associated with the reports of the independent public accountant, by representatives of the Commission, if requested in writing for purposes of an examination of the adviser? Should the rule require the investment adviser, pursuant to a written agreement between the adviser and the accountant, to require the independent public accountant to discuss with representatives of the Commission, if requested in writing for purposes of an examination of the adviser, the findings associated with the reports of the independent public accountant?

231. Should the accountant instead be required to file Form ADV-E in a similar manner as independent public accountants who complete surprise examinations? If so, what types of information should be included on Form ADV-E with respect to financial statement audits? Should a copy of the audit report or a copy of the audited financial statements be filed with the Commission? If so, would there be issues with making copies of these reports publicly available, particularly since the adviser typically is not a party to the audit engagement agreement between the audited entity and the independent public accountant?

232. Is one business day the appropriate timeframe for notification upon an accountant issuing a modified opinion? Should we use a different timeframe, such as promptly? Why or why not?

233. Is four business days the appropriate timeframe for notification after an accountant's resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed? Should we use a different timeframe? Why or why not?

234. Should the independent public accountants completing financial statement audits under the proposed rule be required to provide these proposed notifications of resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed? Are there any instances of resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed that should not be reported? If so, why? Should we also amend the instructions to Form ADV-E in a similar way?

2. Discretionary Authority

The proposed rule would contain an exception from the surprise examination requirement for client assets if the adviser's sole basis for having custody is discretionary authority with respect to those assets, provided this exception applies only for client assets that are maintained with a qualified custodian in accordance with the proposed rule and for accounts where the adviser's discretionary authority is limited to instructing its client's qualified custodian to

transact in assets that settle exclusively on a DVP basis.[315] In DVP transactions, clients' custodians are generally under instructions to transfer assets out of a client's account only upon corresponding transfer of assets into the account.

When a custodian is under instructions to transfer assets out of a client's account only upon corresponding transfer of assets into the account, there is a reduced risk that the adviser could misappropriate the assets, and when the transaction settles on a DVP basis there is a reduced risk of theft of the asset because, on a non-DVP basis, the seller of an asset could deliver the asset but not receive payment or the buyer of an asset could make payment but not receive delivery of the asset.[316] We believe this exception will focus the requirement to obtain a surprise examination where the risk of misappropriation is greatest. As an example, if the custodian's instructions from the client authorize the adviser to wire cash from the client's account in exchange for an equivalent amount of XYZ stock that is to be received into the client's account, the adviser need not undergo a surprise examination. If, however, the custodian's instructions from the client authorize the adviser to wire cash from the client's account without receipt of a corresponding asset, the adviser would need to undergo a surprise examination.

We propose to limit this exception to instances where this is the adviser's *sole* basis for custody. Accordingly, if an adviser also has custody of the client's assets for additional reasons,

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315 Proposed rule 223-1(b)(8).

316 We note that the staff has acknowledged that limiting the adviser's authority to transactions that settle via DVP at a qualified custodian is one way for an adviser to avoid inadvertent custody. The staff's statement noted that an adviser could draft a letter (or other form of document) addressed to the custodian that limits the adviser's authority to "delivery versus payment," notwithstanding the wording of the custodial agreement, and have the client and custodian provide written consent to acknowledge the new arrangement. *See* 2017 IM Guidance, *supra* footnote 135.

such as via a power of attorney that confers one-way transfer authority, the adviser cannot rely on the exception. Conversely, if an adviser also has custody of the client's assets for reasons that are also subject to similar exceptions (*e.g.*, sole basis is fee deduction, sole basis is related person custody),[317] the adviser can rely on the exception. These exceptions from the surprise examination requirement are not mutually exclusive of one another notwithstanding our use of "solely" in each of them.[318]

We request comment on all aspects of the proposed exception for discretionary authority, including the following items.

235. Should we provide an exception from the requirement to obtain an independent verification of client assets if an adviser's sole basis for custody is having discretionary authority with respect to client assets that are maintained with a qualified custodian in accordance with the rule? Does providing such an exception from asset verification in these limited circumstances produce additional risks for client assets?

236. Are we correct in our assessment that this proposed exception would better balance the costs and protections of the proposed rule?

237. Should we limit the exception to situations in which the qualified custodian implements certain policies and procedures? If so, what should they include? For example, would a qualified custodian need to demonstrate that it has certain systems,

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317 *See* Rule 206(4)-2(b)(3) and (6) and proposed rule 223-1(b)(6).

318 *See* proposed rule 223-1(b)(9).

confirmations, or authorizations in place to ensure that an adviser is unable to initiate any one-way transactions and that the adviser's authority is limited to only trading?

238. Should we limit the exception to situations in which the adviser implements certain policies and procedures with regard to discretionary authority? If so, what should those policies and procedures be? If we were to rely more heavily on the adviser's policies and procedures, should we require external testing or auditing of those policies and procedures or internal controls? For example, should we require an internal control report with similar control objectives to the internal control reports we require under the custody rule or what we would require under the safeguarding rule?

239. Do commenters agree with our assessment of the risks to client assets as a result of discretionary authority in qualified custodian accounts? Do commenters agree with our assumption that a one-way transfer of assets from an account at a qualified custodian is a riskier form of discretionary authority than DVP transactions? Are there circumstances in a discretionary trading environment at a qualified custodian where risks of misappropriation or theft in an account are not mitigated by DVP settlement or requiring a one-for-one exchange of assets? If so, please provide such examples.

240. If an adviser's authority over an account with a qualified custodian includes the ability to transfer assets free of payment to another account with the same account title, should such an account still be eligible for the limited exception to the surprise examination?

241. Should this exception apply "solely" when the basis for custody is discretionary authority? Should we allow use of the exception when the adviser also qualifies for another exception that is similarly premised on an adviser "solely" having custody for a specifically identified reason, such as when an adviser has custody of client assets "solely" as a consequence of its authority to make withdrawals from client accounts to pay its advisory fee, or "solely" because a related person has custody of them in connection with the adviser's advisory services? Notwithstanding the use of "solely" in certain exceptions from the surprise examination requirement, these limited exceptions are not mutually exclusive; should they be?[319]

3. Standing Letters of Authorization

The proposed rule also contains an exception from the surprise examination requirement for client assets if the adviser has custody of those assets solely because of a standing letter of authorization ("SLOA").[320] The rule would define SLOA as an arrangement among the adviser, the client, and the client's qualified custodian in which the adviser is authorized, in writing, to direct the qualified custodian to transfer assets to a third-party recipient on a specified schedule or from time to time. In such an arrangement the client's qualified custodian could not be an adviser's related person.[321] Such an authorization must include the client's signature, the third party recipient's name, and either the third party's address or the third party's account number at

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319 *See* rule 206(4)-2(b)(3) and (6); proposed rule 223-1(b)(3) and (6).

320 Proposed rule 223-1(b)(7).

321 The term "related person" would have the same meaning as in the current rule.

a custodian to which the transfer should be directed. The authorization must also provide that the investment adviser has no ability or authority to designate or change any information about the recipient, including name, address, and account number.[322]

Clients increasingly grant their advisers limited powers to disburse assets from their accounts to one or more specifically designated third parties in a manner that limits the adviser's ability to redirect the assets. For example, a client may grant its adviser this authority pursuant to a one-time or standing letter of instruction or other similar asset transfer authorization arrangement that the client establishes with qualified custodians. In granting such authority the client may authorize the adviser to perform transfers or disbursements via automated clearing house (*i.e.*, ACH) transfers, wires, checks, or other methods. Such authorizations can be for one-time wires out of the account or standing authorization where an adviser is given ongoing authority by the client to execute certain asset movements into and out of a client's account.

The written instruction and authorization could be provided to the adviser on the same form the client delivers to its qualified custodian, or it could be provided separately, but it must be delivered to both parties. The required signature would ensure that the instructions and authorizations are verifiably from the client. We believe the types of financial institutions identified as meeting the proposed definition of qualified custodian are required by their primary functional regulator or otherwise to perform procedures to verify the instruction and authorization, through a signature review and, if determined to be necessary, based on the facts and circumstances, another method of verification. The required information could help ensure that the instructions to the qualified custodian provide relevant information about the recipient.

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322 Proposed rule 223-1(d)(12).

These instructions could include a specified schedule for transfers, or they could include a more general instruction for the adviser to direct transfers to the recipient from time to time.

Where the arrangement is structured so that the adviser's role is limited to determining the timing and amounts when disbursing a client's assets, we believe that the adviser's role in effecting any change in beneficial ownership is circumscribed and ministerial, and there is little risk to clients of loss, misuse, misappropriation, or theft of its asset.[323] We also believe under such circumstances that a qualified custodian would be best positioned to ensure that the required authorizations and instructions are properly and verifiably issued by the client (*e.g.*, the client's signature is verifiable), provided the custodian is not a related person of the adviser to reduce the incentive and opportunity to collude in such an arrangement.[324] Under these circumstances, we believe that the proposed rule's independent verification requirement would not be meaningfully additive to protect a client's assets.[325]

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323 We note that the staff has taken a similar position. *See* Investment Adviser Association, SEC Staff No-Action Letter (Feb. 21, 2017) (indicating the staff would not recommend enforcement action to the Commission if advisers exercise limited authority pursuant to a SLOA without undergoing an annual surprise examination, if the SLOA arrangement meets certain specified conditions).

324 Each of the types of financial institutions identified in the proposed rule as meeting the definition of qualified custodian is subject to anti-money laundering and know your customer requirements that require the financial institution to verify signatures. *See*, *e.g.*, 12 C.F.R. 21.21 (requiring every national bank and savings association to have a written, board approved program that is reasonably designed to assure and monitor compliance with the Bank Secrecy Act); FINRA Rule 3310 (setting forth the minimum standards for broker-dealer firm's written anti-money laundering compliance programs); FINRA Rule 2090 (requiring broker-dealers to use reasonable diligence, in regard to the opening and maintenance of customer accounts, to know (and retain) essential facts concerning its customers and concerning the authority of each person acting on behalf of such customers); *see also* Federal Financial Institutions Examination Council Bank Secrecy Act/Anti-Money Laundering Examination Manual, available at https://bsaaml.ffiec.gov/manual database of BSA/AML policies and procedures.

325 An adviser would be required to report to the Commission on Form ADV if it is relying on this exception. *See* proposed Form ADV amendment to Item 9 (Safeguarding). In addition, we are proposing corresponding amendments to the books and records rule. Proposed rule 204-2(b)(2) would require advisers to retain true, accurate, and current copies of, and records relating to, any SLOA issued by a client to the adviser. Proposed rule 204-2(b)(2)(vi).

Finally, as noted above, this exception is not mutually exclusive of similar limited exceptions within the proposed rule, notwithstanding our use of "solely" in each of them. It would not, however, be available if the adviser has custody for another reason outside of the ones that would qualify the adviser for an exception as a sole basis for custody. In our view, the approach outlined above clarifies that the initiation of SLOAs means that advisers have custody under the rule, but also recognizes the lower risks to client assets associated with these arrangements. We request comment on all aspects of the proposed rule's SLOA exception, including the following items.

242. Do commenters agree that an adviser should be exempt from the independent verification requirements if it has custody solely because of an SLOA where the client grants its adviser the limited power for disbursements to third parties specifically designated by the client and the adviser can comply with the conditions of the proposed exception? Are there other protections we should require? If so, what protections?

243. Should this exception be available when the client's assets are not maintained with a qualified custodian? Does a qualified custodian better protect client assets subject to limited powers of attorney (such as by performing signature verification procedures under anti-money laundering and know-your-customer requirements that require the financial institution to verify signatures)?

244. Should this exception be unavailable when the client's assets are at a related qualified custodian, as proposed? If not, what specific conditions would safeguard client assets from the risks of loss, theft, misuse, or misappropriation in these circumstances?

245. Would an adviser's authority be appropriately limited (and therefore circumscribed and ministerial) if the client's instructions include the name and either the address or the account number of the recipient to whom a transfer of investments should be directed? Should the instructions and authorization include different, or additional, information, and if so, what?

246. Are qualified custodians required to verify SLOAs, or other limited power of attorney, instructions under their governing regulations, such as a signature review or other method? If not, should we require the adviser to confirm or contract with the qualified custodian so that it takes these steps?

247. Would it be appropriate to permit another party, such as an introducing broker, to perform these steps for the qualified custodian? Is this sometimes necessary, such as in the context of signature verification, if the introducing broker has a relationship with the client while a clearing broker serves as qualified custodian? If yes, under what conditions? For instance, should the person performing the steps be regulated for this activity? Should the person be prohibited from performing these steps if it is a related person of the adviser?

248. Are qualified custodians required under their governing regulations to provide a transfer of funds notice to the client promptly after each transfer under a power of attorney and/or send the client, in writing, an initial notice confirming the instruction and an annual notice reconfirming the instruction? If not, should we require the qualified custodian take these steps as part of this proposed exception? Alternatively, should we require the adviser to include a provision requiring such notice in its written agreement with the qualified custodian?

249. Do commenters agree that, in order to rely on this proposed exception, the investment adviser must have no authority or ability to designate or change the identity of the third party, the address, or any other information about the third party contained in the client's instruction, as proposed? Are there other safeguards that an investment adviser should comply with in order to rely on this proposed exception?

250. Are clients that issue limited powers of attorney able to terminate or change the instruction to their qualified custodians? If not, should we require that the client have this ability as part of this proposed exception?

251. Are there some types of limited powers of attorney for which an adviser cannot satisfy the proposed conditions, where we should nevertheless permit an adviser to rely on this proposed exception? In those cases, is the adviser's role in effecting any change in beneficial ownership of a client's assets similarly circumscribed by the client and ministerial in nature? If so, what are they?

252. Could online bill pay be integrated into the proposed framework for the standing letters of authorization exception or another exception? Would there be the difficulties in crafting an exception for bill pay that offered similar protections to those we describe above?

253. Given the general irreversibility of crypto asset transactions in the event of erroneous or fraudulent transactions, should this proposed exception be unavailable for crypto assets?

H. Amendments to the Investment Adviser Recordkeeping Rule

We are proposing to amend rule 204-2 to set forth requirements for making and keeping books and records related to the requirements of the proposed custody rule. The proposed

amendments to rule 204-2 are designed to work in concert with the proposed rule to help ensure that a complete custodial record with respect to client assets is maintained and preserved.

The proposed changes to the recordkeeping rule would help facilitate the Commission's inspection and enforcement capabilities, including assessing compliance with the requirements of the proposed rule. Reviewing client account activity and holdings is a routine part of most adviser examinations conducted by Commission staff. Currently, however, Commission staff experience challenges in requesting, receiving, and reconciling complete and accurate client-level information from some investment advisers due to a lack of recordkeeping and coordination between advisers and custodians. The proposed recordkeeping amendments are designed to help reduce these challenges by making it easier for examiners to obtain and review more complete and accurate advisory client account records. We believe having more complete records would facilitate client account reconciliation of all debits and credits to and from client accounts. This would benefit investors directly by virtue of enhanced detection and deterrence of possible misappropriation or fraud. More complete records also would better enable examiners to identify and detect potential investment adviser misappropriation or loss or misuse of client assets during their examinations, resulting in more effective investor protections.

The proposed amendments to rule 204-2 would require an investment adviser that has custody of client assets to make and keep true, accurate, and current records of required client notifications and independent public accountant engagements under proposed rule 223-1, as well as books and records related to specific types of client account information, custodian information, transaction and position information, and standing letters of authorization.[326] The

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[326] Advisers would be required to maintain the proposed records for a period of not less than five years as required under the current books and recordkeeping rule. *See* rule 204-2(e)(1).

proposed amendments would require a more detailed and broader scope of records of trade and transaction activity and position information for each client account than the existing requirements for such records.[327] The proposed amendments also would add new recordkeeping requirements that include: (i) retaining copies of required client notices;[328] (ii) creating and retaining records documenting client account identifying information, including copies of all account opening records and whether the adviser has discretionary authority;[329] (iii) creating and retaining records of custodian identifying information, including copies of required qualified custodian agreements, copies of all records received from the qualified custodian relating to client assets, a record of required reasonable assurances that the adviser obtains from the qualified custodian, and if applicable, a copy of the adviser's written reasonable determination that ownership of certain specified client assets cannot be recorded and maintained (book-entry, digital, or otherwise) in a manner in which a qualified custodian can maintain possession or control of such assets;[330] (iv) creating and retaining a record that indicates the basis of the adviser's custody of client assets;[331] (v) retaining copies of all account statements;[332] and (vi)

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327 *Compare* rules 204-2(b)(1) through (4) *with* proposed rule 204-2(b)(2)(v). Advisers would continue to be required to make and keep a record describing the basis upon which the adviser has determined that the presumption that any related person is not operationally independent has been overcome, as required under current rule 204-2(b)(5). This requirement would be renumbered in the proposed rule with an updated cross-reference to the definition of "operationally independent" in proposed rule 223-1(d)(7).

328 Proposed rule 204-2(b)(1).

329 Proposed rule 204-2(b)(2)(i). Given this proposed client account recordkeeping requirement, we would eliminate the current requirement under rule 204-2(a)(8) to keep a list or other record of all client accounts for which the investment adviser has any discretionary power.

330 Proposed rule 204-2(b)(2)(ii).

331 Proposed rule 204-2(b)(2)(iii).

332 Proposed rule 204-2(b)(2)(iv).

retaining copies of any standing letters of authorization.[333] Lastly, the proposed amendments would add new recordkeeping requirements to address independent public accountant engagements.[334] We believe that all of these requirements would enhance the Commission's oversight of the safeguarding practices of advisers and their compliance with the rule, which would, in turn, promote investor protection.

1. Client Communications

The proposed amendments also would require an adviser to maintain a copy of all written notices to clients required under the proposed rule and any responses thereto.[335] Specifically, this would include notifications provided by the adviser to each client upon opening accounts at qualified custodians on the client's behalf, along with notices in writing of any subsequent changes in the qualified custodian's name, address, and account number, and the manner in which the client's assets are maintained.[336] Again, we believe these requirements will enable our staff to confirm that an adviser is complying with providing appropriate client communications requirements under proposed rule 223-1.

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333 Proposed rule 204-2(b)(2)(vi).

334 Proposed rule 204-2(b)(3). Given that the proposed independent public accountant recordkeeping requirements would include a requirement to retain copies of internal control reports under proposed rule 223-1, we would eliminate the current requirement under rule 204-2(a)(17)(iii) to keep a copy of any internal control report obtained or received pursuant to rule 206(4)-2(a)(6)(ii). *See* proposed rule 204-2(b)(3)(ii).

335 *See* proposed rule 204-2(b)(1).

336 *See* proposed rule 223-1(a)(2).

2. Client Accounts

Additionally, the proposed amendments would require an adviser to maintain six categories of records[337] with respect to each client account for which the adviser has custody of client assets: (1) client account identification;[338] (2) custodian identification;[339] (3) the basis for the adviser having custody of client assets in the account, and whether a related person holds the adviser's client assets; (4) any account statements received or sent by the adviser, including those delivered by the qualified custodian; (5) transaction and position information; and (6) standing letters of authorization.

Included among the proposed advisory account identification records an adviser would be required to maintain is a record indicating whether the adviser has discretionary authority with respect to any client assets in the account.[340] This requirement would inform whether the independent verification exception applies in the specific circumstance of the adviser having custody of client assets solely because the adviser has discretionary authority with respect to

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337 *See generally* proposed rule 204-2(b)(2) for these six categories of records.

338 For each client account, the adviser would maintain: the advisory account name; client contact information (including name, mailing address, phone number, email address); advisory account number; client type (as identified in Item 5.D. of Form ADV); or any other identifying information used by the investment adviser to identify the account. Further, the provision would require that the record identify the inception date for the advisory account, whether the investment adviser has discretionary authority with respect to any client assets in the account, whether the investment adviser has authority to deduct advisory fees from the account, and, if applicable, the termination date of the account, asset disposition upon termination, and the reason for the termination.

339 For each client account, the adviser would maintain a record that identifies and matches, for each client of which the adviser has custody of client assets, the account name and account number, or any other identifying information, from any person or entity, including any qualified custodian, that maintains client assets to the corresponding advisory account record for each client required by rule 204-2(b)(2)(i). To the extent applicable, the record must contain a copy of the required written agreement with each qualified custodian under proposed rule 223-1(a)(2)(i), including any amendments thereto. The record must also reflect the basis for the reasonable assurances that the investment adviser obtains from the qualified custodian under proposed rule 223-1(a)(1)(ii).

340 *See* proposed rule 204-2(b)(2)(i).

those assets.[341] This requirement also would subsume and replace the requirement in the current recordkeeping rule to make and keep a list or other record of all client accounts for which the adviser has any discretionary power.[342] The proposed advisory account identification records also would require the adviser to maintain a record indicating whether the adviser has authority to deduct advisory fees from the account.[343] This requirement would inform whether the independent verification exception applies in the specific circumstance of the adviser having custody of client assets solely as a consequence of the adviser's authority to make withdrawals from the account to pay its advisory fee, and the qualified custodian being an operationally independent related person.[344]

Included among the custodian identification information an adviser would be required to maintain are copies of each contract with a qualified custodian and copies of all records received from the qualified custodian thereunder relating to client assets, if applicable, and a record that indicates the basis for the reasonable assurances the adviser obtains from the qualified custodian under proposed rule 223-1(a)(1).[345] These aspects of the client account recordkeeping requirements generally are designed to specify that advisers must maintain such records whenever client assets are maintained by a qualified custodian. These records also would be necessary for the adviser to help demonstrate its compliance with the requisite set of qualified custodian contractual provisions and reasonable assurances it must obtain from qualified custodians in proposed rule 223-1(a)(1). It would also help the adviser to identify and match the

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341 *See* proposed rule 223-1(b)(8).

342 *See* rule 204-(2)(a)(8).

343 *See* proposed rule 204-2(b)(2)(i).

344 *See* proposed rule 223-1(b)(3).

345 *See* proposed rule 204-2(b)(2)(ii).

client custodial account to the corresponding advisory account record as discussed above. If applicable, the custodian identification information would require the adviser to maintain a copy of its written reasonable determination that ownership of certain specified client assets cannot be recorded and maintained in a manner in which a qualified custodian can maintain possession or control of such assets. This recordkeeping obligation would be required if the adviser wants to rely on the exception for privately offered securities and physical assets to be held at a qualified custodian. It also would help our examination staff to verify the reasonableness of the adviser's determination and enable both internal advisory personnel and our examination staff to readily identify the specified client assets that are at risk of loss or misappropriation.

The proposed recordkeeping rule would also require the adviser to document the basis for the adviser's custody of client assets, including whether a related person holds the adviser's client assets or has any authority to obtain possession of them in connection with the adviser's advisory services.[346] This information would be essential for internal advisory personnel and for our examination staff to be able to readily identify the client assets that are at risk of loss or misappropriation. It also would provide additional explanation in the client account record to complement the custodial information discussed above.

3. Account Activity

In addition to client account identification requirements, the proposed amendments include corollary books and records requirements relating to client account activity that address account statements, transaction and position information, and standing letters of authorization. In order to demonstrate compliance with the account statement aspects of the rule, the proposed

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[346] *See* proposed rule 204-2(b)(2)(iii).

amendments would require an investment adviser to maintain copies of any account statement delivered by the qualified custodian to the client and to the adviser under proposed rule. The adviser also would be required to maintain copies of any account statement it delivers to the client, including copies of any account statement it delivers to the client containing the required notification under proposed rule 223-1(a)(2).[347] If the client is a pooled investment vehicle, we would require that the record reflect the delivery of account statements, notices, or financial statements, as applicable, to all investors in such client pursuant to proposed rule 223-1(c).[348]

Regarding transaction and position information in client accounts, we are proposing several modifications that would clarify certain obligations of the current recordkeeping rule's requirements.[349] First, we are proposing modifications to the current recordkeeping rule's requirement that the adviser maintain records related to a client's position in each security.[350] The proposed amendments would replace the current rule's references to "security" or "securities" with "asset" or "assets" to align this requirement with the broader scope of proposed rule 223-1.

Second, we would modify the current recordkeeping requirement for advisers to make and keep records of debits and credits in client accounts, including all purchases, sales, receipts, and deliveries of securities for such accounts.[351] Specifically, we propose to require that in

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347 *See* proposed rule 223-1(a)(2). If the adviser sends account statements to a client to which the adviser is required to provide the account opening notice under this section, the adviser must include in that notice and in any subsequent account statement it sends to such client, a statement urging the client to compare the account statements from the custodian with those from the adviser.

348 *See supra* section II.B.3.b.ii, for discussion of proposed rule 223-1(c).

349 *Compare* rules 204-2(b)(1) through (4) *with* proposed rule 204-2(b)(2)(v).

350 *See* rule 204-2(b)(4).

351 *Compare* rules 204-2(b)(1) and (2) *with* proposed rule 204-2(b)(2)(v)(A).

addition to trade activity, as required by rule 204-2, the records should reflect other *transaction* activity in client accounts, which we would interpret more broadly to include all debits and credits to or from the account, including deposits, transfers, and withdrawals as well as cash flows, corporate action activity, maturities, expirations, expenses, and income posted. The adviser's records also would be required to include the date and price or amount of any purchases, sales, receipts, deliveries, including any one-way delivery of assets, and free receipt and delivery of securities and certificate numbers, deposits, transfers, withdrawals, cash flows, corporate action activity, maturities, expirations, expenses, income posted to the account, and all other debits and credits. Although we are not prescribing the particular form in which the records must be kept, we would view as acceptable keeping the records on a trade blotter, customer account ledger, or accounting records maintained by the adviser. We believe that these modifications would help ensure that an adviser maintains sufficient information regarding client account activity when an adviser has custody of client assets, and would enhance the ability of our examination staff to verify the proper handling of client assets by the adviser and compliance with the proposed rule and other applicable provisions of the Federal securities laws.

We also would modify the current recordkeeping rule's requirement that advisers keep copies of confirmations of all transactions effected by or for the client in the client account.[352] The proposed amendments would expressly provide for trade confirmations that show the date and price of each trade as well as any instruction received by the adviser concerning transacting in the assets.[353] We believe these modifications are necessary because our staff has periodically

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352 *Compare* rule 204-2(b)(3) with proposed rule 204-2(b)(2)(v)(B).

353 As under the current rule, advisers would be required to retain information about all orders placed (whether executed or not). *See* rule 204-2(a)(3).

received questions as to what is required under the current rule and, particularly, whether the current rule requires only that the adviser maintain a record of trade tickets rather than counterparty confirmations.

4. Independent Public Accountant Engagements

The proposed amendments also would require advisers to retain copies of documents relating to independent account engagements.[354] Specifically, these documents include: (1) all audited financial statements prepared under the safeguarding rule;[355] (2) a copy of each internal control report received by the investment adviser;[356] and (3) a copy of any written agreement between the independent public accountant and the adviser or the client, as applicable, required under proposed rule 223-1.

With respect to all three aspects of the proposed amendments for independent public accountant engagements, we believe that maintaining these records would give our staff critical access to the findings of the independent public accountant(s) that perform procedures to verify the existence of client assets not maintained with a qualified custodian and/or the accuracy of an adviser's transactions in client assets using enhanced authority.

5. Standing Letters of Authorization

Finally, we propose to add a requirement for advisers to keep copies of, and records relating to, any standing letter of authorization issued by a client to the investment adviser.[357] These records generally should include the name and either the address or the account number of

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354 Proposed rule 204-2(b)(3).

355 Proposed rule 204-2(b)(4).

356 This requirement would subsume and replace the current recordkeeping requirement to retain a copy of any internal control report obtained or received under the current custody rule. *See* rule 204-2(a)(17)(iii).

357 *See* proposed rule 204-2(b)(vi).

each recipient to whom a transfer of client assets may be directed, along with any instructions the adviser has provided to the client's qualified custodian to transfer client's assets to that recipient. We believe that this requirement would enhance the ability of our examinations staff to verify client-authorized transfers of assets to designated recipients. This requirement also would be critical for our examination staff and internal compliance personnel to demonstrate that the adviser is appropriately safeguarding a client's assets while relying on the proposed SLOA exception from the independent verification requirements in the proposed rule.[358]

We request comment on all aspects of the proposed books and recordkeeping amendments, including the following items.

254. Should we amend rule 204-2 as proposed? Are there any other records that an adviser should be required to maintain? If so, what are they, and why?

255. Are there alternatives to the proposed amendments to rule 204-2 that would minimize recordkeeping burdens and the associated costs, while promoting the goals of facilitating the inspection and enforcement capabilities of the Commission and its staff? If so, what are they, and why?

256. Should we require advisers to maintain the proposed records in electronic, text-searchable, machine-readable, and/or structured format?

257. Should we eliminate the requirement to maintain responses to any written client communications required under proposed rule 223-1? If so, why?

258. The proposed rule would require an adviser to make and keep records that identify client accounts for which the adviser has discretionary authority. As a

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[358] Proposed rule 223-1(b)(7).

result, we are proposing to eliminate the current rule's requirement to keep a list or other record of all client accounts for which the investment adviser has any discretionary power under 204-2(a)(8) as it is no longer necessary. Do commenters agree?

259. Is the proposed requirement sufficiently clear regarding account activity in a client's account? Should we require advisers to include additional information about transactions effected in a client account in their records? If so, please explain what additional information the rule should require and why it should be required. If the proposed requirement should require less information about account activity in a client account, please identify the information that should not be required and why.

260. Would advisers find the proposed modifications to the current recordkeeping rule's requirements regarding transaction and position information helpful for account reconciliation purposes?

261. The proposed rule would require an adviser to maintain the proposed records for the same period as required under the current books and recordkeeping rule (*i.e.*, 5 years). Should advisers be required to maintain these records for a shorter or longer period? If so, what time period, and why?

262. As proposed in amended rule 204-2, advisers that rely on the audited financial statements exception in the safeguarding rule for a pooled investment vehicle or any other entity would be required to maintain copies of such audited financial statements. Should we also require such advisers to maintain records verifying the delivery and distribution of such audited financial statements to investors in the entity (or their independent representatives)?

I. Changes to Form ADV

We are proposing to amend Part 1A, Schedule D, and the Instructions and Glossary of Form ADV.[359] The amendments are designed to help advisers identify when they may have custody of client assets, to provide the Commission with information related to advisers' practices to safeguard client assets, and to provide the Commission with additional data to improve our ability to identify compliance risks. Because Form ADV is publicly available, these amendments may also provide clients or investors additional protection because they will be better able to discern the reasons why a particular adviser has custody. Further, these amendments may offer ancillary market benefits to the extent that market participants are better able to analyze the Form ADV data to assess fraud risk. The proposed amendments would continue to collect much of the information currently reported by advisers in Item 9 of Form ADV Part 1A and the corresponding sections of Schedule D, along with new information that corresponds with certain aspects of the proposed rule.[360] These proposed revisions would also streamline the collection of this information by reorganizing Item 9 and refining certain reporting requirements to eliminate confusion and prevent inaccurate or incomplete reporting.[361]

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359 This section discusses the Commission's proposed rule and form amendments that would affect advisers registered with the Commission. We understand that the state securities authorities intend to consider similar changes that affect advisers registered with the states, who are also required to complete Form ADV Part 1A as part of their state registrations. We will accept any comments and forward them to the North American Securities Administrators Association ("NASAA") for consideration by the state securities authorities. We request that you clearly indicate in your comment letter which of your comments relate to these items.

360 Because Form ADV, Part 1A—including the current Item 9—is submitted in a structured, XML-based data language specific to that Form, the information in the amended Item 9 would continue to be structured (i.e., machine readable) as well. That is, the Commission is not proposing to change the structured data language used for Item 9.

361 *See* proposed Form ADV, Part 1A, Item 9. The following definitions from the proposed rule would be added to Form ADV: Assets (for purposes of Item 9 and related sections of Schedule D), Operationally Independent (for purposes of Item 9 and related sections of Schedule D), Qualified Custodian, and Standing

Item 9 currently requires an adviser to report whether it or a related person has custody of any advisory client's cash or bank accounts or securities, along with certain additional information if an adviser reports having custody. Nonetheless, an adviser is not required to report having custody if it has custody solely because it deducts advisory fees or because a related person has custody but an adviser has overcome the presumption that it is not operationally independent. The adviser may, however, still be required to complete other sections of Item 9. In the Commission's experience, advisers often are confused by these requirements, because they may have custody under the rule but are instructed to report *not* having custody for purposes of completing Item 9.A.(1) of Form ADV. This can result in inaccurate or incomplete reporting, which in turn, could limit our staff's ability to effectively analyze this important Form ADV data. Further, not being required to report having custody on Form ADV when an adviser in fact has custody under the rule may result in adviser's erroneously believing that it is not subject to the custody rule. The proposed amendments to Form ADV are designed to eliminate this confusion, improve the information available to the Commission and the public about how advisers safeguard clients' assets, and promote greater compliance with the proposed safeguarding rule.

First, consistent with the proposed rule, we are proposing to capture information in Item 9 about an adviser's custody of its "client assets" including a client's funds, securities, and other

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Letter of Authorization. Additionally, the definition of Discretionary Authority or Discretionary Basis would be expanded to include Discretionary Trading Authority. *See* proposed Form ADV, Part 1A, Glossary and Item 9.C, D, E, and F, which currently collect information about an adviser's methods of compliance with rule 206(4)-2, whether a related-party acts as a qualified custodian, whether the adviser was subject to a surprise examination, and the number of qualified custodians, respectively, would be deleted or revised in the proposed Item 9 to reflect the proposed changes to the rule and to collect similar information more effectively.

positions held in a client's account. We are proposing to revise the introductory language, replace references to funds and securities in Item 9 with the term assets (as defined in the proposed rule), and add a new sub-item to allow advisers to indicate their reliance on certain exceptions in the proposed rule.[362] These revisions are designed to align Form ADV with the proposed rule.

Next, we are also proposing to revise Item 9.A.(1) to require advisers to indicate, in a single place, if they directly, or indirectly through a related person, have custody of client assets, including if custody is solely due to an adviser's ability to deduct fees from client accounts or because the adviser has discretionary authority.[363] Form ADV, Part 1A currently distinguishes reporting among advisers having direct custody, advisers subject to the current rule because a related person has custody, and advisers having custody of client funds or securities solely because of the ability to deduct advisory fees from client accounts. Further, as noted above, in certain circumstances advisers are currently instructed not to report having custody in Item 9.A.(1), despite having custody (*i.e.*, when the basis for custody is an adviser's ability to deduct advisory fees or through an operationally independent related person). While these distinctions are important for evaluating compliance risks, the current structure of Item 9 makes it difficult to easily analyze this data. For example, under the current structure of Item 9, we cannot easily identify the total number of clients or the total amount of assets over which an adviser has custody. The proposed revisions to Item 9.A.(1) are designed to increase the quality of the

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362 We would retain the instruction to exclude reporting information in Item 9 about advisory clients that are investment companies registered under the Investment Company Act as this provision in rule 223-1 is not proposed to be amended.

363 We are also proposing to include new instructional language directing advisers to answer "Yes" to Item 9.A.(1) if they have the ability to deduct advisory fees directly from client accounts, reported discretionary RAUM in Item 5.F.(2).(a), or reported having discretionary trading authority in Item 8.C.(1).

information reported on Form ADV by reducing confusion about how and where to report certain information and make it easier for the public and the Commission to understand and analyze.

Third, we are proposing to modify Item 9.A.(2) to preserve information currently reported by advisers in Item 9 about the amount of client assets and number of clients falling into each category of custody (*i.e.*, direct or indirect) and to require advisers to report similar information about client assets over which they have custody resulting from (1) having the ability to deduct advisory fees; (2) having discretionary trading authority; (3) serving as a general partner, managing member, trustee (or equivalent) for clients that are private funds; (4) serving as a general partner, managing member, trustee (or equivalent) for clients that are not private funds; (5) having a general power of attorney over client assets or check-writing authority; (6) having a standing letter of authorization; (7) having physical possession of client assets; (8) acting as a qualified custodian; (9) a related person with custody that is operationally independent; and (10) any other reason.[364] We believe this information would enhance the quality and utility of the data reported on the form, enhancing the Commission's ability to exercise oversight of the safeguarding practices of advisers. We believe this information may also be beneficial to clients or investors attempting to discern the reasons why a particular adviser has custody. Further, this updated format may help market participants to analyze Form ADV data on an aggregated basis to assess fraud risk more accurately.

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[364] Proposed Form ADV, Part 1A, Item 9.A.(2). Advisers are currently required to report information with respect to funds and securities over which their related persons have custody, including the dollar amount and number of clients whose funds or securities are in the adviser's custody and whether any related person has custody of any clients' cash or bank accounts or securities and the relevant dollar amount and number of clients. *See* Form ADV, Part 1A Item 9.A.(2) through, Item 9.B. Based on its responses, an adviser is also required to report additional custody-related information in Schedule D of Form ADV, Part 1A.

Fourth, we are also proposing new Item 9.B. requiring an adviser to indicate whether it is relying on any of the exceptions from the proposed rule and, if so, to indicate on which exception(s) the adviser is relying. This information would be valuable for Commission staff to assess compliance with the proposed rule, and it may also be beneficial to clients or investors to assess which exception(s) the adviser is relying upon.

Fifth, we are proposing to require advisers to report whether client assets over which they or a related person have custody are maintained at a qualified custodian and the number of clients and approximate amount of client assets maintained with a qualified custodian.[365] Advisers also would be required to report certain identifying information about the qualified custodians maintaining client assets.[366] Item 9 currently collects only limited information from advisers about advisers and their related persons that act as qualified custodians under the rule.[367] Qualified custodians continue to serve a critical role in safeguarding client assets under the proposed rule. Given this important role, we are proposing to require advisers to report the following information for all qualified custodians maintaining client assets:

- Full legal name of the qualified custodian;
- Location of the qualified custodian's office responsible for the services provided;
- Contact information for an individual to receive regulatory inquiries;
- Type of entity;

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365 *See* proposed Form ADV, Part 1A, Item 9.C.(1)and proposed Form ADV, Part 1A, Schedule D, Section 9.C.(1).

366 Proposed Form ADV, Part 1A, Schedule D, Section 9.C.(1).

367 *See* Form ADV, Part 1A, Item 9.D.(2) and Form ADV, Part 1A, Schedule D, Section 7.A. Advisers are currently required to report more detailed custodial information about their separately managed accounts and about the private funds they advise. *See* Form ADV, Part 1A, Schedule D, Section 5.K.(3); Form ADV, Part 1A, Schedule D, Section 7.B.(1)(25).

- Legal Entity Identifier (if applicable);
- Number of clients and approximate amount of client assets (rounded to the nearest $1,000) maintained by the qualified custodian; and
- Whether the qualified custodian is a related person, and if so, the identifying information for the independent public accountant engaged to prepare the proposed internal control report and verification required under the proposed safeguarding rule.[368]

Similarly, we are also proposing revisions to Item 9 that would require advisers to report information about accountants completing surprise examinations, financial statement audits, or verification of client assets under the proposed rule.[369] We believe requiring advisers to disclose more detailed information about the qualified custodians maintaining client assets and the accountants completing these engagements under the proposed rule would provide useful information to the public and facilitate the Commission's examination efforts.

Advisers currently are required to file an other-than-annual-amendment to Form ADV promptly if certain information provided in response to Item 9 becomes inaccurate in any way.[370]

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368 *See* proposed Form ADV, Part 1A, Schedule D, Section 9.C.(1). This information is similar to the information advisers currently report regarding separately managed accounts and private fund custodians. *See* Form ADV, Part 1A, Schedule D, Section 5.K.(3); Form ADV, Part 1A, Schedule D, Section 7.B.(1)(25).

369 *See* proposed Form ADV, Part 1A, Schedule D, Section 9.C.(3). Advisers report similar information about the independent public accountants completing surprise examinations under the current rule in Section 9.C of Form ADV Part 1A Schedule D.

370 *See* Form ADV, General Instructions. Advisers, however, are not required to file an other-than-annual amendment to update information provided in response to Items 9.A.(2), 9.B.(2), 9.E, and 9.F even if that information becomes inaccurate—though advisers are required to update this information when filing their next annual updating amendment. *Id*.

Information triggering this obligation includes whether the adviser or a related person has custody of client cash, bank accounts, or securities;[371] the methods by which the adviser complies with the custody rule;[372] and whether the adviser or a related person acts as a qualified custodian.[373] Given the importance of this information, we continue to believe that advisers should update this information to the extent it becomes inaccurate. Thus, we are proposing to retain the current requirement that advisers file an other-than-annual-amendment to Form ADV promptly if similar information we are proposing to collect on Form ADV becomes inaccurate.[374] More specifically, we are proposing to require an adviser to file promptly an other-than-annual amendment to Form ADV if any of an adviser's responses regarding the following becomes inaccurate in any way: (1) whether the adviser has custody of client assets either directly or because a related person has custody of client assets in connection with advisory services that the adviser provides to the client; (2) whether the adviser is relying on certain exceptions to the proposed rule; (3) whether client assets are maintained with a qualified custodian; (4) whether the adviser or a related person serves as a qualified custodian under the proposed rule; (5) whether client assets are not maintained by a qualified custodian; (6) whether the adviser is required to obtain a surprise examination by an independent public accountant under the proposed rule; or (7) whether the adviser is relying on the audit provision.[375] An adviser would be required to update the other information reported in Item 9 (*e.g.,* information

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371 *See* Form ADV, Item 9.A.(1) and Item 9.B.(1).

372 *See* Form ADV, Item 9.C.

373 *See* Form ADV, Item 9.D.

374 *See* proposed amendments to Form ADV General Instructions.

375 *See generally* proposed Form ADV, Items 9.A.(1), 9.B.(1), 9.C., 9.D.(1), and 9.E.

about the number of clients and approximate amount of assets or certain information about qualified custodians) only on its annual updating amendment, which is the same frequency with which advisers update similar information on the current form.[376]

We request comment on all aspects of proposed revisions to Form ADV Part 1A, including the following items.

263. Would the proposed reorganization of Item 9 make it easier for advisers to complete Item 9 more accurately and eliminate the confusion created by the current structure or wording of Item 9? Are there other changes to Item 9 that would make the information reported on that Item more accurate or less confusing? Is additional guidance needed to clarify any of the requirements of the proposed revisions?

264. In proposed Item 9.A.(2), we ask advisers to identify various ways that they may have custody, directly or indirectly, broken out by the approximate amount of client assets and number of clients. Based on our experience, we understand that a client may have several different advisory accounts. Should we also ask for information at the advisory account level? Should we ask for information on an account level basis rather than a client level basis? Would this information be more meaningful? Why or why not?

265. In proposed Item 9.B.(2), we ask advisers about which exception(s) in rule 223-1(b) they are relying upon. Should we also ask for the approximate amount of assets and number of clients under each exception? Should we also ask for information at the advisory account level for each exception? Should we ask for information on an

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376 *See* proposed amendments to Form ADV, General Instructions.

account level basis rather than a client level basis for each exception? Would this information be more meaningful? Why or why not?

266. Would advisers be able to provide the information we are proposing to collect about qualified custodians? Should we collect additional or different information from advisers about qualified custodians? If so, what types of information should advisers be required to report? Does the proposal seek to collect information about qualified custodians that would be unnecessary or overly burdensome for advisers to report? For example, do advisers keep records of the regulator for foreign financial institutions acting as qualified custodians? In particular, what information should not be collected and why? For instance, are there any privacy laws or other legal barriers that would prohibit or restrict an adviser from reporting this information about qualified custodians?

267. Should advisers be required to file promptly an other-than-annual-amendment to Form ADV when the information provided in response to certain parts of Item 9 becomes inaccurate? Should an adviser be required to update promptly only some of this information, as proposed, or, alternatively, all of this information when it becomes inaccurate? Are there different items on Form ADV that advisers should have to update promptly than those proposed?

268. Is there any additional information an adviser should be required to report regarding its practices to safeguard client assets? If so, what types of additional information should advisers be required to report on Form ADV?

269. Should advisers be required to report their holdings of physical assets on Form ADV?

270. Should advisers be required to report their holdings of privately offered securities that cannot be recorded and maintained with a qualified custodian on Form ADV?

271. Should advisers also be required to report information about the independent public accountant where the adviser cannot maintain assets with a qualified custodian?

272. Should advisers be required to disclose information on Form ADV regarding sub-custodial, securities depository, or other similar arrangements about client assets? Do advisers often have this information?

273. Should advisers be required to disclose on Form ADV whether financial statements distributed to investors under the audit provision comply with U.S. GAAP or another comprehensive body of accounting standards?

274. Some of the information we are proposing be reported in Section 9.C.(1) and 9.C.(3) of Schedule D is similar to the information adviser are required to report in Section 7.B.(1) of Schedule D, particularly as it relates to whether reports provided by independent public accountants contain unqualified, qualified, or modified opinions. Should we amend these portions of Section 7.B.(1) of Schedule D to conform with the proposed amendments to Section 9.C.(2) and 9.C.(3)?

275. Where a filing adviser files Form ADV along with a relying adviser, it is our understanding that some filing advisers may include the amount of client funds and securities and total number of clients for which the filing adviser has custody in response to Item 9.A.(2) and for which the relying adviser has custody in response to

Item 9.B.(2) of Form ADV.[377] Should we provide additional guidance in Form ADV about how we expect filing and relying advisers to complete Item 9? If so, please explain.

J. Existing Staff No-Action Letters and Other Staff Statements

Staff in the Division of Investment Management is reviewing certain of its no-action letters and other staff statements addressing the application of the custody rule to determine whether any such letters, statements, or portions thereof, should be withdrawn in connection with any adoption of this proposal. We list below the letters and other staff statements that are being reviewed as of the date of any adoption of the proposed rules or following a transition period after such adoption. If interested parties believe that additional letters or other staff statements, or portions thereof, should be withdrawn, they should identify the letter or statement, state why it is relevant to the proposed rule, and how it or any specific portion thereof should be treated and the reason therefor. To the extent that a letter listed relates both to the custody rule and another topic, the portion unrelated to the custody rule is not being reviewed in connection with the adoption of this proposal.

Letters to be reviewed

Name of Staff Statement	**Date Issued**
All staff statements issued prior to the 2003 Commission Adopting Release	Various Dates

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377 *See Form ADV and Investment Advisers Act Rules,* Advisers Act Rel. No. 4509 (Aug. 25, 2016) where the Commission amended Form ADV instructions, among other items, to allow umbrella registration for a filing adviser and relying advisers.

American Bar Association (Question 1, Custody Rule Section, only)	December 8, 2005
American Bar Association (Question D only)	August 10, 2006
Deloitte & Touche LLP	August 28, 2006
Investment Adviser Association	September 20, 2007
Investment Company Institute	September 5, 2012
Investment Adviser Association	April 25, 2016
Investment Adviser Association	February 21, 2017
Madison Capital Funding, Inc.	December 20, 2018
Robert Van Grover, Esq., Seward and Kissel LLP	December 11, 2019
Privately Offered Securities Under the Investment Advisers Act Custody Rule, Investment Management Guidance Update ("IMGU") 2013-04	August 2013
Private Funds and the Application of the Custody Rule to SPVs and Escrows, IMGU 2014-07	June 2014
Inadvertent Custody, IMGU 2017-01	February 2017
Staff Responses to Questions About the Custody Rule (all)	Issued on various dates since 2003

K. Transition Period and Compliance Date

We are proposing a one-year transition period to provide time for advisers to come into compliance with the following if they are adopted: redesignation of rule 206(4)-2 as new rule 223-1, and corresponding amendments to rule 204-2 and Form ADV, as applicable. Accordingly, we propose that the compliance date of any adoption of this proposal would be one year following the rules' effective dates which would be sixty days after the date of publication of the final rules in the Federal Register for advisers with more than $1 billion in regulatory assets under management ("RAUM"). For advisers with up to $1 billion in RAUM, we propose that the compliance date of any adoption of this proposal would be 18 months following the rules' effective dates which would be sixty days after the date of publication of the final rules in the Federal Register. If adopted as proposed, approximately 10,454 advisers, which represents approximately 69% of all registered advisers and 2.5% of the total RAUM of all advisers, would be subject to the longer, 18 month transition period.[378] The chart below indicates the impact applying different RAUM threshold would have on the number of advisers subject to the proposed 18-month transition period.[379]

Threshold	**Number of Advisers Under Threshold**	**Percent of Advisers Under Threshold**	**Total RAUM of Advisers Under Threshold**	**Percent of Total RAUM of Advisers Under Threshold**
$500 million	8,396	55.4%	$1.7	1.3%
$1 billion	10,454	69.0%	$3.2	2.5%
$1.5 billion	11,448	75.5%	$4.4	3.4%
$2 billion	11,987	79.1%	$5.3	4.1%
$2.5 billion	12,378	81.6%	$6.2	4.8%

[378] As of June 2022, 15,062 investment advisers were registered with the Commission and reported a total of $128.96 trillion in RAUM, while 10,454 advisers reported having less than $1 billion in RAUM, while the aggregate RAUM reported by these advisers as of June 2022 was approximately $3.2 trillion.

[379] The data in the table is based upon data reported by advisers as of June 2022.

$3 billion	12,657	83.5%	$6.9	5.4%
$3.5 billion	12,859	84.8%	$7.6	5.9%
$4 billion	13,044	86.0%	$8.3	6.5%
$4.5 billion	13,215	87.2%	$9.0	7.0%
$5 billion	13,357	88.1%	$9.7	7.6%
$10 billion	13,994	92.3%	$14.1	11.0%

Under this proposal, advisers could continue to rely on current rule 206(4)-2, rule 204-2, and Form ADV until the compliance date. We are proposing that once the rules become effective, advisers may voluntarily comply with them in advance of the compliance date. To promote regulatory consistency, however, we are proposing that any adviser that elects to rely, prior to the compliance date, on the effective rule 223-1 must also comply with, as applicable, the amended rule 204-2 and the amended Form ADV beginning at the same time.

We request comments on the proposed transition period:

276. Do commenters agree that a one-year transition period following each rule's effective date is appropriate for advisers with more than $1 billion in RAUM? Should the period be shorter or longer? For example, would six months be an appropriate amount of time? Alternatively would 18 months be necessary? Do commenters agree that an 18-month transition period following each rule's effective date is appropriate for advisers with up to $1 billion in RAUM? Should the period be shorter or longer? For example, would one year be an appropriate amount of time? Alternatively would 24 months be necessary? Should there be different compliance dates for different types of advisers, such as advisers to pooled investment vehicles or advisers to separate account clients? Should the $1 billion threshold for the different compliance groups be higher or lower?

277. Should the transition period be the same for proposed new rule 223-1 and amendments to rule 204-2 and Form ADV? Should we permit that once the rules become effective, advisers may voluntarily comply with them in advance of the compliance date, and require that any adviser that elects to rely on new rule 223-1 prior to the compliance date must also comply beginning at the same time with the amended rule 204-2 and amended Form ADV? Does this promote regulatory consistency, and if not, why not?

278. Should we also require that any adviser that elects to rely on rule 223-1 and amended rule 204-2 and amended Form ADV prior to the compliance date must also cease to rely on Commission and staff letters and other statements that would be withdrawn on the compliance date?

279. Should the transition period vary for different rule requirements? For example, would advisers need 18 months to comply with the proposed amendments to the qualified custodian provisions and three months to comply with the exception from the surprise examination for SLOAs? Please explain your answer and suggest transition period durations.

III. ECONOMIC ANALYSIS

A. Introduction

We are mindful of the costs imposed by, and the benefits obtained from, our rules. Section 202(c) of the Advisers Act provides that when the Commission is engaging in rulemaking under the Act and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider whether the action will promote efficiency, competition, and capital formation, in addition to the protection of investors. The following analysis considers, in detail, the likely significant economic effects that may result

from the proposed rule amendments, including the benefits and costs to investors and other market participants as well as the broader implications of the proposed rule amendments for efficiency, competition, and capital formation.

Where possible, the Commission quantifies the likely economic effects of its proposed amendments and rules. However, the Commission is unable to quantify certain economic effects because it lacks the information necessary to provide estimates or ranges of costs. Additionally, in some cases, quantification would require numerous assumptions to forecast how investment advisers and other affected parties would respond to the proposed amendments, and how those responses would in turn affect the broader markets in which they operate. In addition, many factors determining the economic effects of the proposed amendments would vary significantly among investment advisers. Investment advisers vary in size and sophistication as well as the assets on which they provide advice. As a result, investment advisers' existing practices and the extent to which investment advisers qualify for exceptions from the rule varies, making it inherently difficult to quantify economic effects. Even if it were possible to calculate a range of potential quantitative estimates, that range would be so wide as to not be informative about the magnitude of the benefits or costs associated with the proposed rule. Many parts of the discussion below are, therefore, qualitative in nature. As described more fully below, the Commission is providing a qualitative assessment and, where practicable, a quantified estimate of the economic effects.

B. Broad Economic Considerations

Investors rely on the asset management industry for a wide variety of wealth management and financial planning functions. These services are critical for investors to plan for the future and diversify their investment risks. Investment advisers are a key part of this industry, as they provide investment advice to investors and clients about the value of, or about investing in,

securities and other investment products.[380]

When performing services for investors and clients, an adviser may frequently have access to client assets, exposing them to the risk of loss, misuse, theft, or misappropriation. This gives rise to a principal-agent problem between investors and clients (the principals) on the one hand and their investment advisers (the agents) on the other. This is because, while advisers face relevant competitive market forces and therefore have private reputational incentives to maintain some level of oversight and internal controls, as discussed below market failures can lead their chosen levels of oversight and control to be sub-optimally low. The current custody rule, which the Commission has amended over time, has been designed to deter such behavior and alleviate these market failures in part by relying on a third party, a qualified custodian, in safeguarding client assets. While requiring the use of a qualified custodians helps mitigate the principal-agent problem between investors, clients, and their advisers, the introduction of an additional agent – the custodian – introduces the potential for additional principal-agent conflicts.

Such principal-agent problems provide the economic rationale for revised Commission rules aimed at further mitigating the underlying market failures. [381] Specifically, in the absence of targeted regulation, principal-agent problems can result when investment advisers and custodians have different preferences and goals than clients. As a result, investment advisers and custodians might take actions that increase their well-being at the expense of imposing agency

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380 *See, e.g.,* https://www.investor.gov/introduction-investing/investing-basics/glossary/investment-adviser.

381 As discussed above in section I, there have been market developments that suggest a need to better protect client assets by broadening the scope of the application of the rule and by improving its efficacy.

costs on investors and clients.[382] For example, a custodian may not have sufficient incentive to provide custodial account records to an independent public accountant on a timely basis, to the extent providing a timely response is burdensome to a custodian. This would make adviser compliance with the audit provision, surprise examination, or Form ADV-E filing provisions of the rule more difficult, which would ultimately be to the disadvantage of clients.

Market forces generally provide some incentive for principals and agents to mitigate principal-agent conflicts. Advisers that effectively mitigate conflicts, for example, by offering targeted private contract terms, may, all else being equal, gain a reputational advantage that will help them in retaining and attracting investors and clients. The assurance provided by such terms, however, would depend on both investors' perception of the costs of enforcing the terms, as well as the likelihood that disputes would be resolved in investors' favor.[383] A market failure may exist to the extent that more costly enforcement of the contract and more unpredictable favorable outcomes reduce the effectiveness of the contract in mitigating conflicts of interest between clients and investment advisers. Factors affecting the cost of enforcement in the context of investment advice may include: 1) the cost of verifying adviser conduct, 2) the extensiveness and complexity of services over which the terms apply, and 3) the ability of investors, who likely lack specialized knowledge, to understand how adviser conduct relates to the terms.[384]

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382 *See, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J.FIN. ECON. 305 (1976).

383 *See, e.g.,* Andrei Shleifer, "*Efficient Regulation*", (2010), available at http://www.nber.org/papers/w15651 ("Shleifer paper"), for a general discussion of these points.

384 *See* Shleifer paper for a general discussion of factors affecting the cost of enforcement of the terms and the predictability of favorable legal outcomes. Several factors may also affect an investor's assessment of a favorable legal outcome should the investor believe an adviser to have violated the contractual terms. First, while investors may believe an adviser has violated the terms, investors may be uncertain of their ability to verify such conduct. Second, given the potentially complex fact patterns of litigation related to the

When the incentives of advisers or custodians do not sufficiently align with investors' or clients' interests, and market failures prevent market participants from effectively resolving these conflicts of interest via private contracting, targeted regulatory requirements can help increase the level of investor protection. The investor protection benefits of such regulatory requirements will depend, however, on an adviser's ability and incentive to comply with the requirements. Encouraging or requiring independent oversight and verification of adviser conduct is one way to incentivize compliance.[385] For example, an adviser is less likely to engage in unauthorized trading in a client's account when the adviser knows that the client will be receiving an account statement detailing any trading activity. Similarly, an adviser is less likely to misappropriate client assets when it knows that an independent public accountant is required to verify client assets.[386]

There are three ways in which regulation facilitating clients' and third parties' oversight of advisers' conduct through verification of client assets can reduce potential harm to investors

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provision of investment advice, investors may believe that there is some chance that courts will simply "get it wrong." Third, advisers may have access to substantially greater financial resources than investors. Investors may believe that the financial inequality between themselves and advisers makes a favorable legal outcome less likely. An investment adviser's fiduciary duty to their clients could mitigate the incentive for an adviser to provide fewer terms that protect investors. The ability of the adviser's fiduciary duty to mitigate the incentive for an adviser to provide fewer terms that protect investors will depend on factors affecting the cost of enforcing that duty. *See*, Frank H. Easterbrook & Daniel R. Fischel, "The Economic Structure of Corporate Law," 1991, Harvard University Press.

385 Even in the absence of such a regulatory requirement, an adviser could contractually offer independent oversight and verification of its conduct to its investors and clients. However, there may be practical impediments, such as the lack of specialized knowledge, which may lead investors to not seek out such terms. In addition, individual negotiation of contracts may be less cost effective than a market-wide regulatory solution.

386 *See, e.g.*, Stephen G. Dimmock & William W. Gerken,"*Predicting fraud by investment managers,"* 105 J. FIN. ECON.153 (Aug. 2011). This article finds that monitoring is a significant predictor of investment fraud. For example, large investors who have stronger incentive and greater ability to monitor are associated with fewer frauds. *Also see, e.g.*, Ben Charoenwong, Alan Kwan & Tarik Umar, "*Does Regulatory Jurisdiction Affect the Quality of Investment-Adviser Regulation?*," 109 AM. ECON. REV., AM. ECON. ASS'N. 3681(Oct. 2019). This article finds that registered investment advisers that are costlier for state regulators to supervise, or primarily serve less sophisticated investors, receive more complaints.

and clients. First, such regulation can increase the likelihood that any non-compliant behavior by advisers is detected. Second, it can increase the likelihood that any non-compliant behavior is detected sooner, potentially mitigating loss to clients. Third, and perhaps most importantly, facilitating verification of client assets would likely have a prophylactic effect, countering the incentive for non-compliant behavior by advisers. Indirectly, regulation that enhances verification of client assets also reduces potential harm to clients by facilitating detection of non-compliant behavior by the qualified custodians with whom the clients have custody agreements, potentially mitigating client losses and deterring non-compliant behavior by custodians. This ameliorates principal-agent problems between the client and the qualified custodian and facilitates advisers' exercise of fiduciary duty over client assets held by the qualified custodian.[387]

Finally, the ability to oversee investment advisers' (and custodians') conduct through verification of client assets depends on the quality of the third party's verification processes and the independence of the third party.[388] Generally, a higher quality verification process is one that has an increased likelihood of detecting misconduct.[389] Similarly, a more independent third

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337 For those custodians that are registered broker-dealers, it also facilitates compliance with their obligations under Exchange Act Rule 15c3-3.

388 *See. e.g.,* Ross L. Watts & Jerold L. Zimmerman, "*Positive Accounting Theory*: *A Ten Year Perspective,"* 65 ACC. REV. 131 (Jan. 1990).

389 The use of PCAOB-registered independent public accountants is required for certain engagements under the current rule. In particular, a PCAOB-registered independent public accountant is required to perform surprise examinations and periodically inspect internal controls under the current rule when an adviser or its related person serves as a qualified custodian for client assets, and a PCAOB-registered independent public accountant must audit the financial statements of a pooled investment vehicle to be deemed to be in compliance with the surprise examination requirement. *See current* rule 206(4)-2(a)(6) and (b)(4). As the Commission noted in adopting these requirements in 2009, the Commission has greater confidence in the quality of audits conducted by an independent public accountant registered with, and subject to regular inspection by, the PCAOB. *See* 2009 Adopting Release*, supra* footnote 11, at 17.

party is one that is more likely to report misconduct or violations of regulatory requirements that it detects.[390] Regulation designed to enhance the quality of third-party verification processes and/or enhance the independence of third parties, then, generally enhances the ability of third parties to oversee investment advisers' conduct.

C. Baseline

The Commission assesses the economic effects of the proposed amendments relative to the baseline of existing requirements and practices of advisers.

1. Current Regulation

a. Custody

As discussed in greater detail in section II above, the regulatory framework regarding safeguarding of investment adviser client assets is set forth in rule 206(4)-2, which applies to any investment adviser registered or required to be registered with the Commission under section 203 of the Act that has custody of client funds or securities.[391] As defined by the current rule, "custody" means that the investment adviser, or its related persons, holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them.[392]

The current rule requires such advisers to maintain all funds and securities of which the

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390 *See. e.g.,* Ross L. Watts & Jerold L. Zimmerman, "*Agency Problems, Auditing and the Theory of the Firm: Some Evidence*," 26 J. L. ECON. 613 (1983).

391 *See* rule 206(4)-2(a). Our exam program commits significant resources ensuring advisers are in compliance with the custody rule and verifying the existence of investor assets at custodians -- a process called asset verification. In FY 2022, EXAMS verified over 2.1 million investor accounts, totaling over $2 trillion.

392 Rule 206(4)-2(d)(2). The Commission stated in 2003, however, that because a one-for-one exchange of assets represents a limited risk of client loss, an adviser's authority to issue instructions to a broker-dealer or another custodian to effect or to settle trades does not constitute "custody" under the current rule. See 2003 Adopting Release at footnote 10. *See also* rule 206(4)-2(d)(7), defining "related person" as "any person, directly or indirectly, controlling or controlled by [the investment adviser], and any person that is under common control with [the investment adviser]."

adviser has custody with a "qualified custodian" in separate accounts under that client's name or in accounts containing only the funds and securities of such adviser's clients, under the adviser's name as agent or trustee, subject to certain exceptions.[393] Qualified custodians generally include banks and savings associations, broker-dealers, futures commission merchants, and certain FFIs[394]—all of which are financial institutions that are currently subject to regular government oversight and are subjected to periodic inspection and examination.[395]

The current rule generally requires an adviser with custody of client assets to obtain an annual surprise examination from an independent public accountant to verify client funds and securities independently.[396] With certain exceptions, the adviser must report on Form ADV whether it or its related person has custody of an advisory client's cash, bank accounts, and securities, and disclose the details of the custodial relationship (including, *inter alia*, dollar amounts, total number of clients, distribution of quarterly account statements, audits, annual surprise examinations, and internal control reports).[397]

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393 *See* rule 206(4)-2(a)(1).

394 *See* rule 206(4)-2(d)(6).

395 *See supra* footnote 89.

396 *See* rule 206(4)-2(a)(4). A 2013 Government Accountability Office (GAO) study, which examined 12 average-sized registered advisers, found that the cost of surprise examinations ranged from $3,500 to $31,000. The GAO noted that the costs of surprise examinations vary widely across advisers and are typically based on the amount of hours required to conduct the examinations, which is a function of a number of factors including the number of client accounts under custody. *See* GOV'T ACCOUNTABILITY OFFICE, GAO-13-569, INVESTMENT ADVISERS: REQUIREMENTS AND COSTS ASSOCIATED WITH THE CUSTODY RULE (2013), https://www.gao.gov/assets/gao-13-569.pdf.

397 17 CFR 279.1; Form ADV, Part 1A, Item 9; *see also* supra notes 268.268-69, 271, 274-77.297, 303-309. An adviser must also include a notice in its brochure concerning its qualified custodian's account statement obligations, and a disclosure in its balance sheet of any financial conditions that are reasonably likely to impair the adviser's ability to meet contractual commitments to clients, when the adviser has discretionary authority or custody over client funds or securities. *See* Form ADV, Part 2A, Items 15, 18.

In situations where the adviser or a related person acts as qualified custodian, the current rule requires advisers to obtain, or receive from its related person, an annual internal control report with respect to the adviser's or related person's custody controls, which includes an opinion from an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB.[398] The required internal control report addresses the greater custodial risks associated with situations where an adviser, or its related person, acts as a qualified custodian.[399]

The current rule's requirements are, however, subject to certain exceptions. Specifically, the current rule provides an exception to the requirement to maintain securities with a qualified custodian for certain "privately offered securities".[400] The current rule also provides that advisers need not comply with the requirements of rule 206(4)-2 with respect to the accounts of registered investment companies,[401] and allows shares of mutual funds to be maintained with the

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398 *See* rule 206(4)-2(a)(6). The surprise examination must also be conducted by a PCAOB-registered and inspected independent public accountant. *See* Custody Rule Amendments Adopting Release, *supra* footnote 11 (stating that the internal control report should address control objectives and associated controls related to the areas of client account setup and maintenance, authorization and processing of client transactions, security maintenance and setup, processing of income and corporate action transactions, reconciliation of funds and security positions to depositories and other unaffiliated custodians, and client reporting).

399 As noted in the Custody Rule Amendments Adopting Release, *supra* footnote 11, the surprise examination alone does not adequately address custodial risks associated with self-custody or related-person custody because the independent public accountant seeking to verify client assets would rely, at least in part, on custodial reports issued by the adviser or its related person. The internal control report can significantly strengthen the utility of the surprise examination when the adviser or its related person acts as qualified custodian for client assets because it provides a basis for the independent accountant performing the surprise examination to obtain additional comfort that the confirmations received from the custodian are reliable.

400 See rule 206(4)-2(b)(2). As discussed in Section II.C, we understand that demand for custodial services of privately offered may be thin.

401 *See* rule 206(4)-2(b)(5).

fund's transfer agent in lieu of a qualified custodian.[402] In addition, an adviser that has custody solely because of its authority to deduct advisory fees, or because a related person has custody and such related person is operationally independent of the adviser, is not required to obtain an annual surprise examination.[403]

The current rule also requires that certain communications be made to clients. An investment adviser is required to provide its clients notice if the adviser establishes an account with a qualified custodian on a client's behalf.[404] Advisers must also have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement, at least quarterly, to each of the adviser's applicable clients.[405] When an adviser has custody of funds and securities belonging to a client that is a pooled investment vehicle, these account statements must be sent to each limited partner, member, or other beneficial owner if the adviser or its related person is a general partner of a limited partnership, managing member of a limited liability company, or holds a comparable position for another type of pooled investment vehicle.[406]

An adviser is not required to comply with the notice and account statement delivery requirements of the rule and shall be deemed to comply with the surprise examination requirement with respect to the account of a limited partnership or other pooled investment vehicle that is subject to annual audit, provided certain conditions are satisfied (the "current audit

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402 Rule 206(4)-2(b)(1).

403 *See* rule 206(4)-2(b)(3), (6).

404 *See* rule 206(4)-2(a)(2).

405 *See* rule 206(4)-2(a)(3).

406 *See* rule 206(4)-2(a)(5).

provision").[407] To rely on the current audit provision, the pool's financial statements must, among other things, be prepared in accordance with U.S. GAAP and distributed to all limited partners (or other beneficial owners) within 120 days of the end of the pool's fiscal year. The current audit provision also requires the auditor to be registered with and subject to inspection by the PCAOB.

b. Recordkeeping

Rule 204-2 applies to any investment adviser registered or required to be registered with the Commission under section 203 of the Act. This rule requires, among other things, that an adviser make and keep a list or other record of all client accounts for which the adviser has any discretionary power,[408] and copies of internal control reports obtained or received pursuant to current rule 206(4)-2.[409] Rule 204-2 also currently requires investment advisers subject to rule 206(4)-2 to make and keep records regarding all purchases, sales, receipts and deliveries of securities for such accounts and all other debits and credits to such accounts, separate ledgers for such accounts, copies of confirmations of all effected transactions, a record for each security in which any such client has a position, and a memorandum describing the basis upon which the adviser has determined that the presumption that any related person is not operationally independent has been overcome.[410]

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407 *See* rule 206(4)-2(b)(4).

408 *See* rule 204-2(a)(8).

409 *See* rule 204-2(a)(17)(iii).

410 *See* rule 204-2(b).

c. Regulation of Qualified Custodians

Finally, other regulations affect entities' responsibilities as qualified custodians, namely, banks and savings associations, broker-dealers registered with the Commission, futures commission merchants registered with the CFTC, and FFIs. A broker-dealer acting in the capacity of a custodian is subject to Exchange Act Rule 15c3-3, under which customers' assets must be segregated from proprietary assets to permit prompt return in the event of the firm's liquidation in a proceeding under the Securities Investor Protection Act of 1970;[411] and, where applicable, to FINRA rule 2231, requiring broker-dealers' statements of assets to be sent to customers not less than quarterly. Futures commission merchants are subject to Commodities Exchange Act sections 4d(a)(2) and 4d(b) and regulations issued thereunder, which require segregation of client funds from the entities' funds, and impose related accounting and recordkeeping requirements.[412] Banks and savings associations are also subject to regulation with respect to their custodial services. For example, under applicable Treasury regulations, generally, a depository institution holding government securities for its customers must segregate the customer's securities from its own assets, free of any lien, charge, or claim of any third party

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411 17 CFR 240.15c3-3.

Specifically, see Rule 15c3-3(b)(1) (requirement for a broker-dealer to promptly obtain and maintain the physical possession or control of all fully-paid securities and excess margin securities carried for the account of customers); (e)(1) (requiring every broker-dealer to maintain with a bank a "Special Reserve Bank Account for the Exclusive Benefit of Customers" and a "Special Reserve Bank Account for Brokers and Dealers," separate from each other and from the broker-dealer's other bank accounts); and (f) (requiring written notification that the bank was informed that cash or securities are being held for the exclusive benefit of the broker-dealer's customers and account holders, separate from the broker-dealer's other accounts; and that the broker-dealer must have a written contract with the bank providing that the cash or securities will not be used as security for a loan to the broker-dealer by the bank, and will not be subject to any right, charge, security interest, lien, or claim in favor of the bank or any person claiming through the bank).

412 7 U.S.C. 6d(a)(2), 6d(6); 17 CFR 1.20-1.30, 1.32, 1.36; *see also supra* note 104.

granted or created by such custodian; and it may lend the securities to a third party only by written agreement with the customer and in full compliance with the appropriate regulatory agency.[413] Additionally, national banks and federal savings associations are subject to OCC regulations when providing fiduciary custody services,[414] and the OCC has provided substantial guidance with respect to these firms' non-fiduciary custody services.[415] As a result, banks and savings associations have developed and deployed comprehensive custodial service agreements governing their relationships with their custodial customers. In addition, depository institutions are subject to the long-standing, efficient orderly resolution process deployed by the FDIC and non-depository member banks are subject to the efficient orderly resolution process by the OCC. Finally, as noted in part II.C.1, some FFIs are regulated in their local jurisdictions and subject to laws and regulations established by their national jurisdictions to combat money laundering and terrorism financing, consistent with standards and measures recommended by the FATF.

d. Accredited Investors

Aspects of the proposed rule address investments in privately offered securities such as investments in private companies, and offerings made by certain hedge funds, private equity funds, and venture capital funds.[416] Congress and the Commission have provided exemptions for these offerings based on various factors, including that the offerings are generally limited to individuals and entities (*e.g.*, accredited investors) that do not require the protection of

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413 17 CFR 450.4(a)(1), (a)(6).

414 *See* 12 CFR 9.1 *et seq*. (rules governing fiduciary powers of national banks); 12 CFR 150.10 *et seq*. (rules governing fiduciary powers of federal savings associations).

415 *See generally* OCC Custody Handbook, *supra* note 237.

416 The Securities Act of 1933 contains a number of exemptions from its registration requirements and authorizes the Commission to adopt additional exemptions.

registration.[417] Under Commission rules, qualifying as an accredited investor allows an investor to participate in investment opportunities that are generally not available to non-accredited investors, including certain investments in private companies and offerings by certain hedge funds, private equity funds, and venture capital funds.

e. Effect of State Law

The relationship between clients and qualified custodians is also governed by the common law of agency and contracts, and -- to the extent adopted under state law -- corresponding articles of the Uniform Commercial Code (UCC).[418] Thus under sections 8-504 and 8-509 of the UCC, unless otherwise agreed to, and unless duties are specified otherwise by statute, regulation, or rule, a custodian "may not grant security interests in a financial asset it is obligated to maintain" for the client and must exercise "due care in accordance with reasonable commercial standards to obtain and maintain the financial asset."[419]

2. Affected Parties and Industry Statistics

The proposed amendments would affect registered investment advisers, and those required to be registered, as well as current and prospective clients of investment advisers, qualified custodians, and independent public accountants.

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417 Historically, the Commission has stated that the accredited investor definition is "intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or fend for themselves render the protections of the Securities Act's registration process unnecessary." See Regulation D Revisions; Exemption for Certain Employee Benefit Plans, Release No. 33-6683 (Jan. 16, 1987) [52 FR 3015 (Jan. 30, 1987)]. See also SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) (taking the position that the availability of the Section 4(a)(2) exemption "should turn on whether the particular class of persons affected needs the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering'").

418 *See supra* notes 164, 184.

419 U.C.C. 8-504(b), (c), 8-509(a) (AM. L. INST. & UNIF. L. COMM'N 2021).

a. Investment Advisers

As of June 2022 there were 15,062 investment advisers registered with the SEC. Registered investment advisers reported $128.96 trillion in RAUM with $117.57 trillion in 47.51 million accounts over which advisers have discretionary authority and $11.38 trillion in 14.55 million accounts over which advisers do not have discretionary authority.[420] The average RAUM among registered investment advisers was $8.56 billion and the median was $427.53 million.

b. Clients

Form ADV requires investment advisers to indicate the approximate number of advisory clients and the amount of total RAUM attributable to various client types.[421] Table 1 provides information on the number of client accounts, total RAUM, and the number of advisers by client type.

Table 1

Investment Adviser Clients

Client Type	Number of Clients (thousands)	Total RAUM (billions)	Registered Investment Advisers
Investment Companies	25	$43,838	1,603
Pooled investment vehicles - Other	95	$34,584	5,763
High net worth individuals	6,917	$11,832	8,989
Pension Plans	431	$8,106	5,271
Insurance Companies	13	$7,630	1,028

[420] The term "regulatory assets under management" or "RAUM" refers to an adviser's assets under management as reported in response to Item 5.F. of Part 1A of Form ADV. See Form ADV: Instructions for Part 1A, instr. 5.b. (setting forth instructions for calculation of assets under management for regulatory purposes).

[421] If a client fits into more than one category, Form ADV requires an adviser to select one category that most accurately represents the client (to avoid double counting clients and assets).

Non-high net worth individuals	43,824	$7,093	8,286
State/Municipal Entities	27	$4,285	1,299
Corporations	340	$3,267	4,934
Foreign Institutions	2	$2,209	363
Charities	121	$1,613	5,134
Other Advisers	908	$1,427	814
Banking Institutions	11	$966	432
Business Development Companies	<1	$211	98

Source: Form ADV, Items 5D

c. Qualified Custodians

Qualified custodians include state and federally-chartered trusts, banks and savings associations, broker-dealers, FCMs, and certain FFIs.[422] The custody service industry has been characterized as dominated by a small number of large market share participants.[423] Several factors contribute to this: (i) economies of scale, because custodial services require a costly infrastructure capable of processing a large volume of transactions reliably; (ii) low margins, which makes it difficult for new entrants to compete against incumbents; and (iii) the importance

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422 The FDIC reports that as of March 31, 2022, there were 4,194 FDIC-insured commercial banks and 602 FDIC-insured savings institutions. See https://www.fdic.gov/analysis/quarterly-banking-profile/statistics-at-a-glance/2022mar/industry.pdf. We do not have data on the number of FDIC-insured commercial banks and FDIC-insured savings institutions providing custodial services. As of November 2022, there were 3,530 broker-dealers registered with the Commission. See https://www.sec.gov/files/data/broker-dealers/company-information-about-active-broker-dealers/bd110122.txt. The CFTC reports that as of September 30, 2022, there were 60 FCMs. See https://www.cftc.gov/sites/default/files/2022-11/01%20-%20FCM%20Webpage%20Update%20-%20September%202022.pdf. Out of 3,498 broker-dealers registered with the Commission, 153 were classified as carrying broker-dealers based on FOCUS filings as of June 2022. Per EDGAR Form Custody: A "Carrying broker-dealer" is a broker-dealer that carries customer or broker or dealer accounts and receives or holds funds or securities for those customers. We do not have data on the number of qualifying FFIs.

423 Deloitte, "*The evolution of core financial service. Custodian & Depository Banks*." (2019), available at https://www2.deloitte.com/content/dam/Deloitte/lu/Documents/financial-services/lu-the-evolution-of-a-core-financial-service.pdf. *See* also Congressional Research Service, "Digital Assets and SEC Regulation," January 30, 2020. According to this report, in 2020, four large banks service around $114 trillion of *global* assets under custody.

of reputation/trust.[424] Large financial institutions headquartered in the U.S. dominate the global custody service industry.[425] In 2020, four large U.S. banks serviced around $114 trillion of global assets under in their custody.[426]

d. Independent Public Accountants

As discussed above, the current rule generally requires an adviser with custody of client assets to obtain an annual surprise examination from an independent public accountant.[427] As of June 2022, 13% of investment advisers obtain a surprise examination by an independent public accountant.[428] Not all advisers with custody, however, are subject to an annual surprise examination. For example, as of June 2022, 4,933 investment advisers satisfied their custody rule obligations by complying with the current rule's audit provision.[429] Advisers reported that 86% of the accountants performing surprise examinations or conducting pooled investment vehicle financial statement audits are subject to regular inspection by the PCAOB.[430]

Advisers that are subject to an annual surprise examination also are required to obtain (or receive from the relevant related person) an internal control report if the adviser or a related

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424 Charles-Enguerrand Coste et al., *One size fits some: analyzing profitability, capital and liquidity constraints of custodian banks through the lens of the SREP methodology* (Eur. Cent. Bank Occasional Paper No. 256, 2021).

425 *Id*; *see* also Congressional Research Service, "*Digital Assets and SEC Regulations*," (Jan. 30, 2020.).

426 Congressional Research Service, "*Digital Assets and SEC Regulations*," (Jan. 30, 2020.).

427 *See* rule 206(4)-2(a)(4).

428 Based on advisers' responses to Item 9.C.(2) of Part 1A of Form ADV. Comparable numbers for 2019, 2020, and 2021 were 13%, 13%, and 13%, respectively.

429 Based on advisers' responses to Item 9.C.(3) of Part 1A of Form ADV. Comparable numbers for 2019, 2020, and 2021 were 4,460, 4,565, and 4,768, respectively.

430 These percentages are based on advisers' responses to Item 9.C.(3) of Part 1A of Form ADV. Comparable percentages for 2019, 2020, and 2021 were 86%, 86%, and 86%, respectively.

person of the adviser serves as a qualified custodian for client assets. However, in the circumstance where an adviser is deemed to have custody solely because of a related person custodian and the related person custodian is operationally independent of the adviser, the adviser is not required to have an annual surprise examination but is subject to the internal control requirement.[431] As of June 2022, 98 investment advisers have a control report prepared by an independent public accountant without being subject to a surprise examination.[432]

3. Market Practice

a. Investment Advice

Academic studies have documented a number of benefits to retail investors from receiving investment advice, including, but not limited to: higher household savings rates, setting long-term goals and calculating retirement needs, more efficient portfolio diversification and asset allocation, increased confidence and peace of mind, facilitation of small investor participation, and improved tax efficiency.[433] Investment advisers can also help correct potential

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431 *See* rule 206(4)-2(a)(6) and (b)(6). In these circumstances, the adviser typically receives the internal control report from the related person custodian.

432 Based on advisers' responses to Item 9.C.(3) and 9.C.(4) of Part 1A of Form ADV. Comparable numbers for 2019, 2020, and 2021 were 117, 112, and 105, respectively.

433 *See*, *e.g.*, Mitchell Marsden, Catherine D. Zick, & Robert N. Mayer, *The Value of Seeking Financial Advice*, 32 J. FAM. & ECON. ISSUES 625 (2011); Jinhee Kim, Jasook Kwon & Elaine A. Anderson, *Factors Related to Retirement Confidence: Retirement Preparation and Workplace Financial Education*, 16 J. FIN. COUNSELING & PLAN. 77 (2005); Michael S. Finke, Sandra J. Huston, & Danielle D. Winchester, *Financial Advice: Who Pays*, 22 J. FIN. COUNSELING & PLAN. 18 (2011); Daniel Bergstresser, John M.R. Chalmers, & Peter Tufano, *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry*, 22 REV. FIN. STUD. 4129 (2009); Ralph Bluethgen, Steffen Meyer & Andreas Hackethal, *High-Quality Financial Advice WANTED!* (Working Paper, Feb. 2008), available at http:// https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1102445; Neal M. Stoughton, Youchang Wu & Josef Zechner, *Intermediated Investment Management*, 66 J. FIN. 947 (2011). Marsden et al. (2011) documents benefits attributable to hiring a financial professional, such as better retirement account diversification and savings goals, but does not find that hiring a financial professional measurably increases the amount of overall wealth accumulation for those investors. *See*, *also*, Jeremy Burke & Angela A. Hung, *Do Financial Advisors Influence Savings Behavior?*, RAND Labor and Population Report Prepared for the Department of Labor (2015), available at https://www.rand.org/pubs/research_reports/RR1289; Terrance Martin &

systematic errors that retail investors might make, including limited allocation of savings to equities, under-diversification, or investing too little in foreign assets.[434]

Investor demand for investment advice, however, may be affected by investor's assessment of the conflicts between themselves and investment advisers. For example, while investors may benefit from receiving investment advice, reports have indicated that the ability to trust the advice of a financial professional is an important factor in determining investors' demand for investment advice. In particular, one academic study has shown that trust in financial institutions is associated with the propensity to use financial advice.[435] Based on survey data analysis, this study found that financial trust is correlated with the likelihood of seeking financial advice. Using data from experiments, this study found that trust is an

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Michael Finke. "*A Comparison of Retirement Strategies and Financial Planner Value*." 27 J. FIN. PLAN. 46 (2014); Crystal R. Hudson L& Lance Palmer. "*Low-Income Employees: The Relationship between Information from Formal Advisors and Financial Behaviors*." 23 FIN. SERV. REV. (2014): 25; Marc M. Kramer, *Financial Literacy, Overconfidence and Financial Advice Seeking* (Working Paper, Dec. 19, 2014), available at https:// efmaefm.org/0EFMAMEETINGS/ EFMA%20ANNUAL%20MEETINGS/2015- Amsterdam/papers/EFMA2015_0067_fullpaper.pdf.; John R. Salter, Nathan Harness & Swarn Chatterjee. "*Utilization of Financial Advisors by Affluent Retirees*." 19 FIN. SERV. REV. 245 (2010), for additional studies on the causal relation between the use of a financial professional and wealth accumulation. Francis M. Kinniry et al., Putting a Value on Your Value: Quantifying Vanguard Advisor's Alpha, Vanguard Research (Sept. 2016), available at https://advisors.vanguard.com/iwe/pdf/IARCQAA.pdf, estimates the value to investors associated with obtaining financial advice of approximately 3% in net returns to investors, associated with suitable asset allocation, managing expense ratios, behavioral coaching, alleviating home bias, among others.

434 *See*, *e.g.*, Luigi Guiso, Paolo Sapienza & Luigi Zingales, *People's Opium? Religion and Economic Attitudes*, 50 J. MONETARY ECON. 225 (2003); Laurent E. Calvet, John Y. Campbell & Paolo Sodini, *Down or Out: Assessing the Welfare Costs of Household Investment Mistakes*, 115 J. POL. ECON. 707 (2007); Brad M. Barber & Terrance Odean, "*Trading is Hazardous to Your Wealth: The Common Stock Performance of Individual Investors"*, 55 J. FIN. 773 (2000); Karen K. Lewis, *Trying to Explain Home Bias in Equities and Consumption*, 37 J. ECON. LITERATURE 571 (1999). Guiso et al., 2003; Calvet et al., 2007; Barber and Odean, 2000; Lewis, 1999. Possible explanations for these investor mistakes may arise from behavioral biases, such as cognitive errors, the cost of information acquisition, or the selection of the financial professional. For example, investors have been observed to hold too little of their wealth in foreign assets, which is often called "home bias."

435 *See, e.g.*, Jeremy Burke & Angela A. Hung, *Trust and Financial Advice* (RAND Working Paper WR-1075, 2015).

important predictor of who takes up advice, even after controlling for demographic characteristics and financial literacy.

b. Adviser Custody

As of June 2022, 8,536 advisers (56.67% of the total number of advisers) reported on Form ADV that they or their related persons, in aggregate, had custody of $45.56 trillion (35.33% of aggregate RAUM) of client assets.[436,437] Advisers reported directly having custody of approximately $21.28 trillion, and $24.28 trillion resulted indirectly from custody through a related person. As of June 2022, 1,904 (12.64% of the total) advisers reported that an independent public accountant conducted an annual surprise examination of client assets.[438] 4,933 advisers reported that an independent public accountant annually audits the pooled investment vehicle(s) the adviser manages and the audited financial statements are distributed to investors in the pools.[439] 1,405 (9.33% of the total) advisers reported having a qualified

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436 This analysis is based on advisers' responses to Items 9.A. and 9.B. of Part 1A of Form ADV. The instructions to Item 9.A. of Part 1A of Form ADV provide that an adviser that has custody solely because (i) it deducts advisory fees directly from client accounts, or (ii) an operationally independent related person has custody of client assets in connection with advisory services provided to clients, should answer "No" in response to Item 9.A.(1), which asks whether the adviser has custody of client assets, meaning the number of advisers with custody is likely larger.

437 The total number of advisers reporting custody of client assets or custody by a related person, in response to Items 9.A. and 9.B. of Part 1A of Form ADV was 7,424 in 2019, 7,774 in 2020, and 8,180 in 2021. As a percent of the total number of registered advisers, the percent of advisers reporting custody of client assets or custody by a related person in response to Items 9.A. and 9.B. of Part 1A of Form ADV was 55.20% in 2019, 55.88% in 2020, and 55.95% in 2021. As a percent of aggregate RAUM, advisers reporting custody of client assets or custody by a related person in response to these Items of Form ADV, managed 33.92% in 2019, 33.80% in 2020, and 34.44% in 2021.

438 Based on advisers' responses to Item 9.C.(3) of Part 1A of Form ADV, the total number of advisers reporting that an independent public accountant conducts an annual surprise examination of client assets was 800 (13.38%) in 2019, 1,834 (13.18%) in 2020, and 1,887 (12.91%) in 2021.

439 Based on advisers responses to Item 9.C.(2) of Form ADV. Comparable numbers for 2019, 2020, and 2021 were 4,460, 4,565, and 4,768, respectively.

custodian send quarterly statements to investors in pooled investment vehicles.[440] As of June 2022, 98 (0.65%) registered advisers reported that they had an internal control report prepared by an independent public accountant but did not report that they were subject to a surprise examination.[441]

As of June 2022, approximately 0.5% of all registered investment advisers (6.51% of aggregate RAUM) acted as a qualified custodian for their clients. Approximately 0.6% of all registered investment advisers (23.67% of aggregate RAUM) had a related person acting as a qualified custodian.

c. Market Practice Baseline

In addition to rule 206(4)-2, the 2009 Accounting Guidance, no-action letters, interpretive letters, and other staff statements (some of which are enumerated in Section II.K) shape investment advisers' custody rule compliance. For example, staff has issued 70 FAQs on a wide range of topics, including the contours of custody and how custody applies in the setting of pooled investment vehicles.[442]

Banks' practices as qualified custodians are also shaped by guidance, such as the Office of the Comptroller of the Currency's handbook on custody, which furnishes guidance to national

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In addition, based on advisers' responses to Items 9.A., 9.B., and 9.F., 8,165 registered advisers had custody solely because of their authority to deduct fees in 2020 as of June 2022.

440 Based on advisers' responses to Item 9.C.(2) of Form ADV. Comparable numbers for 2019, 2020, and 2021 were 1,313 (9.76%), 1,328 (9.55%), and 1,348 (9.22%), respectively.

441 These statistics are based on advisers' responses to Items 9.C.(3) and (4) of Part 1A of Form ADV. The comparable numbers for 2019, 2020, and 2021 were 117 (0.87%), 112 (0.81%), and 105 (0.72%), respectively.

442 *See supra* note 17.

banks and savings associations acting as custodians.[443] The OCC guidance provides that the custodian's management has the responsibility to assess its control environment and ensure an appropriate system of internal controls, including separation of duties, and accounting controls to monitor and measure transactional workflows and their accuracy.[444] The custodian's management should further ensure that custody account assets are kept separate from the custodian's own assets and maintained under joint control, and that securities under custody are not subject to lending transactions without a written agreement between the custodian and the client.[445]

d. Custody Market Trends

Competition among bank qualified custodians has been characterized as fierce, with shrinking profit margins, and the dominance of a handful of large entities.[446] One report noted that custodians need to adapt and expand their service offerings to accommodate new types of assets, such as crypto assets, and assets that are now held and transferred using new technological methods, such as central bank digital currencies (also known as CBDCs).[447]

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443 OFF. OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK, CUSTODY (2002), available at https://www.occ.gov/publications-and-resources/publications/comptrollers-handbook/files/custody-services/index-custody-services.html.

444 COMPTROLLER'S HANDBOOK, CUSTODY at 6-7.

445 *Id*. at 14, 30.

446 *Id*. at 1. *See. also,* Deloitte, "*The evolution of a core financial service. Custodian & Depository Banks*." (2019) available at https://www2.deloitte.com/content/dam/Deloitte/lu/Documents/financial-services/lu-the-evolution-of-a-core-financial-service.pdf. *See* also Congressional Research Service, "Digital Assets and SEC Regulations," January(Jan. 30, 2020.). According to this report, in 2020, four large banks service around $114 trillion of *global* assets under custody.

447 *See. e.g.,* Deloitte, "*The evolution of a core financial service. Custodian & Depository Banks*." (2019) available at https://www2.deloitte.com/content/dam/Deloitte/lu/Documents/financial-services/lu-the-evolution-of-a-core-financial-service.pdf.

The industry-reported market capitalization for crypto assets experienced a rapid growth from $1 billion in 2018 to $1 trillion in 2021.[448] One survey found that 16 percent of U.S. adults say they personally have invested in, traded, or otherwise used "cryptocurrencies."[449] Institutional investors also invested in "cryptocurrencies."[450] The Commission analyzed the extent to which investment advisers offer various kinds of services related to digital assets.[451] This analysis relied on Commission filings, advisers' websites, and mentions of an adviser's services from third-party online news sources.[452] The analysis was conducted as of June 2022[453] and focuses on the 50 largest investment advisers[454] by RAUM. The Commission estimates that,

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448 *See e.g.,* Deloitte, "*Market Manipulation in Digital Assets*" (Mar. 2021), available at https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Financial-Services/gx-design-market-manipulation-in-digital-assets-whitepaper-v2-1.pdf.

449 *See* "46% of Americans who have invested in cryptocurrency say it's done worse than expected,"." Pew Research Center, Washington, D.C. (Aug. 23, 2022), available at https://www.pewresearch.org/fact-tank/2022/08/23/46-of-americans-who-have-invested-in-cryptocurrency-say-its-done-worse-than-expected/. Also, another study in 2019 estimated about 40 million Americans owned assets identified as cryptocurrencies. *See* Office of the Comptroller of the Currency, Interpretative Letter #1170, July 2020.

450 *See* Office of the Comptroller of the Currency, Interpretative Letter #1170, July 2020.

451 A search of Commission filings, advisers' websites, and mentions of an adviser's services from third-party only news services used the term "digital assets" because several of the sources did not explicitly state that they were strictly referring to crypto assets.

452 Filings on Form ADV did not, in all cases, provide sufficient information to determine exactly the extent to which an adviser offers services related to digital assets. Therefore, this analysis relied on supplementary information obtained from advisers' websites, online news sources, and in two cases, other forms filed with the SEC. Both of these two cases involved funds that held digital assets. In the case of one adviser, the staff used information from Form D, in the case of the other the staff used information from Form S-1. Webpages whose terms and conditions required citation are: https://investor.vanguard.com/, www.franklintempleton.com, www.mufg.jp, https://www.pimco.com/, and https://citywire.com/.

453 Commission analysis used advisers' most recent filings that were submitted during the period from July 2021 to June 2022. Supplemental data from websites was evaluated in October 2022.

454 The Commission considered filers that represent the same firm to be a single adviser. In aggregate, these 50 investment advisers i) reflect 49% of total RAUM (as reported in response to question 5F(2)(c)), ii) manage 37% of all accounts (as reported in response to question 5F(2)(f)), iii) hold 35% of client funds and securities in investment adviser firm's custody or in a related person's custody (as reported in response to questions 9A(2)(a) and 9B(2)(a)), and hold 32% of client funds and securities in investment adviser firm's custody (as reported in response to question 9A(2)(a) only).

of these 50 largest investment advisers, i) 21 are offering or planning on offering some services related to digital assets,[455] ii) 9 are giving or planning on giving investment advice related to digital assets,[456] iii) 13 provide or are planning on providing custody of digital assets or custodial services of digital assets,[457] and iv) 7 advise or are planning on advising a pooled investment vehicle (like a fund or commodity pool) that holds some digital assets.[458]

The market for crypto asset custodial services continues to develop. Our understanding is that one OCC-regulated national bank, four OCC-regulated trusts, approximately 20 state-chartered trust companies and other state-chartered, limited purpose banking entities, and at least one FCM currently offer custodial services for crypto assets. We also understand that the provision of custodial services for crypto assets can arise in the context of the trading of crypto assets. As discussed above, many platforms that provide users with the ability to transact in crypto assets are not qualified custodians and require investors to pre-fund trades, a process in which investors transfer their crypto assets or fiat currency to such a platform prior to the execution of any trade.[459] Our understanding is that the majority of crypto asset trading occurs on platforms requiring pre-funding of trades, though crypto asset trading also occurs on so-called

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455 These investment advisers comprise 67% of RAUM and manage 66% of accounts of the largest 50 investment advisers.

456 These investment advisers comprise 26% of RAUM and manage 41% of accounts of the largest 50 investment advisers.

457 These investment advisers comprise 51% of RAUM and manage 43% of accounts of the largest 50 investment advisers. They further comprise 49% of client funds and securities in the largest fifty investment adviser firms' custody or in related persons' custody (as reported in response to questions 9A(2)(a) and 9B(2)(a)) and 48% of client funds and securities in the largest fifty investment adviser firms' custody (as reported in response to question 9A(2)(a) only).

458 These investment advisers comprise 67% of RAUM and manage 66% of accounts of the largest 50 investment advisers.

459 *See supra*, footnote 128 and accompanying text.

decentralized platforms that may not rely on pre-funding. We are aware that a limited number of SEC-registered crypto asset securities trade on Alternative Trading Systems ("ATSs") that do not require pre-funding of trades. [460] ATSs that trade crypto asset securities follow a three-step process or four-step process[461] that does not involve the broker-dealer operator of the ATS providing custodial services for the crypto asset securities.[462] We understand, however, that ATSs do not offer trading of crypto asset non-securities.

We understand that certain advisers provide advisory services with respect to client funds and securities that would generally result in an adviser having "custody" within the meaning of

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460 ATSs that do not trade NMS stocks file with the Commission a Form ATS notice, which the Commission does not approve. In addition, all ATSs must file quarterly reports on Form ATS-R with the Commission. Form ATS-R requires, among other things, volume information for specified categories of securities, a list of all securities traded in the ATS during the quarter, and a list of all subscribers that were participants. To the extent that an ATS trades crypto asset securities, the ATS must disclose information regarding its crypto asset securities activities as required by Form ATS and Form ATS-R. Form ATS and Form ATS-R are deemed confidential when filed with the Commission. Based on information provided on these forms, a limited number of ATSs have noticed on Form ATS their intention to trade certain crypto asset securities and a subset of those ATSs have reported transactions in crypto asset securities on their Form ATS-R.

461 For background on the models, the staff has noted as follows: A non-custodial ATS four-step model involves the following steps: Step 1 - the buyer and seller send their respective orders to the ATS; Step 2 - the ATS matches the orders; Step 3 - the ATS notifies the buyer and seller of the matched trade; and Step 4 - the buyer and seller settle the transaction bilaterally, either directly with each other or by instructing their respective custodians to settle the transaction on their behalf. In a non-custodial ATS three-step model involves the following steps: Step 1 - the buyer and seller send their respective orders to the ATS, notify their respective custodians of their respective orders submitted to the ATS, and instruct their respective custodians to settle transactions in accordance with the terms of their orders when the ATS notifies the custodians of a match on the ATS; Step 2 - the ATS matches the orders; and Step 3 - the ATS notifies the buyer and seller and their respective custodians of the matched trade and the custodians carry out the conditional instructions. The custodians would then settle the trade on behalf of the buyer and seller based on the instructions received in Step 1. As with the four-step process, the broker-dealer operator does not guarantee or otherwise have responsibility for settling the trades and does not at any time exercise any level of control over the digital asset securities being sold or the cash being used to make the purchase (e.g., the ATS does not place a temporary hold on the seller's wallet or on the buyer's cash to ensure the transaction is completed) other than by notifying the custodians for the buyer and seller, and the buyer and seller, of the match. *See* finra-ats-role-in-settlement-of-digital-asset-security-trades-09252020.pdf.

462 Our understanding is that for existing ATSs, custodial services are typically provided by state-chartered trust companies and other state-chartered, limited purpose banking entities.

the rule (*e.g.,* serving as the general partner for a private fund that holds crypto asset securities), and therefore are required to comply with the rule. Some of these advisers, however, may not maintain their client's crypto assets with a qualified custodian, instead attempting to safeguard their client's crypto assets themselves—a practice that is not compliant with the custody rule if those crypto assets are funds or securities and do not meet an exception from the qualified custodian requirement. Other advisers offering similar advisory services may take the position that crypto assets are not covered by the custody rule at all because they believe that crypto assets are neither funds nor securities.[463]

Assets other than publicly traded stocks and bonds have increased.[464] One investment services industry data provider forecasted that global assets under management across alternative asset classes would grow by 60 percent between the end of 2020 and the end of 2025.[465] For example, capital raised in the private equity market was less than $60 billion in 2010. About a decade later, in 2019, capital raised in the private equity market was more than $316 billion.[466] Also, investor interest in physical assets may have increased.[467] As discussed in Section II.D,

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463 This, however, is incorrect because most such assets are likely to be funds or crypto asset *securities* covered by the current rule. *See infra* footnote 29 and accompanying text.

464 Financial Times, "*Global shift into alternative assets gathers pace*," (July 16, 2017,), available at https://www.ft.com/content/1167a4b8-6653-11e7-8526-7b38dcaef614

465 *See. e.g.,* David Lowery & Preqin Blog, "*Future of Alternative 2025: Preqin Forecasts Alternative AUM Growth of 9.8% though to 2025*," (Nov. 4, 2020), available at https://www.preqin.com/insights/research/blogs/preqin-forecasts-alternative-aum-growth-of-9-8-percent-through-to-2025

466 *See., e.g.*, PitchBook, " Data, Inc., *A PE fundraising record could await in 2021*,", (Dec. 15, 2020), available at https://pitchbook.com/newsletter/a-pe-fundraising-record-could-await-in-2021.

467 For example, the creation of art-market indices suggests that interest in physical assets, such as fine art, may have increased. Sotheby's, "*The Sotheby's Mei Moses Indices*," available at https://www.sothebys.com/en/the-sothebys-mei-moses-indices

safeguarding alternative assets may involve unique procedures that differ across each specific asset type and that substantially differ from safeguarding practices with respect to more traditional asset classes (like equities and fixed income products). Additionally, physical assets potentially create more complex challenges with regard to transaction processing, monitoring, and reporting services.[468] The breadth and variety of alternative assets diminish an entity's ability to scale and automate its safekeeping services for efficiency and profitability and, therefore, entities providing safekeeping services may be reluctant to expend the resources necessary to accommodate such assets. As a result, custodians may outsource the safekeeping of alternative assets to entities that specialize in safekeeping certain asset classes.[469]

Staff has observed that custodians often include indemnification clauses in their custodial agreements with customers. Generally, the provisions indemnify custodial customers from losses arising out of or in connection with the custodian's execution or performance under the agreement to the extent the loss is caused by, among other things, the custodian's negligence, gross negligence, bad-faith, recklessness, or willful misconduct.[470] Staff has also observed that the contractual limitations on custodial liability vary between a gross negligence standard and a simple negligence standard. Also, we understand that some custodial agreements contain contractual language addressing when a lien or similar claim will attach to client assets. Finally,

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468 Deloitte, "*The evolution of core financial service. Custodian & Depository Banks*." (2019) available at https://www2.deloitte.com/content/dam/Deloitte/lu/Documents/financial-services/lu-the-evolution-of-a-core-financial-service.pdf

469 *See. e.g.,* Colonnade, "*Alternative Asset Custody Services, Positive Dynamics Power Growth*," Market Commentary – (Jan. 2015), available at https://www.coladv.com/wp-content/uploads/Alt-Asset-Admin-Jan-2015-FINAL.pdf

470 Custodial agreements are generally between an advisory client and a qualified custodian. We do not have data on custodial agreements that would allow us to characterize the relative frequency of various agreement provisions.

staff has observed a practice by custodians in which the custodian lists assets for which it does not accept custodial liability on a client's account statement on an accommodation basis only; the custodian does not attest to the holdings of, or transactions in, those investments or take steps to ensure that the investments are safeguarded appropriately. The custodian reports the holdings or transactions as reported to it by the adviser.

e. Compliance Trends

In 2013, the Commission staff issued a National Exam Program ("NEP") Risk Alert stating that the NEP had observed widespread and varied non-compliance with elements of the custody rule.[471] In reviewing examinations that contained significant deficiencies, the NEP found that approximately one-third (over 140) included custody-related issues. The findings from the examinations resulted in remedial measures taken by advisers, including among other things, drafting, amending or enhancing their written compliance procedures, policies, or processes; changing their business practices; or devoting more resources or attention to the area of custody.

In 2017, the Commission staff issued a NEP Risk Alert reporting that deficiencies or weaknesses related to the custody rule were among the five most frequent compliance topics identified during examinations of investment advisers.[472] Typical examples of deficiencies or weaknesses with respect to the custody rule identified by the staff were: 1) advisers did not

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471 *See. e.g.,* SEC, "*National Exam Program Risk Alert*" (Mar. 4, 2013), available at https://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf.

472 *See. e.g.,* SEC, "National Exam Program Risk Alert" (Feb. 7, 2017), available at https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdfhttps://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf..https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf.

recognize that they may have custody due to online access to client accounts, 2) advisers with custody obtained surprise examinations that did not meet the requirements of the custody rule, and 3) advisers did not recognize that they may have custody as a result of certain authority over client accounts.

In 2021, the Division of Examinations issued a Risk Alert stating that in its experience, a number of activities related to digital asset securities presented specific risks to investors.[473] Included among the risks identified by the Division of Examinations were risks related to advisers' crypto asset custodial practices and their compliance with the custody rule. As discussed above, the custody rule was designed to help ensure advisers adequately safeguard client investments in their custody by requiring advisers to take steps to mitigate the risk that client investments will be lost, misused, stolen, misappropriated, or subject to the financial reverses, including insolvency, of an investment adviser.[474] Crypto assets are not exempt from these risks. Based on that experience, the Division of Examinations indicated that it would continue to review the risks and practices related to crypto asset custody and examine for compliance with the custody rule.[475]

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473 See, Division of Examinations, "Risk Alert: The Division of Examinations' Continued Focus on Digital Asset Securities" (Feb. 26, 2021), available at https://www.sec.gov/files/digital-assets-risk-alert.pdf .

474 *See* Section I *infra*.

475 Specifically the Division of Examinations stated that staff would review: i) occurrences of unauthorized transactions, including theft of digital assets, ii) controls around safekeeping of digital assets (*e.g.*, employee access to private keys and trading platform accounts), iii) business continuity plans where key personnel have exclusive access to private keys, iv) how the adviser evaluates harm due to the loss of private keys, v) reliability of software used to interact with relevant digital asset networks, vi) storage of digital assets on trading platform accounts and with third party custodians, and vii) security procedures related to software and hardware wallets.

D. Benefits and Costs of Proposed Rule and Form Amendments

1. Scope

The proposed rule would change the current rule's scope in two ways. First, it would expand the types of investments covered by the rule beyond a client's funds or securities to include other positions held in a client's account that are not funds or securities. Second, the proposed rule would make explicit that the current rule's defined term "custody" includes discretionary trading authority. The scope of the rule determines, in part, the costs and benefits of the regulatory program set forth by the other components of the proposed rule (the "programmatic effects").

a. Scope of Assets

The proposed rule's expanded scope would include all client assets for which an adviser has custody. The proposed rule would define "assets" as "funds, securities, or other positions held in a client's account."[476] Assets under the rule also would include financial contracts held for investment purposes, collateral posted in connection with a swap contract on behalf of the client, and other assets that may not clearly be funds or securities covered by the current rule. "Other positions held in the client's account" covers current asset types and asset types that develop in the future regardless of their status as funds or securities. The addition of "other positions held in the client's account" would also include crypto assets when not otherwise covered by the rule's references to funds and securities.[477] Further, the proposed rule's use of the term "assets" would not exclude client investments that may appear in the liabilities column of a

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476 Proposed rule 223-1(d)(1).

477 *See* Part II.A, *supra*.

balance sheet or that may be represented as a financial obligation of the client including short positions, written options, or negative cash.

We believe that the proposed rule reduces the risk of loss of client assets by expanding the types of assets covered by the rule beyond "funds and securities." Bringing more categories of assets into the scope of the rule's requirements will protect investors because the assets will be subject to custodial safeguards. Expanding the scope of the rule will also reduce uncertainty over the status of assets under advisement that must be held in the custody of a qualified custodian, thereby reducing the legal risk associated with advisory services and custodial arrangements for the assets. This may increase investment opportunities and the availability of advisory services for those assets. Looking forward, the proposed definition of assets is designed to remain evergreen, encompassing new investment types as they continue to evolve and to recognize that the protections of the rule should not depend on which type of assets the client entrusts to the adviser.

Expanding the scope of the custody rule to include client assets instead of only client funds and securities would also involve costs. We expect that this expansion in scope would cause advisers to incur compliance costs in connection with these newly covered investment positions. Accordingly, advisers with custody of such assets would incur additional costs to ensure their safeguarding practices with respect to such assets comply with the custody rule; for example, the costs associated with finding a qualified custodian that is able to take possession or control of these assets. Rather than incur such costs, advisers may continue providing advice with respect to clients' funds and securities, but stop providing advice with respect to clients'

other assets within the scope of the expanded rule.[478] Investment advisers may accordingly eliminate the aspect of their services that gives them custody (they may decline the authority to hold or take possession of the other assets, including any discretionary authority to withdraw or transfer beneficial ownership of such assets). To the extent clients benefit from advice on such other assets – which may be merely ancillary to advice on funds and securities – investors would no longer receive these benefits.[479] Also, advisers would forego any fees associated with providing such services.

The expanded scope of assets subject to the proposed rule could create other costs. For example, as discussed above, the staff has observed a growing number of state-chartered trust companies and other state-chartered, limited purpose banking entities now offering custodial services for crypto assets. Also, the staff has observed an increase in the number of entities that provide platform users with the ability to transact in crypto assets. In connection with these services, these entities and/or their agents might safeguard the platform user's crypto asset(s) and also maintain the cryptographic key information necessary to access the crypto asset.

The expanded scope of assets subject to the proposed rule could create costs for those advisers (and their clients) with custody of crypto assets that are not funds or securities subject to

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478 Analysis described in Section III.C.3.d indicates that seven advisers either currently advise, or are planning to advise, a pooled investment vehicle (such as a private fund or commodity pool) that holds some crypto assets. To the extent these pooled investment vehicles hold crypto assets that may be outside of the current rule's scope (*i.e.,* they are neither funds nor securities), those assets would be within the scope of the proposed rule. To the extent that it becomes cost-prohibitive for advisers to find a qualified custodian, or otherwise comply with the proposed rule with respect to these newly covered crypto assets, we believe that advisers may choose to cease providing advisory services to pooled investment vehicles holding such assets,, implying these pooled investment vehicles may no longer be offered to investors.

479 To the extent competition in the market for those aspects of services that gives advisers custody is linked to the number of advisers offering such services, advisers choosing to eliminate the aspect of their services that gives them custody could result in a reduction in competition. A reduction in competition could result in higher fees for investors, lower quality services, or some combination of the two.

the current custody rule. For example, to the extent advisers have custody of client crypto assets that are not funds or securities and those assets are maintained with state-chartered trust companies, other state-chartered, limited purpose banking entities, and entities providing platform users with the ability to transact in crypto assets who may choose not to make the changes necessary to satisfy all of the requirements to act as a qualified custodian under the proposed rule, the proposed rule would require such crypto assets to be removed from those entities. Removing assets from those entities could create costs for investors. For example, there would be costs associated with switching from one entity to another. As we noted in Section II.C.3, the technical requirements for transacting and safeguarding crypto assets are likely to differ from those of traditional assets that include stocks, bonds, and options. The proposed rule could cause investors to remove their assets from an entity that has developed innovative safeguarding procedures for those assets, possibly putting those assets at a greater risk of loss. These costs would be mitigated, however, to the extent existing qualified custodians develop, or otherwise acquire, innovative safeguarding procedures for crypto assets, or are able to contract with specialized sub-custodians, as a result of the proposed rule.

If investors remove newly scoped-in assets from entities currently providing safeguarding services, those entities providing safeguarding services will experience a decline in fees because they would be providing custody for fewer assets. For example, if investors remove their crypto assets that are not funds or securities subject to the current rule from entities such as state-chartered trust companies, other state-chartered, limited-purpose banking entities, and entities providing platform users with the ability to transact in crypto assets, those entities could experience a decline in fees. The extent of the decline in fees would depend on investors' holdings of crypto assets that are not funds or securities subject to the current rule, the rates

charged by those entities for safeguarding crypto assets, as well as the extent to which investors remove their crypto assets from those entities. We do not have data that would allow us to predict accurately investor holdings of crypto assets or the extent to which investors would remove crypto assets from those entities, or the resulting effect on profitability. A sufficiently large decline in profitability could lead such entities to reconsider their business models or exit the business altogether.

This aspect of the proposed rule could create additional costs as well. Independent public accountants would have to perform verification procedures over a larger universe of investments which could increase the cost of performing verification procedures. Absent an increase in the capacity of independent public accountants, the increased demand on the services of independent public accountants resulting from having to perform verification procedures over a larger universe of assets could result in increased costs for accountant services generally. To the extent independent public accountants reallocate resources away from other services to meet the increased demand for asset verification, other services provided by independent public accountants could become more costly. That said, as a result of requiring that all assets be held in the possession or control of a qualified custodian, performing verification procedures may be less labor-intensive and less costly than under the current rule.

b. Scope of Activity Subject to the Proposed Rule

The proposal would generally preserve the current rule's definition of "custody". The current definition of custody includes three categories that serve as examples of custody including certain arrangements when the adviser is authorized or permitted to instruct the client's custodian. The proposed rule would explicitly identify discretionary trading authority as an arrangement that triggers the rule. An adviser with this ability or authority can subject a

client's assets to the risks of loss, misuse, misappropriation, theft, or financial reverses of the adviser. The proposed rule would also expand the scope of subject activity by explicitly identifying discretionary trading authority as an arrangement that triggers the rule.

The authority for discretionary trading presents the kinds of risks to client assets that the rule is designed to address. When advisers have this authority, they have the ability to sell or purchase assets for the client's account without first obtaining client consent. This creates an opportunity for an adviser to put those assets at risk of loss, misuse, misappropriation, theft, or financial reverses of the adviser. If an adviser has custody solely because the adviser has discretionary authority that is limited to instructing the custodian to transact in assets that settle on a DVP basis, the risk of loss is less pronounced, though not completely eliminated, when a client's custodian must participate in the transaction. In those cases, the custodian will observe, and record on a client's account statement, that assets are transferred out of a client's account only upon corresponding transfer of other assets of equal value into the account. Although the risk of loss is not reduced to zero in these situations, the client is at least on notice via the account statement from the custodian that a transaction has occurred. The proposed rule would thus benefit clients by extending the protections of the rule, namely the protections of the qualified custodian and the account statement reporting, to instances where an adviser has discretionary trading authority. The benefits will be mitigated to the extent that advisers comply with the rule today for reasons other than discretionary trading authority.

Advisers who currently do not need to comply with the rule for this type of authority will bear the costs of compliance with the rule. Those costs will be mitigated to the extent that advisers comply with the rule today for reasons other than discretionary trading authority. For example, if advisers also have a general power of attorney with respect to the same assets, such

advisers already have custody of these assets under the current rule. For advisers that will be newly subject to the rule as a result of this change, the costs of compliance will be reduced if discretionary trading authority is their sole reason for having custody because they will not have to comply with the surprise examination requirement.[480]

Investment advisers with custody of client assets because of discretionary trading authority may continue to provide discretionary trading services to their clients, or, as discussed above, they may choose to no longer provide advice on assets which are not funds or securities and, accordingly, no longer exercise custody (including discretionary trading) for such other assets as a result of the compliance costs. If advisers choose to no longer offer discretionary trading services for assets other than funds or securities, to the extent clients benefit from those discretionary trading services, investors would bear a cost associated with the loss of those services or with finding an investment adviser that provides them.

2. Qualified Custodian Protections

As discussed in Section II.B above, the proposed rule would require investment advisers to maintain client assets with a qualified custodian having "possession or control" of client assets pursuant to a written agreement between the qualified custodian and the investment adviser. The term "possession or control" would mean holding assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets, the qualified custodian's participation would effectuate the transaction involved in the change in beneficial

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480 Proposed rule 223-1(b)(9).

ownership, and the qualified custodian's involvement is a condition precedent to the change in beneficial ownership. In the case of a qualified custodian that is the adviser, the proposed rule would require that the written agreement be between the adviser and the client.[481]

The proposed rule also would require the adviser to obtain reasonable assurances in writing from the custodian regarding certain vital protections for the safeguarding of client assets. If the qualified custodian is the adviser, the proposed rule would require that the reasonable assurances be part of the written agreement between the adviser and the client, described above.[482]

a. Definition of Qualified Custodian

Banks. The current rule includes in the definition of qualified custodian a bank as defined in section 202(a)(2) of the Advisers Act (15 U.S.C. 80b-2(a)(2)) or a savings association as defined in section 3(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(b)(1)) that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act (12 U.S.C. 1811). The proposed rule would largely retain this definition of qualified custodian relating to banks and savings associations. However, in connection with the proposed rule's focus on setting certain minimum protections for client assets, the rule would require that a qualifying bank or savings association hold client assets in an account designed to protect such assets from creditors of the bank or savings association in the event of the insolvency or failure of the bank or savings association in order to qualify as a qualified custodian. While applicable insolvency law and procedures vary depending on any particular

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481 Proposed rule 223-1(a)(1)(i).

482 Proposed rule 223-1(a)(1)(ii)

bank's regulatory regime, we understand that assets held in these accounts are more likely to be returned to clients upon the insolvency of the qualified custodian because they may pass outside of a bank's insolvency, may be recoverable if wrongly transferred or converted, and are not treated as general assets of the bank.[483]

We believe that requiring banks and savings associations to hold client assets in an account designed to protect such assets from creditors of the bank or savings association in the event of the insolvency or failure of the bank or savings association would benefit clients by providing client assets with enhanced protection from general creditors in the event of the qualified custodian's insolvency or failure and increasing the likelihood of return of client assets to advisory clients upon a qualified custodian's insolvency or failure. We acknowledge, however, that the benefit would be limited to the clients of those qualified custodians that would not be subject to the resolution processes deployed by the FDIC or by the OCC or have not developed and deployed comprehensive custodial service agreements governing their relationships with their custodial customers. For those custodians that would not be subject to the resolution processes deployed by the FDIC or by the OCC or have not developed and deployed comprehensive custodial service agreements governing their relationships with their custodial customers, we estimate that changing the terms of account agreements to comply with the proposed account requirement would require 1 hour from an assistant general counsel ($510/hour) and 5 hours from a paralegal ($199/hour), for a total estimated cost of $1,505 per agreement.

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483 *See supra* footnote 96.

Foreign Financial Institutions. The proposed definition of qualified custodian would continue to include FFIs, but would require an FFI to satisfy certain additional conditions in order to serve as a qualified custodian for client investments. For an FFI to be a qualified custodian under the proposed rule, it would need to be:

- Incorporated or organized under the laws of a country or jurisdiction other than the United States, provided that the adviser and the Commission are able to enforce judgments, including civil monetary penalties, against the FFI;
- Regulated by a foreign country's government, an agency of a foreign country's government, or a foreign financial regulatory authority[484] as a banking institution, trust company, or other financial institution that customarily holds financial assets for its customers;
- Required by law to comply with anti-money laundering and related provisions similar to those of the Bank Secrecy Act [31 U.S.C. 5311, et seq.] and regulations thereunder;
- Holding financial assets for its customers in an account designed to protect such assets from creditors of the foreign financial institution in the event of the insolvency or failure of the foreign financial institution;
- Having the requisite financial strength to provide due care for client assets;

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484 Defined in section 202(a)(24) of the Advisers Act [15 U.S.C. 80b-2(a)(24)].

- Required by law to implement practices, procedures, and internal controls designed to ensure the exercise of due care with respect to the safekeeping of client assets; and
- Not operated for the purpose of evading the provisions of the proposed rule.[485]

As discussed in Section II.B.1.b above, these proposed conditions are partly drawn from our experience with the conditions on the types of foreign financial entities that can act as "eligible foreign custodians" as defined in rule 17f-5 under the Investment Company Act.[486] Such conditions are designed to provide enhanced investor protections for advisory clients and their assets that we believe would help promote an FFI having generally similar protections as a U.S.-based qualified custodian.

Advisory clients often invest in securities traded on foreign exchanges and their advisers must, as a practical matter, maintain securities with financial institutions in foreign countries where the securities are traded. In order to facilitate these types of holdings, the current rule includes any FFI that customarily holds financial assets for its customers, as qualified custodian, provided that the FFI keeps the advisory clients' assets in customer accounts segregated from its proprietary assets. The proposed new conditions would require that an FFI have similar protections as a U.S.-based qualified custodian, thereby enhancing investor protections for advisory clients by reducing the risk of loss of their securities and other financial assets held outside the United States. For example, for an FFI to be a qualified custodian under the proposed rule it would need to be regulated by a foreign country's government, an agency of a

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485 Proposed rule 223-1(d)(10)(iv).

486 Furthermore, the proposed rule would replace and strengthen the segregation requirement applicable to FFIs in the current custody rule, and it is designed to complement the proposed segregation requirements of the safeguarding rule.

foreign country's government, or a foreign financial regulatory authority as a banking institution, trust company, or other financial institution that customarily holds financial assets for its customers. An FFI also would have to be required by law to comply with AML requirements and related requirements comparable to those of the Bank Secrecy Act.[487] We believe the requirement to comply with AML and related provisions similar to those of the BSA and regulations thereunder would help increase the likelihood that the FFI would readily identify and investigate aberrant behavior in a client account, such as activity that might suggest misappropriation or some other type of loss to a client. An FFI also would have to hold financial assets for its customers in an account designed to protect such assets from creditors of the foreign financial institution in the event of the insolvency or failure of the foreign financial institution. We believe this requirement would help to promote investor protections that are more comparable, particularly in the event of an FFI insolvency or bankruptcy, to those we are proposing for assets held with U.S.-regulated bank or savings association qualified custodians.

FFIs that no longer meet the conditions to be a qualified custodian would either incur costs to become compliant, or incur costs in the form of lost custodial business, and potential loss of other banking business from the same clients. Clients of FFIs that incur costs to become compliant may experience higher fees. Clients whose assets were maintained with banks and savings associations that do not comply with the proposed requirements would incur one-time costs related to switching custodians or, if no financial institutions qualify as custodians in a

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487 Proposed rule 223-1(d)(10)(iv)(C); see also pt. II.B.1 and *supra* note 95.

country where securities are traded on a foreign exchange,[488] costs associated with divestiture, potentially at a loss. Advisers would incur costs associated with loss of client assets under management. The magnitude of these costs would depend on the number of client accounts and the quantity of assets affected.[489]

b. Possession or Control

Under the custody rule, advisers with custody of client funds and securities must maintain them with a qualified custodian, subject to certain exceptions.[490] The proposed rule would require that an investment adviser with custody of client assets maintain those assets with a qualified custodian that must maintain possession or control of those assets.[491] The term "possession or control" would mean holding assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets, the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership, and the qualified custodian's involvement is a condition precedent to the change in beneficial ownership.[492]

The proposed requirement would benefit clients in several ways. First, a critical custodial function is to prevent loss or unauthorized transfers of ownership of client assets. It is our understanding that a custodian will only provide this safeguarding function and assume custodial liability for a custodial customer's loss if the custodian has possession or control of the

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488 This could occur if, for example, if the country does not have a regulatory framework equivalent to the Bank Secrecy Act requirements for reporting transactions to financial intelligence authorities.

489 We do not have data on the number of client accounts and the quantity of assets affected.

490 *See* rule 206(4)-2(a)(1).

491 *See* proposed rule 223-1(a)(1)(i).

492 *See* proposed rule 223-1(d)(8).

asset that is lost. Second, because the qualified custodian would be required to participate in any change in beneficial ownership of a client asset, the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership, and the qualified custodian's involvement is a condition precedent to the change in beneficial ownership, the proposed possession or control definition would provide assurance to the client that a regulated party who is hired for safekeeping services by the client to act for the client is involved in any change in beneficial ownership of the client's assets. Further, clients would be able to review their account statements to evaluate the legitimacy of any movement within their account, whether it is a trade, a payment, or a fee withdrawal. Finally, clients could take greater comfort that what is reported on their account statements is an accurate attestation of holdings and transactions because anything held by a qualified custodian would be required to be in its possession or control.

The proposed definition is designed to be consistent with the laws, rules, or regulations administered by the qualified custodian's functional regulator for purposes of its custodial activities. As detailed in Section II.C.2 above, this would include Exchange Act requirements for broker-dealers, regulatory requirements for national banks, Commodity Exchange Act requirements for FCMs, as well as the broad range of regulatory requirements for FFIs. Given the proposed definition's consistency with the laws, rules, or regulations administered by a qualified custodian's functional regulator, we believe the additional cost of the proposed definition of "possession or control" on qualified custodians would be minimal.

It is our understanding that custodians have been unwilling or unable to take possession or control of certain investments, such as a variety of privately issued securities. Advisers sometimes request that custodians report these securities as an "accommodation" on a custodial

account statement so that the client is aware of their existence. We acknowledge, however, that to the extent account statements provided by a qualified custodian on an accommodation basis offer a client the ability to review all of its investments in a single consolidated account statement, and potentially alert a client or an auditor to the existence of an investment, the proposed rule's elimination of the custodian's ability to provide account statements on an accommodation basis could impose a cost on investors. Clients would bear costs to collect information from multiple sources rather than relying on a single consolidated account statement.[493] If a client requests such assets be included on its account statement, the account statement may identify the assets, but only if the account statement clearly indicates that the custodian does not have possession or control of the assets.[494]

c. Reasonable Assurances

We understand that under existing market practices, advisers are rarely parties to the custodial agreement, which is generally between an advisory client and a qualified custodian. The proposed rule would require an adviser to obtain reasonable assurances in writing from qualified custodians regarding certain vital protections for the safeguarding of client assets and that the adviser maintain an ongoing reasonable belief that the custodian is complying with the client protections for which the adviser obtains reasonable assurances.

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493 It is possible that the requirement could lead to reduced costs for custodians. Our understanding, however, is that the custodian merely reports the holdings or transactions as reported to it by the adviser - the custodian does not attest to the holdings of or transactions in those investments or take steps to ensure that the investments are safeguarded appropriately. As a result, we would expect cost savings for custodians to be minimal.

494 *See supra* note 185.

i. Benefits

Due Care. The proposed rule would require that the adviser obtain reasonable assurances from the qualified custodian that the qualified custodian will exercise due care in accordance with reasonable commercial standards in discharging its duty as custodian and will implement appropriate measures to safeguard client assets from theft, misuse, misappropriation, or other similar types of loss.[495] We recognize that the appropriateness of the measures required to safeguard assets varies depending on the asset.[496] We believe such appropriate measures would, in turn, mitigate the risk to client assets from theft, misuse, misappropriation, or other similar types of loss.

Indemnification. The proposed rule would require the adviser to obtain reasonable assurances from the qualified custodian that the qualified custodian will indemnify the client (and will have insurance arrangements in place that will adequately protect the client) against the risk of loss in the event of the qualified custodian's own negligence, recklessness, or willful misconduct.[497] Our staff has observed that custodians often include indemnification clauses in their custodial agreements with customers. Staff has also observed that the contractual limitations on custodial liability vary widely in the marketplace, in some instances reducing a qualified custodian's liability to such an extent as to not provide an appropriate level of investor protection. By requiring advisers to obtain reasonable assurances from the qualified custodian that the qualified custodian will indemnify the client against the risk of loss in the event of the qualified custodian's own negligence, recklessness, or willful misconduct, the proposed rule

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495 Proposed rule 223-1(a)(1)(ii)(A).

496 *See* discussion in Section II.B.3.a.i and supra footnote 154.

497 Proposed rule 223-1(a)(1)(ii)(B).

seeks to create a minimum floor of custodial protection for investors in the event of custodial misconduct (*i.e.*, simple negligence). For those investors whose qualified custodians indemnify the client against the risk of loss in the event of the qualified custodian's gross negligence, the proposed requirement that an adviser obtain reasonable assurances from the qualified custodian that the qualified custodian will indemnify the client against the risk of loss in the event of the qualified custodian's own negligence, recklessness, or willful misconduct would likely operate as a substantial expansion in the protections provided by qualified custodians to advisory clients by preventing these custodians from disclaiming liability for misconduct that does not rise to the level of gross negligence.

Sub-custodian or Other Similar Arrangements. The proposed rule would require the adviser to obtain reasonable assurances from the qualified custodian that the existence of any sub-custodial, securities depository, or other similar arrangements with regard to the client's assets will not excuse its obligations to the client.[498]

As discussed in Section II.B.3.a.3 outsourcing has become increasingly common in the custodial space, whether outsourcing of back-office functions or the core function of safeguarding a custodial customer's assets. Additionally, we understand that the delegation of safeguarding to sub-custodians can result in opaque structures; for example, involving several FFI sub-custodians in different countries. This proposed requirement would enhance investor protections by reducing the ability of a qualified custodian to avoid responsibility for the other important safeguarding obligations it has to the advisory client by delegating custodial responsibility to a sub-custodian, securities depository, or other similar arrangements. To the

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[498] Proposed rule 223-1 (a)(1)(ii)(C).

extent advisory clients are aware of risks resulting from a qualified custodian delegating its safeguarding obligations to a sub-custodian, we believe that this requirement would give advisory clients greater confidence that their assets maintained with a qualified custodian would not lose protections as a result of such a delegation.

Segregation of Client Assets. The proposed rule would require the adviser to obtain reasonable assurances from the qualified custodian that the qualified custodian will clearly identify the client's assets as such, hold them in a custodial account, and segregate them from the qualified custodian's proprietary assets.[499] The proposed requirement would benefit investors by helping to ensure that client assets are at all times readily identifiable as client property and remain available to the client even if the qualified custodian becomes financially insolvent. We believe this proposed requirement would also benefit clients by helping to protect client assets from claims by a qualified custodian's third-party creditors looking to secure or satisfy an obligation of the qualified custodian. We believe that the proposed requirement would also benefit clients by helping to identify clearly client assets as belonging to the appropriate client and, in the context of an FFI in a region facing political risk, we believe these actions would help to preserve the client's interests in the event of a government taking.

No Liens Unless Authorized in Writing. The proposed rule would require the adviser to obtain reasonable assurances from the qualified custodian that the qualified custodian will not subject client assets to any right, charge, security interest, lien or claim in favor of the qualified custodian or its related persons or creditors, except to the extent agreed to or authorized in writing by the client.[500] This requirement would benefit clients by discouraging qualified

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499 Proposed rule 223-1(a)(1)(ii)(D).

500 *See* proposed rule 223-1(a)(1)(ii)(E).

custodians from using client assets in a manner not authorized by the client, reducing the risk of loss of client assets. The requirement would also help reduce the risk of the loss of client assets to claims by the qualified custodian, or a third party looking to secure or satisfy an obligation of the qualified custodian, including in cases of the qualified custodian's insolvency or bankruptcy. The magnitude of the benefits will depend on the extent to which such arrangements may already be common. As discussed in Section II.B.3.a.v, we believe that many qualified custodians maintain their custodial customer assets free of liens and similar claims, other than those agreed to or authorized in writing by the client. Further, we understand that some custodial agreements contain contractual language addressing when a lien or similar claim will attach to client assets.

ii. Costs

Obtaining Reasonable Assurances. The proposed rule would require an adviser to obtain reasonable assurances in writing from a qualified custodian regarding certain client protections. As discussed above, one way that advisers are likely to satisfy this requirement is by seeking confirmation from a qualified custodian that the custodial agreement with the advisory client contains contractual language reflecting the reasonable assurances required by the rule. The reasonable assurances requirement could also require conforming changes in custody agreements between clients and qualified custodians. The cost of obtaining reasonable assurances and conforming changes in custody agreements include costs attributable to attorneys and compliance professionals, both prior to and at the inception of the relationship between a client and a qualified custodian as well as over the life of the relationship. We describe the nature of these costs in detail below. For purposes of the Paperwork Reduction Act, we estimate that qualified custodians and advisers will incur aggregate initial costs of $27,469,680 associated

with advisers obtaining reasonable assurances from qualified custodians.[501] The requirements that an adviser obtain reasonable assurances from qualified custodians also will require due diligence and periodic monitoring by the adviser. For purposes of the Paperwork Reduction Act, we estimate that qualified custodians and advisers will incur aggregate ongoing annual costs of $5,493,936 associated with advisers obtaining reasonable assurances from qualified custodians.[502]

Due Care. The proposed due care requirement is the same as the standard that generally applies to custodians under Article 8 of the Uniform Commercial Code.[503] As a result, we believe the proposed standard of care is not uncommon in the custodial market, and that financial institutions acting as qualified custodians are familiar with it. We believe, however, that the standard of care is not universal in the custodial market. As discussed above, this requirement may result in certain qualified custodians incurring costs to change the terms of their custodial agreements with advisory clients to incorporate this standard.[504]

Indemnification. As discussed above, staff has observed that the contractual limitations on custodial liability vary widely in the marketplace. The proposed rule seeks to create a minimum floor of custodial protection for investors in the event of custodial misconduct. First, the proposed simple negligence requirement could impose operational costs on those custodians holding advisory client assets subject to a gross negligence standard. The operational costs would include the costs of adapting existing systems and processes to meet the more stringent

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501 *See infra* footnote 620.

502 *See infra* footnote 622.

504 *See infra* footnote 619

simple negligence standard. Second, the insurance requirement of the proposed indemnification requirement would likely create a substantial increase in the cost of liability insurance for custodians that currently do not insure against loss resulting from simple negligence. We note, however, that operational costs and costs of liability insurance would be mitigated to the extent custodians who currently hold client assets subject to a gross negligence standard already have systems, processes and liability insurance that are consistent with a simple negligence standard.

Sub-custodian or Other Similar Arrangements. As discussed above, staff has observed custodial agreements addressing the use of sub-custodians that seek to contractually limit the custodian's liability for acts or omissions of the sub-custodian in a variety of ways, including expressly limiting the contractual liability of the custodian for acts of the sub-custodian, as well as limiting the affirmative steps the custodian may be required to take in connection with any loss of client assets as a result of the sub-custodian's willful default or insolvency. The proposed reasonable assurances requirement could impose operational costs on those custodians who make use of sub-custodial, securities depository, or other similar arrangements and who would seek to disclaim responsibility in circumstances where a loss or other failure to satisfy its obligations to the client can be attributed to a sub-custodian or other third party selected by the qualified custodian. The operational costs would include the costs of adapting existing systems and processes to meet the proposed requirement. We note, however, that the costs would be mitigated to the extent custodians who make use of sub-custodial, securities depository, or other similar arrangements already have systems and processes in place that are consistent with the proposed requirement.

Segregation of Client Assets. We understand that custodial agreements between advisory clients and qualified custodians may currently contain a contractual provision requiring

segregation of client assets from the custodian's assets. In addition, we understand that many qualified custodians are currently required by their functional regulator to segregate assets. The proposed segregation requirements are drawn from rule 15c3-3 of the Exchange Act. To the extent existing regulatory requirements for qualified custodians are the same or similar to the requirements of 15c3-3, the costs of adapting existing systems may be mitigated for broker-dealers who act as qualified custodians. For example, rule 15c3-3 of the Exchange Act requires broker-dealers to safeguard their customer assets and keep customer assets separate from the firm's assets. Given their existing regulatory requirements, we believe custodian broker-dealers already have systems to segregate customer assets from their own and, as a result, the cost of the proposed requirement for broker-dealer qualified custodians largely would be mitigated. Other regulatory regimes have adopted similar requirements. For example, under the Commodity Exchange Act, futures commission merchants are required to segregate customer assets from their own assets.[505] Because futures commission merchants already have systems to segregate customer assets from their own, we believe their cost of meeting the segregation requirement of the proposed rule would also largely be mitigated for futures commission merchants.

We believe, however, that not all financial institutions that serve as qualified custodians are required to segregate and identify their client assets, particularly FFIs. In addition, for those qualified custodians that are required to segregate and identify their client assets, the extent of those activities varies.[506] To the extent certain custodians currently do not segregate client

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505 *See* discussion in Section III.C.1.

506 *See*, *e.g.,* 12 U.S.C. 92(c) and 12 U.S.C. 1464(n)(2) (requiring national banks and federal savings associations to segregate all assets held in any fiduciary capacity from their general assets and to keep a separate set of books and records showing all transactions in these accounts); section 4d(a)(2) of the Commodity Exchange Act (requiring FCMs to segregate from their own assets all money, securities and

assets, the reasonable assurances requirement in the proposed rule would result in qualified custodians adapting existing systems and processes to meet the proposed requirement.

No Liens Unless Authorized in Writing. The rule would not prohibit liens and the other claims addressed in the proposed rule, but would require that the adviser obtain reasonable assurances from the qualified custodian that the client has authorized in writing any right, charge, security interest, lien, or claim in favor of the qualified custodian or its related persons or creditors. The proposed reasonable assurances requirement could impose operational costs on those custodians who make use of liens and the other claims addressed in the proposed rule. The operational costs would include the costs of adapting existing systems and processes to ensure that qualified custodians get written client authorization. The proposed requirement may also result in qualified custodians adding a conforming provision to custodial agreements for those clients that authorize such claims. Doing so would result in an additional burden for those qualified custodians. We believe that many qualified custodians maintain their custodial customer assets free of liens and similar claims, other than those agreed to or authorized in writing by the client. Further, we understand that some custodial agreements contain contractual language addressing when a lien or similar claim will attach to client assets. Operational costs and the cost of adding conforming provisions for those clients that authorize such claims would be mitigated to the extent qualified custodians already have such systems and provisions in place.

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other property deposited by futures customers to margin, secure, or guarantee futures contracts and options on futures contracts traded on designated contract markets).

d. Written Agreement

The proposed rule would require advisers to enter into a written agreement with a qualified custodian based upon a reasonable belief that certain contractual provisions have been implemented. Further, during the term of the written agreement and related advisory relationship, advisers generally should have a reasonable belief that the qualified custodian is complying with the contractual obligations of the agreement and continuing to provide the protections to client assets for which the adviser obtained reasonable assurances from the qualified custodian.

We discuss the benefits and costs of the proposed written agreement requirement below. The magnitude of both the benefits and costs of the proposed written agreement requirement would depend on the extent to which advisers currently are party to custodial agreements, and advisers' actions to ensure that the elements of the written agreements are effective and being met.[507]

i. Benefits

Under the proposed rule, one provision would require the qualified custodian to provide promptly, upon request, records relating to clients' assets held in the account at the qualified custodian to the Commission or to an independent public accountant engaged for purposes of complying with the rule. Another provision would specify the adviser's agreed-upon level of authority to effect transactions in the account. A third provision would require the qualified custodian to deliver account statements to clients and to the adviser, whereas currently, advisers must only have a reasonable basis for believing that clients are receiving these account

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[507] While we understand that advisers are rarely parties to the custodial agreement, which is generally between an advisory client and its qualified custodian, we lack quantitative data to confirm this understanding.

statements upon due inquiry. The fourth provision would require the qualified custodian to obtain a written internal control report that includes an opinion of an independent public accountant regarding the adequacy of the qualified custodian's controls.

Record Sharing. The proposed rule would require that the written agreement with the qualified custodian include a provision requiring the qualified custodian to provide, promptly, upon request, records relating to client assets to the Commission or an independent public accountant engaged for purposes of compliance with the rule.[508] We understand, currently, that accountants often struggle to obtain – or to obtain timely – information from qualified custodians when performing surprise examinations under the current rule unless the advisory client requests that the qualified custodian share the information. We believe that accountants likely struggle to obtain information from qualified custodians because the qualified custodian has no contractual agreement with the adviser or the accountant that has been hired by the adviser. We believe that the proposed contractual requirement would mitigate these record access challenges because the qualified custodian would be in direct contractual privity with the adviser and would have a contractual obligation to provide the records required by the rule—potentially reducing the costs attributable to completing a surprise examination under the rule.

Account Statements. The proposed rule would require that the written agreement provide that the qualified custodian will send account statements (unless the client is an entity whose investors will receive audited financial statements as part of the financial statement audit process pursuant to the proposed rule), at least quarterly, to the client and the investment adviser,

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[508] Proposed rule 223-1(a)(1)(i)(A).

identifying the amount of each client asset in the custodial account at the end of the period as well as all transactions in the account during that period.[509] We believe that the delivery of quarterly account statements to the adviser, which is a new requirement, would allow the adviser to more easily perform account statement reconciliations. We believe that qualified custodians' delivery of account statements directly to advisory clients enhances investor protections by facilitating clients' ability to verify adviser conduct as well as client assets. We also continue to believe that qualified custodians' delivery of account statements directly to advisory clients – without the involvement of the adviser – helps provide clients with confidence that any erroneous or unauthorized transactions by an adviser would be reflected in the account statement and, as a result, would deter advisers from fraudulent activities.[510]

The proposed rule would also require a provision prohibiting the account statement from identifying assets for which the qualified custodian lacks possession or control, unless requested by the client and the qualified custodian clearly indicates that the custodian does not have possession or control over such assets. We believe the proposed requirement would enhance investor protections by enhancing the integrity and utility of the account statements, thereby reducing the risk investors are misled or become confused about those assets for which the custodian is responsible in the event of a loss.

Internal Control Report. The proposed rule would require that the written agreement with the qualified custodian provide that the qualified custodian, at least annually, will obtain, and provide to the investment adviser a written internal control report that includes an opinion of

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509 Proposed rules 223-1(a)(1)(i)(B), 223-1(b)(4).

510 Rule 206(4)-2(a)(3) requires the adviser to have reasonable belief upon due inquiry that the qualified custodian delivers quarterly account statements to the client.

an independent public accountant as to whether controls have been placed in operation as of a specific date, are suitably designed, and are operating effectively to meet control objectives relating to custodial services (including the safeguarding of the client assets held by that qualified custodian during the year). The objectives and scope of the proposed internal control report are substantially the same as those of the internal control report required under the current rule, but would expand the requirement to all qualified custodians as opposed to the current rule, which only requires the internal control report when the adviser or its related person acts as a qualified custodian.

In circumstances where the qualified custodian is not the adviser or its related person, we believe the proposed requirement would help enhance investor protections by ensuring that the qualified custodian's controls with respect to its safeguarding practices are routinely evaluated in a timely manner by an independent third party. Also, in those circumstances where qualified custodians currently obtain internal control reports, the scope of those reports likely covers the financial institutions' safeguarding activities for "funds and securities" rather than all "assets," as defined in the proposed amendments. We believe the proposed requirement would help enhance investor protection by expanding the scope of internal control reports to cover safeguarding actives for "assets" rather than "funds and securities." We believe the requirement that auditors must be independent in fact and in appearance contributes to investor protection and investor confidence in connection with the relationship between an auditor and the qualified custodian. Unlike the current rule that only requires an internal control report when the adviser or its related person acts as a qualified custodian, the proposed rule would mitigate risks to client assets regardless of the affiliation of the qualified custodian.

Under circumstances where the proposed rule requires the engagement of a PCAOB-registered and inspected public accountant, we anticipate that the proposed rule will have client protection benefits. As the Commission noted in adopting the current custody rule, the Commission has greater confidence in the quality of the processes followed by an independent public accountant registered with, and subject to regular inspection by, the PCAOB.[511,512] We believe that registration and the periodic inspection of an independent public accountant's system of quality control by the PCAOB would provide clients with confidence in the quality of the reports produced under the proposed rule.

Adviser's Level of Authority. The proposed rule would require that the adviser's written agreement with the qualified custodian specify the investment adviser's agreed-upon level of authority to effect transactions in the custodial account as well as any applicable terms or

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511 *See* Custody Rule Amendments Adopting Release*, supra* footnote 11, at 17.

512 For example, in response to our 2009 proposed Custody Rule amendments requiring the use of PCAOB-registered independent public accountants for annual surprise examinations in certain circumstances, many commenters agreed with our belief that PCAOB registration and inspection provided an important quality check on the independent accountants providing those examinations. *See* comment letter of Investment Adviser Association (July 24, 2009); comment letter of The National Association of Active Investment Managers (July 27, 2009); comment letter of Timothy P. Turner (July 27, 2009); comment letter of American Bar Association (Committee on Federal Regulation of Securities) (July 28, 2009); comment letter of Curian Capital LLC, Financial Wealth Management, Inc., LPL Financial Corporation, and SEI Investments Company (July 28, 2009); comment letter of Ernst & Young (July 28, 2009); comment letter of Financial Planning Association (July 28, 2009); comment letter of Coalition of Private Investment Companies (July 31, 2009); comment letter of North American Securities Administrators Association, Inc. (Aug. 5, 2009). Academic research suggests that PCAOB registration and inspection is associated with higher quality engagements. *See, e.g.,* Mark L. DeFond & Clive S. Lennox, *Do PCAOB Inspections Improve the Quality of Internal Control Audits*? (Sept. 2015), available at https://pcaobus.org//News/Events/Documents/10222015_CEA/PCAOB-Inspections-Internal-Control-Audits-DeFond_Lennox.pdf. DeFond and Lennox (2015) posit that auditors are motivated to receive clean inspection reports from the PCAOB because adverse inspection outcomes are detrimental to the auditors' compensation (Johnson, Lindsay, Marsha Keune & Jennifer Winchel, Auditors' Perceptions of the PCAOB Process (2015) working paper, University of Virginia). They also note that the PCAOB has broad powers within its jurisdiction to sanction individual auditors and firms that provide substandard audits, which provides further incentive for auditors to perform high quality audits.

limitations.[513] As discussed in Section II.B.3.b.iv above, our understanding is that custodial agreements between advisory clients and qualified custodians often contain provisions that give investment advisers authority over their clients' custodial accounts that may be broader than what the adviser and client have agreed to in their advisory agreements. For example, an adviser may not have authority under its advisory agreement with a client to instruct the client's custodian to disburse client assets, or the advisory agreement may not be entirely clear on the level of authority granted to the adviser. If, however, the client's agreement with its qualified custodian grants the adviser broad authority over the client's account, the qualified custodian will accept and act upon instructions from the adviser to disburse or transfer assets, for example, without verifying or confirming those instructions with the advisory client), even though the adviser's agreement with its client does not give the adviser the authority to do so.[514] This puts client assets at risk by giving the adviser access to client assets that the adviser may not otherwise be authorized to access. The proposed requirement that the contract between the adviser and the qualified custodian specify the adviser's agreed upon level of authority would mitigate these concerns and empower advisers to tailor custodial arrangements to better reflect client intentions and to be consistent with the adviser's contractual obligations to its clients.

ii. Costs

The proposed written agreement requirements would impose costs on advisers and qualified custodians related to negotiating, drafting, and implementing the written agreements.

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513 Proposed rule 223-1(a)(1)(i)(D).

514 *See supra* note 202.

(a) Negotiating, Drafting, and Forming a Reasonable Belief the Agreement Provisions have been Implemented

We understand that advisers are rarely parties to the custodial agreements. Those advisers who are not a party to a custodial agreement and those qualified custodians with whom they would be contracting would have to bear costs to negotiate and draft the written agreement required by the proposed rule, and the adviser would be required to form a reasonable belief that the agreement provisions have been implemented by the qualified custodian. This would include costs attributable to attorneys and compliance professionals, both prior to and at the inception of the written agreement, and over the life of the written agreement. For purposes of the Paperwork Reduction Act, we estimate that investment advisers and qualified custodians would incur aggregate initial costs of $41,218,464 to prepare these written agreements,[515] and that aggregate annual costs associated with modifying these agreements would be $3,503,599.[516] Advisers may also incur costs associated with developing and maintaining a reasonable belief that the contractual provisions have been implemented. These costs would largely depend upon how each adviser satisfies and evidences compliance with this requirement, making them difficult to quantify. However, the proposed revisions to the recordkeeping rule would require an adviser to maintain records that would likely be useful in demonstrating an adviser's reasonable belief that a qualified custodian has implemented the proposed contractual provisions. As a result, we

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515 *See infra* footnote 593.

516 *See infra* footnote 595.

estimate any additional costs incurred by an adviser to develop and maintain a reasonable belief that the proposed contractual provisions have been implemented would be marginal.[517]

(b) Required Provisions

The proposed rule would require a written agreement between advisers and qualified custodians that incorporates certain elements. We believe the cost of including elements likely varies, depending on the nature of each required element. Including certain elements may involve minimal cost, while including other elements may involve more substantial costs.

We understand that qualified custodians often do not provide independent public accountants access to custodial account records in light of privacy concerns for their customers. The requirement that the written agreement with the qualified custodian include a provision requiring the qualified custodian to promptly, upon request, provide records relating to client assets to the Commission or an independent public accountant for purposes of compliance with the rule could impose additional costs on custodians. We believe these costs would largely be mitigated because we believe that providing custodial account records is consistent with the longstanding custodial practice of providing account statements to clients.[518] For purposes of the

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[517] For example, under the revised recordkeeping rule, and adviser would be required to maintain copies of the client account statements it receives from a qualified custodian. These records could form the basis of an adviser's reasonable belief that a qualified custodian has implemented the proposed contractual requirement to deliver account statements. *See* Proposed rule 204-2(b)(iv). The costs associated with proposed amendments to the recordkeeping rule are discussed in more detail below. *See* Section 3.D.7, *infra*.

[518] Current rule 206(4)-2(a)(3). Qualified custodians use custodial account records to produce client account statements.

Paperwork Reduction Act, we estimate that qualified custodians would incur aggregate annual costs of $19,462,024 associated with this record provision requirement.[519]

The proposed rule would require that the written agreement with the qualified custodian provide that the qualified custodian will send account statements (unless the client is an entity whose investors will receive audited financial statements as part of the financial statement audit process pursuant to the audit provision of the proposed rule), at least quarterly, to the client and the investment adviser, identifying the amount of each client asset in the custodial account at the end of the period as well as all transactions in the account during that period. Because qualified custodians generally already send quarterly account statements to clients, we expect the additional costs associated with also sending such statements to advisers to be small. For purposes of the Paperwork Reduction Act, we estimate that qualified custodians would incur aggregate costs of $4,869,322.50 associated with this requirement.[520]

The proposed rule would also require a provision prohibiting the account statements from identifying assets for which the qualified custodian lacks possession or control, unless requested by the client and the qualified custodian clearly indicates that the custodian does not have possession or control over such assets. As discussed in Section III.D.2.b, that provision could impose a cost on clients to the extent account statements provided by a qualified custodian on an

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519 *See infra* footnote 601, which estimates the annual burden associated with records provision to independent public accountants as being 18,422 hours. Using a blended rate of $394 per hour (*see infra* footnote 605) produces an estimated annual burden of (18,422 * $394) = $7,258,268 associated with records provision to independent public accountants. *See infra* footnote 605, which estimates the annual burden associated with records provision to the Commission as being $12,203,756, producing a total annual burden associated with records provision of ($7,258,268 + $12,203,756) = $19,462,024.

520 *See infra* note 609.

accommodation basis offer a client the ability to review all of its investments in a single consolidated account statement and potentially alert a client or an auditor to the existence of an investment. This provision would also impose costs on qualified custodians associated with accommodating customization requests from clients. For purposes of the Paperwork Reduction Act, we estimate that qualified custodians will incur aggregate annual costs of $324,621.50 associated with these customized requests.[521]

Internal Control Report. The objectives of the proposed internal control report are substantially the same as those of the internal control report required under the current rule.[522] The internal control report includes an opinion of an independent public accountant as to whether controls have been placed in operation as of a specific date, are suitably designed, and are operating effectively to meet control objectives relating to custodial services. For those qualified custodians that currently obtain internal control reports, the scope of those reports likely do not cover the financial institutions' safeguarding activities that this proposed requirement, which would expand the scope of the rule to include all "assets" instead of "funds and securities," is designed to cover, thus potentially creating new costs for those firms whose report scope would need to be modified. Any such new cost would be mitigated, however, to the extent newly included assets would share existing controls or implicate controls similar to those for funds and securities. We understand, however, that not all qualified custodians may currently obtain internal control reports—or may not be obtaining internal control reports that meet the requirements of the proposed rule. While we believe those financial institutions will be able to obtain a report that satisfies the requirements of the proposed rule, doing so could pose a

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521 *See infra* note 613.

522 Rule 206(4)-2(a)(4)(ii).

substantial financial burden and time commitment. As discussed above, we are not requiring that a specific type of internal control report be provided under the proposed rule as long as the required objectives are addressed. For example, a report on the description of controls placed in operation and tests of operation effectiveness, commonly referred to as a "SOC 1 Type 2 Report," generally should be sufficient to satisfy the requirements of the proposed internal control report requirement. For purposes of the Paperwork Reduction Act, we estimate that an average internal control report would cost approximately $750,000 per year and that qualified custodians will incur aggregate annual costs of $35,962,500 associated with obtaining internal control reports.[523]

Adviser's Level of Authority. As discussed above, our understanding is that custodial agreements between advisory clients and qualified custodians often give advisers authority over custodial accounts that is broader than what the adviser and client agreed to in the advisory agreement. Our staff has observed that qualified custodians have been reluctant to modify or customize the level of authority of investment advisers with respect to customer accounts. We believe that qualified custodians have been reluctant to modify or customize advisers' level of authority because doing so would increase qualified custodians' need to monitor customer accounts, and to accept liability, for unauthorized transactions by an adviser and its personnel. The proposed requirement could create operational costs for qualified custodians including the costs of adapting existing systems and processes to modify or customize the level of authority of investment advisers with respect to customer accounts. Also, qualified custodians might incur costs to incorporate new provisions into their contracts with advisers as well as amend any

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[523] *See infra* footnote 617.

inconsistent provisions in their existing contracts. As a result, we believe the proposed requirement that the written agreement contain a provision addressing the adviser's authority, including authority of the client and adviser to reduce that authority, may be costly for qualified custodians.

3. Certain Assets that are Unable to be Maintained with a Qualified Custodian

As discussed in Section II.C above, we believe the bulk of advisory client assets can be maintained by qualified custodians. Some assets by their very nature or size may not easily be subject to misuse or misappropriation, and that may reduce the need for the safeguarding protections offered by a qualified custodian, but it is also our understanding that qualified custodians often refuse to custody such assets for both advisers and their clients. In addition, as discussed above, certain privately offered securities may not be able to be maintained by a qualified custodian because, in our understanding, demand for these services is low and thus there may not be a ready market.

In circumstances where the protections of a qualified custodian are unavailable for certain physical assets and privately offered securities, the proposed rule would provide an exception to the requirement to maintain client assets with a qualified custodian, but would also require additional protections to help ensure that these assets are properly safeguarded. In this section, we discuss the costs and benefits of each of the proposed rule's safeguarding requirements for assets that are unable to be maintained by a qualified custodian.

a. Definition of Privately Offered Security

The proposed rule's definition of privately offered securities would retain the elements from the custody rule's description that require the securities to be acquired from the issuer in a transaction or chain of transactions not involving any public offering and transferable only with

prior consent of the issuer or holders of other outstanding securities of the issuer.[524] Like the custody rule, the safeguarding rule would also require the securities to be uncertificated and would require ownership to be recorded only on the books of the issuer or its transfer agent in the name of the client. However, the safeguarding rule would also require that the securities be capable of only being recorded on the non-public books of the issuer or its transfer agent in the name of the client as it appears in the records the adviser is required to keep under rule 204-2.

To the extent crypto asset securities may qualify as privately offered securities under the current rule's privately offered securities exception, advisers with custody of such assets may not be maintaining them with a qualified custodian in reliance upon the exception. However, as discussed above, we believe crypto asset securities issued on public, permissionless blockchains would not satisfy the definition of privately offered securities.[525] As a result, advisers with custody of such crypto asset securities generally would be required to maintain those assets with a qualified custodian and their clients would benefit from the enhanced protections qualified custodians provide.[526] To the extent that crypto asset securities exist or develop that are able to meet the conditions of the privately offered securities exception, the costs and benefits discussed below with respect to the safeguarding of privately offered securities would apply to such assets.

a. Adviser's Reasonable Determination

In order to be eligible for the exception, the rule would require an adviser to reasonably determine, and document in writing, that ownership cannot be recorded and maintained (book-entry, digital, or otherwise) in a manner in which a qualified custodian can maintain possession

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524 *See supra* note 223.

525 *See supra* note 227 and surrounding discussion.

526 *See* Section III.D.2 for a discussion of the benefits and costs for assets that do not qualify for the privately offered security exception and are not physical assets.

or control of such assets. Such a determination necessarily depends on the facts and circumstances at issue. Moreover, these determinations would necessarily evolve over time as assets and the custodial industry change.

An adviser's reasonable determination of whether a qualified custodian is able to maintain possession or control of a particular asset would generally involve an analysis of the asset and the available custodial market. An adviser's reasonable determination generally would not require the identification of every conceivable qualified custodian and an evaluation of its custodial services. Fundamentally, to determine whether an asset can or cannot be maintained by a qualified custodian under the proposed rule, an adviser generally should obtain a reasonable understanding of the marketplace of custody services available for each client asset for which it has custody.

The proposed rule's reasonable determination requirement would benefit investors by limiting the scope of assets eligible for the exception and helping to ensure that any privately offered security or physical asset for which a qualified custodian is available is held by such custodian, maximizing the set of assets for which investors receive the enhanced protections associated with maintaining possession or control by a qualified custodian. The magnitude of this benefit would depend on the extent to which advisers currently would not otherwise maintain assets they have control of with a qualified custodian despite the availability of custodial services for such assets. For example, if the costs associated with maintaining an asset with a qualified custodian exceeded the costs of safeguarding the asset internally, an adviser with custody of the asset might choose to safeguard the asset internally absent this requirement. Alternatively, in cases where custodial services are available at prices that are competitive with

the costs of internally safeguarding an asset, advisers may have chosen to maintain assets in their custody with a qualified custodian regardless of this requirement.

Advisers would incur costs associated with the proposed rule's reasonable determination requirement. For example, while the rule does not prescribe exactly how advisers should comply with the requirement, many advisers may choose to develop policies and procedures that establish the frequency with which the market for custodial services is reviewed, the manner in which the availability of custodial services for an asset should be assessed, and the manner in which an ultimate determination is made. The development and implementation of such policies and procedures, including the documentation of each reasonable determination, would cause advisers to incur costs that may be passed on to their clients in the form of higher fees. The proposed rule does provide advisers with flexibility in determining the frequency with which they make the required reasonable determinations, which should allow advisers to tailor these policies and procedures to the types of asset they hold on behalf of clients and control the associated costs.

In addition, in cases where custodial services become available for an asset but are highly costly, the reasonable determination requirement would force advisers to incur such high custodial costs, which may be passed on to their clients, whereas they otherwise may have chosen to forgo custodial services in such cases. The costs an adviser incurs as a result of the requirement would vary depending on factors such as the types of assets the adviser has custody of and the heterogeneity in these asset types. For example, an adviser that has custody of client assets that are relatively homogenous may only have to monitor a single market for custodial services, whereas an adviser with custody of many different types of assets would likely incur higher costs in monitoring and determining whether custodial services are available in multiple

markets. We lack precise information on the degree of homogeneity versus heterogeneity in the assets held by advisers, as well as the eventual costs advisers would pay to custody assets under the proposed rule, so we cannot quantify the costs associated with this requirement.

b. Adviser Reasonably Safeguards Client Assets that are Unable to be Maintained with a Qualified Custodian

To rely on the exception, the adviser would be required to reasonably safeguard physical assets and privately offered securities that cannot be maintained with a qualified custodian. The proposed rule would not require that advisers implement any particular measures to safeguard physical assets or privately offered securities not maintained with a qualified custodian. Instead, the proposed rule would take a more principles-based approach. If an adviser has custody of a physical asset or privately offered security that it has determined cannot be maintained with a qualified custodian, the adviser may decide to safeguard that asset itself, designing and implementing safeguarding policies and procedures accordingly. An adviser must act consistently with its fiduciary role in safeguarding any particular asset. For example, the adviser might "reasonably safeguard" an asset by looking to reasonable commercial standards for safeguarding that asset from theft, misuse, misappropriation, or other similar type of loss. Under the rule, however, an adviser would have the flexibility to determine the specific safeguarding measures it puts in place, which may differ from asset to asset. If an adviser does not "self-custody" physical assets or privately offered securities that it has determined cannot be maintained with a qualified custodian, and instead maintains those assets with a third party that is in the business of safeguarding those assets, the adviser might implement policies and procedures reasonably designed to ensure that the entity directly maintaining the client's assets has implemented appropriate measures to safeguard them.

Advisers are already obligated to safeguard client assets as part of their fiduciary duty. However, to the extent that the proposed rule would lead advisers to develop practices that more effectively safeguard assets that are not maintained by a qualified custodian, the proposed rule would benefit investors by reducing the risk that their assets are subject to loss, theft, misuse, or misappropriation by an adviser. Even to the extent advisers already effectively safeguard client assets that are not maintained by a qualified custodian, the proposed rule may still benefit investors by establishing a minimum safeguarding standard which they can expect will be applied to those assets, increasing investors' confidence in the market for advisory services.

The proposed rule would not require advisers to implement any particular measures to safeguard physical assets or privately offered securities not maintained with a qualified custodian. This principles-based approach would give advisers the flexibility to safeguard client assets in a way consistent with the nature of the assets and each adviser's individual facts and circumstances. If advisers choose to safeguard client assets themselves, then, to the extent they do not already safeguard client assets in accordance with the proposed requirement, advisers would bear any costs associated with developing and implementing effective safeguarding practices. For example, some advisers may incur costs designing and implementing safeguarding policies and procedures.

If physical assets or privately offered securities are maintained with a third party, advisers might comply with the proposed rule's safeguarding requirement by implementing policies and procedures reasonably designed to ensure that the third party maintaining the client's physical assets has implemented appropriate measures to safeguard them. Such policies and procedures might include robust due diligence and ongoing oversight procedures designed to ensure the adviser has assessed and evaluated the measures put in place by the third party. To the extent

advisers do not already employ practices that can ensure that client assets maintained with a third party are safeguarded consistently with the proposed rule, advisers will incur costs in developing and implementing such practices in order to comply with the rule.

c. Notification and Prompt Independent Public Accountant Verification

The exception to the requirement to maintain assets with a qualified custodian would also require an adviser to enter into a written agreement with an independent public accountant. The proposed rule would require the adviser to notify the independent public accountant of any purchase, sale, or other transfer of beneficial ownership of such assets within one business day. The proposed rule would require the written agreement to require the independent public accountant to verify the purchase, sale, or other transfer promptly upon receiving the required transfer notice. We believe the involvement of independent public accountants in the review and verification of client assets of which advisers have custody is an important safeguarding tool. The timing of the requirement would build a record for the accountant to review in connection with an annual surprise examination or financial statement audit. The written agreement would also require the independent public accountant to notify the Commission by electronic means directed to the Division of Examinations within one business day upon finding any material discrepancies during the course of performing its procedures.

The notification and verification requirement would benefit investors by reducing the risk that a loss, theft, misuse, or misappropriation of their assets goes undetected for a significant amount of time, which might allow investors or the Commission to mitigate losses associated with such events in a timely manner. Even in cases where an adviser fails to notify the independent public accountant of a transaction because it involves loss, theft, misuse, or misappropriation, the absence of such notifications relative to what has been observed in the past

may serve as a warning sign that is useful in identifying potential losses during annual audits or surprise examinations by the independent public accountant.

Advisers would incur costs associated with the proposed rule's notification and verification requirement. While an adviser would likely incur some initial costs associated with designing and implementing any policies and procedures necessary to notify the independent public accountant that a transaction of client assets has occurred, the ongoing costs of notifying the independent public accountant are likely to be small relative to the more involved transaction costs associated with a change of ownership for privately offered securities or physical assets. For purposes of the Paperwork Reduction Act, we estimate that advisers would incur aggregate ongoing annual costs of $48,013 associated with notifying independent public accountants of transactions.[527] Advisers will also incur one-time costs associated with negotiating, drafting, and implementing the written agreement with their designated independent public accountant. Advisers may be able to mitigate these one-time costs if they already have written agreements associated with an annual surprise exam or audit by the same independent public accountant. In addition, advisers may incur minimal costs associated with the occasional modification of these agreements. For purposes of the Paperwork Reduction Act, we estimate that investment advisers would incur aggregate initial costs of $2,443,194 to prepare these written agreements,[528] and that aggregate annual costs associated with modifying these agreements would be $977,514.[529]

Finally, the adviser will have to pay the independent public accountant for its services, the costs of which may be passed onto investors. Verification costs would likely vary across

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527 *See infra* note 648.

528 *See infra* note 642.

529 *See infra* note 644.

advisers depending on factors such as the type of client assets they have custody of as well as the volume of transactions in which they engage. For example, a transaction involving a real estate asset that requires the independent public accountant to verify titles or deeds in person is likely to be costlier to verify than a transaction that can be verified electronically or via telephone. Similarly, an adviser that engages in a high volume of annual transactions would incur higher costs associated with transaction verification, which may ultimately be borne by the advisers' clients. For purposes of the Paperwork Reduction Act, we estimate that advisers would incur aggregate ongoing annual costs of $21,000,000 associated with the verification of transactions by independent public accountants.[530]

d. Surprise Examination or Audit

Like the existing custody rule, the proposed safeguarding rule would require advisers relying on the exception to undergo an annual surprise examination or rely on the audit provision. In a change from the custody rule, however, the proposed rule would require each privately offered security or physical asset not maintained with a qualified custodian to be verified, rather than only requiring that a sampling of assets be verified during a surprise exam or that only assets meeting the materiality threshold be verified during an audit.

The proposed requirement that each asset be verified in annual surprise examinations or audits would benefit investors by reducing the risk that the loss or theft of client assets is not detected when those assets are either not included in a surprise examination's sample or do not meet the materiality threshold when advisers rely on the audit provision. For clients of advisers that do not rely on the audit provision, the magnitude of this benefit depends on the extent to

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[530] *See infra* note 649.

which the sampling techniques used in conducting a surprise examination are likely to omit assets that have been subject to loss or theft. To the extent that the sampling techniques currently used in surprise examinations are effective at capturing instances of asset loss or theft, or that the sampling techniques are already a sufficient deterrent to adviser misconduct that might result in loss or theft, the benefit of this requirement will be more limited with respect to surprise examinations.

For clients of advisers that rely on the audit provision, the magnitude of this benefit depends on the extent to which loss or theft tend to occur in client assets that do not meet the materiality threshold. While the existing custody rule might not deter adviser misconduct in assets below the materiality threshold, the proposed safeguarding rule would act as more of a deterrent against such misconduct because those assets would be subject to regular verification for advisers that rely on the audit provision.

Advisers would incur additional costs as a result of the requirement that, to rely on the exception, each client asset be verified in a surprise examination or annual audit, and these costs may be passed on to their clients. These costs will vary with the type of asset subject to verification and the number of assets held by an adviser. For example, verifying a privately offered security held by an adviser on behalf of its client might require an independent public accountant to contact the issuer of the security or its agent to verify the existence of the asset, or to review documents such as private placement memoranda and the issuer's Regulation D filings. For physical assets, an independent public accountant may be required to review deeds or other land recordation materials (*e.g.*, for real estate assets) or to review other documents, such as warehouse receipts, that confirm the existence of a physical commodity. For both physical assets and privately offered securities, incremental verification costs could be high in cases where the

number of assets held by an adviser is large relative to the number of assets typically verified in surprise examinations or audits under the current custody rule. If the supply of qualified independent public accountants is scarce relative to any increased demand for their services as a result of this requirement, the overall cost of their services would also increase, at least temporarily until those higher prices attract new entrants into the public accounting market. For purposes of the Paperwork Reduction Act, we estimate that advisers would incur aggregate ongoing annual costs of $322,956,000 associated with the verification of transactions by independent public accountants.[531]

4. Segregation of Investments

In addition to requiring advisers to attain reasonable assurance of segregation of client assets from a qualified custodian's assets, the proposed rule also would require advisers to segregate client assets from the adviser's assets and its related person's assets in circumstances where the adviser has custody. Specifically, the proposed rule would require that client assets of which an adviser has custody:

(1) Be titled or registered in the client's name or otherwise held for the benefit of that client;

(2) Not be commingled with the adviser's assets or the adviser's related persons' assets; and

(3) Not be subject to any right, charge, security interest, lien, or claim of any kind in favor of the adviser, its related persons, or its creditors, except to the extent agreed to or authorized in writing by the client.[532]

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531 *See infra* note 655.

532 Proposed rule 223-1(a)(3).

The proposed requirement that a client's assets be titled or registered in the client's name would help ensure that the client's assets are clearly identified as belonging to the appropriate client. The proposed rule would also permit advisers to identify the assets "for the benefit of" a particular client where assets may not be "titled or registered" in the client's name. Permitting advisers to identify assets "for the benefit of" a particular client benefits investors by recognizing that advisory clients can title or register their investments in various ways.

The proposed rule would also require that client assets not be commingled with the adviser's assets or those of its related persons. The proposed requirement would help ensure that client assets are isolated and more readily identifiable as client property. We believe isolating client assets and making them more readily identifiable as client property would help protect client assets from claims by a third party looking to secure or satisfy an obligation of the adviser, including in cases of insolvency or bankruptcy of the adviser, or its related persons.

The proposed rule would also require client assets to remain free from any right, charge, security interest, lien, or claim of any kind in favor of the adviser, its related persons, or its creditors. These requirements would protect client assets by limiting the ability of an adviser, or its related persons, to use client assets for their own purposes or in a manner not authorized by the client. We recognize that some advisers regularly service assets in a manner where such assets are reasonably identifiable from other clients' assets and not subject to increased risk of loss from adviser misuse or in the case of adviser insolvency, thereby mitigating the potential benefits of the proposed requirement. Also, we recognize that, depending on the types of assets, products, or strategies in which they invest, some clients may authorize these types of arrangements. We do not intend this condition to limit or prohibit clients' ability to authorize such arrangements.

We recognize that not all advisers service assets in a manner where such asserts are reasonably identifiable from the other clients' assets and not subject to increased risk of loss from adviser misuse or in the case of adviser insolvency. In addition, for those advisers that segregate and identify their client assets, the extent of those activities varies. To the extent certain advisers currently do not segregate client assets, the segregation requirement in the proposed rule would result in advisers adapting existing systems and processes to meet the proposed requirement.

5. Investment Adviser Delivery of Notice to Clients

The proposed rule, like the custody rule, would require an investment adviser to notify its client in writing promptly upon opening an account with a qualified custodian on the client's behalf. The proposed rule, however, would require that the notice must include the custodial account number in addition to the currently required qualified custodian's name and address.[533] The proposed rule would also continue to allow the notice to be delivered to the client's independent representative. If the client is a pooled investment vehicle, the notice must be sent to all of the investors in the pool, provided that, if an investor is a pooled investment vehicle that is in a control relationship with the adviser or the adviser's related persons, the sender must look through that pool (and any pools in a control relationship with the adviser or its related persons) in order to send the notice to investors in those pools.[534]

The addition of the custodial account number would benefit clients by allowing them to more easily identify the custodial account. The client would be able to compare the custodial account number on subsequent account statements received from the qualified custodian to the

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533 Proposed rule 223-1(a)(2).

534 *See* proposed rule 223-1(c).

custodial account number on the notice received from their investment adviser. Also, if the client is a pooled investment vehicle, the look-through requirement on senders promotes meaningful delivery of this important information.

We understand that custodial account numbers are readily available to qualified custodians and that the cost of including the custodial account number in the notice to clients would be minimal. For purposes of the Paperwork Reduction Act, we estimate that advisers would incur aggregate initial costs of $4,720,044 associated with ensuring that custodial account numbers are included in notices to clients.[535]

6. Exceptions from the Surprise Examination

The proposed rule would create new exceptions to the surprise examination requirement in certain limited circumstances where advisers may have custody. We believe that in these circumstances, the subject activities or arrangements have built-in adequate preventative safeguards or simply pose less risk to client assets.

a. Entities Subject to an Audit

We believe that audits provide substantial protections to private funds and their investors both because audits test assertions associated with the investment portfolio (*e.g.*, completeness, existence, rights and obligations, valuation, presentation) and because they provide a check against adviser misrepresentations of performance, fees, and other information about the fund. Because of that belief, the proposed rule's audit provision would allow audits to serve as a substitute mechanism of compliance with certain aspects of the proposed rule. Elements of the

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535 *See infra* note 624.

proposed rule's audit provision are largely unchanged from the audit provision of the current rule.[536] Differences include: expanded availability from "pooled investment vehicle" clients to "entities," extending the current rule's specific deadlines for distribution of audited financial statements to 180 days in the case of fund of funds or 260 days of a fund of funds of funds of the entity's fiscal year end, and a requirement for there to be a written agreement between the adviser or the client and the auditor requiring the auditor to notify the Commission upon the auditor's termination or issuance of a modified opinion.[537]

i. The Expanded Availability of Audit Provision

While the current rule's audit provision is only available to an adviser to clients that are limited partnerships, limited liability companies, and other types of pooled investment vehicles, the proposed audit provision would also be available to an adviser for any other client "entity" whose financial statements can be audited in accordance with the rule.[538]

As discussed in Section II.G.1.b, this aspect of the proposed rule would extend the investor protection benefits of an audit to a larger number of investors, such as pension plans, retirement plans, college saving plans (529 plans), and Achieving a Better Life Experience savings accounts (ABLE plans or 529 A accounts). Investment advisers do not use the current rule's audit provision for clients that are not pooled investment vehicles, a consequence that may increase compliance burdens for advisers and result in additional costs.

Also, we believe that financial statement audits provide additional meaningful protections to investors by increasing the likelihood that fraudulent activity is uncovered, thereby providing

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536 *See supra* note 282.

537 *See supra* note 283.

538 *Compare* rule 206(4)-2(b)(4); proposed rule 223-1(b)(4).

deterrence against fraudulent conduct by advisers. In a financial statement audit, the accountant performs procedures beyond those procedures performed during a surprise examination. For example, a financial statement audit typically involves tests of valuations of entity investments, income, operating expenses, and, if applicable, incentive fees and allocations that accrue to the adviser. Additionally, a financial statement audit regularly involves an accountant confirming bank account balances and securities holdings as of a point in time, and a financial statement audit frequently includes the testing of transactions that have occurred throughout the year. These common types of audit evidence procedures performed by accountants during a financial statement audit – physical examination or inspection, confirmation, documentation, inquiry, recalculation, re-performance, observation, and analytical procedures – act as an important check on the adviser obviating the need for the account notice and delivery requirements for pooled investment vehicles and other entities.

Based on our experience, we estimate that the party (or parties) that bears the audit expense would pay an average audit fee of $60,000 per fund. We estimate that individual fund audit fees would tend to vary over an estimated range from $15,000 to $300,000, and that some fund audit fees would be higher or lower than this range. We noted that the price of a private fund audit depends on many factors, such as whether it is a liquid fund or an illiquid fund, the number of its holdings, availability of a PCAOB-registered and -inspected auditor, economies of scale, and the location and size of the auditor. We believe that the cost of audit for client entities

whose financial statements can be audited would be of a similar magnitude.[539, 540]

ii. Distribution of Audited Financial Statements

The proposed audit provision would require an adviser to distribute an entity's audited financial statements to current investors within 120 days (or 180 days in the case of a fund of funds or 260 days in the case of a fund of funds of funds) of the entity's fiscal year end, instead of the 120-day period required currently.[541] As discussed in Section II.G.1.e above, we understand that reliance on third parties could cause an adviser to fail to meet the 120-day timing requirements regardless of an adviser's actions. We also recognize there may be times when an adviser reasonably believes that an entity's audited financial statements would be distributed within the required timeframe but fails to have them distributed in time under certain unforeseeable circumstances.

By extending the timeframe in which advisers of certain types of pooled investment vehicles (*i.e.,* funds of funds and funds of funds of funds) must distribute an entity's audited

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539 Although we believe that the procedures performed by the accountant during the course of an audit provide meaningful protections to clients beyond those of a surprise examination, certain protections provided by surprise examinations would no longer be provided. The loss of those protections could create a cost for investors, but we believe the requirements under the proposed rule mitigate those potential costs. For example, although the annual audit is not required to be performed at a time of the accountant's choosing (as is a surprise examination), we believe other elements of the audit incorporate an element of uncertainty similar to the surprise element of the surprise examination, with corresponding benefits to investors. Specifically, in the course of an annual audit, the auditor will select transactions to test during the period that the adviser will not be able to anticipate.

540 Under the proposed rule, only those accountants that are subject to regular inspection by the PCAOB are eligible to perform these services which limits eligible accountants to those that currently conduct public company issuer and broker-dealer audits. The expansion of the availability of audit provision could result in an increase in demand for audit services provided by PCAOB-inspected accountants. Absent an offsetting increase in the supply of such services, the cost of audit services for client entities could increase. If PCAOB-inspected accountants reallocate resources from other market segments, thereby decreasing the supply of PCAOB-inspected accountant capacity in those other market segments, the cost of audit services, more generally, could increase.

541 *See* proposed rule 223-1(b)(4)(iv).

financial statements,[542] the proposed rule may reduce any uncertainty advisers to such pooled investment vehicles face under the current rule. Because we understand existing market practices with respect to these pooled investment vehicles already follow similar timeframes, we believe the costs of the proposed changes to the audit provision with respect to the distribution of audited financial statements would be minimal.

For purposes of the Paperwork Reduction Act, we estimate that investment advisers would incur an aggregate annual burden of $1,242,150 associated with delivering audited financial statements to their clients.[543]

iii. Commission Notification

The proposed rule would require an adviser to enter into, or cause the entity to enter into, a written agreement with the independent public accountant performing the audit to notify the Commission (i) within one business day upon issuing an audit report to the entity that contains a modified opinion and (ii) 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.[544] The written agreement must require the independent public accountant to notify the Commission by electronic means directed to the Division of Examinations. Although there is a requirement on Form ADV for an adviser to a private fund to report to the Commission whether it received a qualified audit opinion and to provide and update its auditor's identifying information, there is not a similar current obligation for an accountant to notify the Commission under the current rule.

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542 *See supra* note 304

543 *See infra* note 660.

544 *See* proposed rule 223-1(b)(4)(v).

The proposed requirement to notify the Commission (i) within one business day upon issuing an audit report to the entity that contains a modified opinion and (ii) 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 would enable the Commission to receive more timely, complete, and independent information in these circumstances and to evaluate the need for an examination of the adviser. Based on our experience in receiving notifications from accountants who perform surprise examinations under the custody rule, we believe that the timely receipt of this information – from an independent third party – would more readily enable our staff to identify advisers potentially engaged in harmful misconduct and who have other compliance issues. This would bolster the Commission's efforts at preventing fraudulent, deceptive, and manipulative activity and would aid oversight of investment advisers. This could lead to a higher rate of detection of activities that lead to the loss of client assets and a greater potential for mitigation of such losses. Anticipating this, advisers would have stronger incentives to avoid such harmful activities.

The proposed written agreement requirement could impose costs on advisers and accountants related to negotiating, drafting, and implementing the written agreements. Based on staff experience, however, we understand that written agreements are commonplace and reflect industry practice when a person retains the services of a professional, such as an accountant, and they are typically prepared by the independent public accountant in advance. Also, the proposed requirements are drawn from the current rule's Form ADV-E filing requirement for independent public accountants performing surprise examinations and, as a result, should not be burdensome

for accountants to include in their written agreements.[545] As a result, we do not believe that the proposed requirement would significantly increase the costs attributable to the proposed requirement. For purposes of the Paperwork Reduction Act, we estimate that investment advisers would incur an initial aggregate burden of 48,735 hours and an ongoing annual burden of 35,869 hours associated with the written agreement.[546]

b. Discretionary Trading Authority

The proposed rule would contain an exception from the surprise examination requirement of client assets if the adviser's sole basis for having custody is discretionary authority with respect to those assets, provided this exception applies only for client assets that are maintained with a qualified custodian and for accounts where the adviser's discretionary authority is limited to instructing its client's qualified custodian to transact in assets that settle exclusively on a delivery versus payment basis.[547] The proposed rule would limit this exception to instances where this is the adviser's *sole* basis for custody. Also, if an adviser also has custody of the client's assets for reasons that are also subject to similar exceptions (*e.g.*, sole basis is fee deduction, sole basis is related person custody),[548] the adviser can rely on the exception.

We understand that certain investors may prefer to give their adviser discretionary trading authority. In delivery versus payment transactions, clients' custodians are generally under instructions to transfer assets out of a client's account only upon corresponding transfer of assets into the account. When a custodian is under instructions to transfer assets out of a client's

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545 Form ADV-E Instructions, pt. 3.ii, https://www.sec.gov/files/formadv-e.pdf.

546 *See infra* notes 662 and 664.

547 Proposed rule 223-1(b)(8).

548 *See* Rule 206(4)-2(b)(3) and (6) and proposed rule 223-1(b)(3) and (6).

account only upon corresponding transfer of assets into the account, there is a reduced risk that the adviser could misappropriate the assets, and when the transaction settles on a DVP basis there is a reduced risk of theft of the asset because, on a non-DVP basis, the seller of an asset could deliver but not receive payment or that the buyer of an asset could make payment but not receive delivery of the asset. The proposed exception would reduce the cost of discretionary trading authority in these instances by not requiring the adviser to comply with the surprise examination requirement of the proposed rule in those circumstances where the discretionary trading authority arrangement minimizes the risk that an investment adviser could withdraw or misappropriate assets in its clients' accounts. We believe this exception will mitigate the creation of new burdens for many advisers, particularly smaller advisers, as a result of the expanded scope of the definition of custody in the proposed rule and will focus the requirement to obtain a surprise examination where the risk of misappropriation is greatest. To the extent advisers pass along cost savings to clients, clients could realize a benefit in the form of reduced fees.

c. Standing Letters of Authorization

The proposed rule would provide an exception from the surprise examination requirement for an investment adviser that has custody of client assets solely because of a standing letter of authorization.[549]

We understand that certain investors may prefer to grant their adviser authority to disburse assets from the client's account to one or more specifically designated third parties in a manner that limits the adviser's ability to redirect the assets, via standing letter of instruction or

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549 Proposed rule 223-1(b)(7).

other similar asset transfer authorization arrangement. The proposed exception would reduce the cost of granting an adviser such authority by not requiring the adviser to comply with the surprise examination requirement of the proposed rule. To the extent advisers pass along cost savings to clients, clients could realize a benefit in the form of reduced fees.

As discussed in Section II.G.3 above, where an arrangement is structured so that the adviser's role is limited to determining when to disburse a client's assets, we believe that the adviser's role in effecting any change in beneficial ownership is circumscribed and ministerial, and there is little risk to clients of loss, misuse, misappropriation, or theft of its asset. We also believe under such circumstances that a qualified custodian would be best positioned to ensure that the required authorizations and instructions are properly and verifiably issued by the client (*e.g.*, the client's signature is verifiable). As a result, we believe the cost of the exception to clients would be minimal.

The proposed required information could benefit qualified custodians by helping ensure that the instructions to the qualified custodian provide relevant information about the recipient. The proposed rule's requirement could also impose operational costs on qualified custodians. As described in Section II.G.3, we believe the types of financial institutions identified as meeting the proposed definition of qualified custodian are required by their primary functional regulator or otherwise to perform procedures to verify the instruction and authorization, through a signature review and, if determined to be necessary, based on the facts and circumstances, another method of verification. To the extent existing regulatory requirements for qualified custodians are the same or similar to the proposed rule's requirements, the costs of adapting existing systems may be mitigated.

7. Amendments to the Investment Adviser Recordkeeping Rule

The proposed amendments to rule 204-2 would require an investment adviser that has custody of client assets to make and keep true, accurate, and current records of required client notifications and independent public accountant engagements under proposed rule 223-1, as well as books and records related to specific types of client account information, custodian information, transaction and position information, and standing letters of authorization.[550] The proposed amendments would require a more detailed and broader scope of records of trade and transaction activity and position information for each client account than the existing requirements for such records.[551] The proposed amendments also would add new recordkeeping requirements that include: (i) retaining copies of required client notices;[552] (ii) creating and retaining records documenting client account identifying information, including whether the adviser has discretionary authority;[553] (iii) creating and retaining records of custodian identifying information, including copies of required qualified custodian agreements, and a record of required reasonable assurances that the adviser obtains from the qualified custodian;[554] (iv) creating and retaining a record that indicates the basis of the adviser's custody of client assets;[555] (v) retaining copies of all account statements;[556] and (vi) retaining copies of any standing letters

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550 Advisers would be required to maintain the proposed records for a period of not less than five years as required under the current books and recordkeeping rule. *See* rule 204-2(e)(1).

551 *Compare* rule 204-2(b)(1)-(4) *with* proposed rule 204-2(b)(2)(v).

552 Proposed rule 204-2(b)(1).

553 Proposed rule 204-2(b)(2)(i).

554 Proposed rule 204-2(b)(2)(ii).

555 Proposed rule 204-2(b)(2)(iii).

556 Proposed rule 204-2(b)(2)(iv).

of authorization.[557] Lastly, the proposed amendments would add new recordkeeping requirements to address independent public accountant engagements.[558]

The proposed recordkeeping requirements are designed to work in concert with the proposed rule to help ensure that a complete custodial record with respect to client assets is maintained and preserved. The proposed changes to the recordkeeping rule would benefit clients by helping to facilitate the Commission's inspection and enforcement capabilities, including assessing compliance with the requirements of the proposed rule. In particular, the proposed recordkeeping requirement would benefit investors by providing more complete records that would facilitate client account reconciliation of all debits and credits to and from client accounts. More complete records also would better enable examiners to identify and detect potential investment adviser misappropriation or loss or misuse of client assets during their examinations, resulting in more effective investor protections. More generally, the recordkeeping requirements would enhance the transparency of custody of client assets and enhance the Commission's oversight capabilities. Enhancing the Commission's oversight capabilities could benefit clients and investors through reduced risks of loss and greater regulatory transparency and resulting effectiveness of the Commission's client and investor protection efforts.

The proposed recordkeeping requirements would impose costs on advisers related to creating and maintaining the required records. These costs include those that can be attributed to compliance professionals who would review and familiarize themselves with requirements as specified in the proposed rule. In particular, advisers would be required to make and retain a list of covered functions and contributing factors, document their due diligence efforts, retain any

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557 Proposed rule 204-2(b)(2)(vi).

558 Proposed rule 204-2(b)(3).

written agreements with service providers, and document periodic monitoring of retained service providers. For purposes of the Paperwork Reduction Act, we estimate that advisers would incur aggregate annual costs of $41,352,853 as a result of the proposed amendments to rule 204-2.[559]

8. Changes to Form ADV

We are proposing to amend Part 1A, Schedule D, and the Instructions and Glossary of Form ADV.[560] The amendments are designed to categorize information about advisers' practices to safeguard client assets, to provide the Commission with information related to these practices, and to provide the Commission with additional data to improve our ability to identify compliance risks. The Commission is not, however, proposing to change the structured data language used for Part 1A. Specifically, given that Form ADV Part 1A currently is submitted in a structured (*i.e.*, machine-readable), XML-based data language specific to that Form, the information in amended new Item 9 would continue to be structured in the same manner.

The amendments will provide the Commission with information related to these practices, and also provide the Commission with additional data to improve our ability to identify compliance risks. Also, public reporting of these custodial practices could allow clients or third parties to assess potential risks (*e.g.*, concentration of investments with a small number of custodians) associated with the market for custodial services, generally. For example, these amendments may also provide clients or investors additional protection because they will be better able to discern the reasons why a particular adviser has custody. Further, these amendments may offer ancillary market benefits to the extent that market participants are better

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559 *See infra* footnote 674.

560 *See supra* note 359.

able to analyze the Form ADV data to assess fraud risk. These proposed revisions would also streamline the collection of this information by reorganizing Item 9 and refining certain reporting requirements to eliminate confusion and prevent inaccurate or incomplete reporting.[561]

Reporting this additional information would impose additional costs on investment advisers, but we believe that such costs would not be significant since we understand that much of the information we propose requesting on Form ADV would be readily available to or easily accessible by advisers.[562]

E. Efficiency, Competition, and Capital Formation

Efficiency. As discussed above, the proposed rule should benefit clients and investors by mitigating risks associated with the custody of client assets, thereby enhancing client and investor protections. The enhancement to client and investor protections could, in turn, lead to current clients being willing to invest a greater portion of their resources with registered advisers or for more clients and investors to seek the advice of registered advisers. Investment advisers provide investment advice to investors and clients about the value of, or about investing in, securities and other investment products. To the extent investors benefit from such advice, we could expect an improvement in the efficiency of client investment.

It is possible, however, that the proposed rule could have the opposite effect on efficiency. The costs of the proposed rule would be borne by advisers, their clients, and qualified custodians. It is possible that the costs borne by advisers may be large enough to cause

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561 *See* proposed Form ADV, Part 1A, Item 9.

562 *See infra* Table 10 for the revised From ADV PRA burden that includes incremental changes due to the proposed amendments as well as adjustments due to wage inflation and changes in the number of advisers.

some advisers to stop providing investment advice for certain assets.[563] If advisers were to stop providing investment advice for certain assets, clients could experience a decrease in the quality of advisers' services. Alternatively, if advisers do try to push the costs, or some component thereof, to clients, it is possible that costs will be large enough to cause some clients to seek alternatives to registered advisers. To the extent clients would benefit from the advice provided by registered investment advisers, the decreased use of advisory services could result in a decline in the efficiency of client investment including lower realized returns.

The proposed amendments would result in a substantive increase in the information about custodial practices available to the Commission. That increased information could, for example, aid Commission staff in examinations, increase the likelihood that non-compliant behavior by custodians or advisers is detected, and increase the likelihood that non-compliant behavior is detected sooner. That increased information should also allow the Commission to develop a better understanding custodial practices, generally. As a result, we would expect an enhancement in regulatory efficiency.

Competition. The proposed rule would enhance protections associated with the custody of client assets. These enhancements to client and investor protection, as well as the additional information available to current and potential clients, could lead to an increased demand for advisory services. That increase in demand for advisory services could, in turn, lead to increased competition among advisers to meet the increased demand. Alternatively, the increased demand for advisory services could lead to an increase in the number of advisers in the marketplace, also

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563 If there are fixed costs associated with the proposed regulations, then smaller advisers will generally tend to bear a greater cost, relative to adviser size, than larger advisers. If there are material fixed costs associated with the proposed rule, then we would expect the possible negative effect on competition to be greater for smaller advisers because the proposed regulations will tend to increase their costs more (relative to adviser size) than for larger advisers.

leading to an increase in competition among advisers. An increase in competition could, presumably, manifest itself in terms of better service, better pricing, or some combination of the two, for clients.

As discussed above, however, it is possible that the proposed rule could have the opposite effect on competition. As noted above, the costs of the proposed rule would be borne by advisers, clients, and qualified custodians. It is possible that the costs borne by advisers may be large enough to cause some advisers to stop providing advice with respect to certain assets. To the extent the proposed rule would create new fixed costs of providing advisory services, those fixed costs would disproportionately impact small or newly emerging advisers. As a result, those fixed costs could discourage entry of new advisers or cause certain advisers to exit the market. Rather than exiting the market, there could be consolidation among advisers that could result in fewer options, and potentially higher costs, for investors. If advisers were to stop providing advice with respect to certain assets, competition among advisers with respect to providing advice for those assets could decline. Further, if advisers do try to push the costs, or some component thereof, to clients, it is possible that costs will be large enough to cause some clients to seek alternatives to the advice of registered advisers. The decreased demand for advisory services could result in a decline in the number of registered advisers and a decrease in competition among registered advisers.

Also, we understand that the requirements of the proposed rule may result in additional costs for qualified custodians, particularly the requirements of a written agreement and reasonable assurances between the qualified custodian and the investment adviser incorporating certain minimum investor protection elements for advisory clients. To the extent qualified custodians are unable to pass these costs along to advisers and their clients, an increase in

compliance costs could cause some qualified custodians to exit the market. A decrease in the number of qualified custodians could, in turn, lead to reduced competition, increased custodial fees, or both.

Capital Formation. As noted above, the proposed amendments enhance investor protections by mitigating risks associated with custody of client assets. Additionally, the proposed rule would result in more information about custodial practices being available to the public. Those enhancements to client and investor protection as well as the additional information available to potential current clients and potential investors could lead to greater investor confidence which could result in current investors being willing to invest more and potential investors being more willing to invest for the first time. To the extent that the proposed rule leads to greater investment, we could expect greater demand for securities, which could, in turn, promote capital formation.

F. Reasonable Alternatives

In this section, reasonable alternatives to the proposed elements of rule 223-1 are discussed.

1. Scope of Assets

The proposed rule would define "assets" as "funds, securities, or other positions held in a client's account." While, like the current rule, the proposed rule would apply to a client's cash and cash equivalents as well as a client's securities, it also would generally apply to other positions held in a client's account that are not funds or securities. The Commission alternatively could define the scope of other positions more narrowly, perhaps by identifying specific types of other positions subject to the proposed rule's safeguarding requirements.

As discussed above, however, we observe a continuing evolution of the types of investments held in advisory accounts. If the proposed rule were to identify specific types of assets as subject to the safeguarding requirements of the rule, clients may not benefit from the safeguarding requirements of the rule if they invest in new asset types introduced in the future that fall outside the rule's scope. We therefore believe a broad definition of other positions strikes the correct balance in terms of investor protections and the cost of complying with the proposed rule.

2. Elimination of Privately Offered Securities Exception

The proposed rule would modify the current rule's exception to the requirement to maintain client funds and securities with a qualified custodian with respect to certain privately offered securities.[564] As discussed above, we believe qualified custodians serve as key gatekeepers to mitigate loss of client assets. The Commission alternatively could seek to enhance investor protections by eliminating the exception—thus requiring advisers with custody of privately offered securities to either maintain these assets with a qualified custodian or eliminate having custody—or retain the current exception without the proposed modifications.

The choice between retaining the current exception, the exception modified as proposed, or eliminating the exception entirely necessarily involves tradeoffs. Eliminating the exception and requiring privately offered securities be maintained with a qualified custodian would increase the likelihood that a loss would be prevented or that non-compliant behavior is detected earlier, potentially mitigating loss to clients. Also, to the extent the likelihood of timely

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564 Proposed rule 223-1(b)(2).

detection deters non-compliant behavior, requiring privately offered securities to be maintained with a qualified custodian could have an important prophylactic effect.

While we believe that requiring a qualified custodian to be involved in any transfer of ownership of privately offered securities would best mitigate the risk of loss of client assets, the current costs associated with this approach would be substantial while a custodial market is still relatively undeveloped. Although we believe that this market would be more robust if the custody rule's exception for uncertificated privately offered securities were eliminated and demand for custodian services would increase, it is possible that this market would not develop as we may expect or would develop in a way that the costs of maintaining privately offered securities with qualified custodians would not be justified by the benefits of doing so. At the same time, we believe retaining the current exception without modification leaves client assets at risk. In our view, the proposed modifications strike the correct balance in terms of investor protections and the cost of complying with the proposed rule.

3. Distribution of Requirements across Reasonable Assurances and Written Agreement

The proposed rule would require an adviser to obtain certain reasonable assurances regarding the protections clients receive from the qualified custodians maintaining their assets. The proposed rule would also require a written agreement between advisers and qualified custodians specifying different provisions related to the relationship among an adviser, its client, and a qualified custodian. Both the proposed reasonable assurances and written agreement requirements expand and formalize the minimum standard protections to advisory clients' assets. The Commission alternatively could specify a different composition of client protections realized via reasonable assurances and written agreements. For example, the Commission could require fewer protections be realized via written agreements and more be realized via a reasonable

assurances requirement. Or, the Commission could require more protections be realized via written agreements and fewer protections be realized via a reasonable assurances requirement.

Under the proposal, the written agreement covers matters that directly affect the adviser's own legal compliance (*i.e.*, requiring the custodian to promptly provide records to the Commission or to an independent public accountant when required for compliance; requiring the qualified custodian to deliver account statements to the adviser as well as to the client; requiring the qualified custodian to assure the adequacy of its internal controls) and that concern the adviser's authority to effect transactions with funds in the client's account held by the custodian. In contrast, the reasonable assurances requirements cover matters which—while within the scope of the adviser's fiduciary duty—principally concern the qualified custodian's direct obligations to the client (*i.e.,* the qualified custodian's standard of due care to the client, the custodian's measures to safeguard the client's assets, the custodian's indemnification of the client against loss, the custodian's obligations to the client when making sub-custodial arrangements, and the custodian's responsibility to identify and segregate the client's assets and to protect the client from liens or third-party claims).

Committing more of these requirements to a written agreement would have the benefit of establishing a uniform, predictable set of requirements for all custodial arrangements and giving the adviser—as well as the client—a contractual enforcement mechanism. The existence of a written agreement might be a greater deterrent to misconduct than a reasonable assurances requirement, and the agreement might provide useful terms of reference for examinations. But committing more of the requirements to a written agreement could result in significant contracting costs, potential loss of flexibility in qualified custodians' business practices, a significant disruption in current practices, and increased litigation costs. In contrast, committing

more of these requirements to reasonable assurances would have the benefit of reducing contracting costs, but with the added cost associated with advisers exercising due diligence and periodic monitoring of qualified custodians to obtain reasonable assurances, without the benefit of an agreement to establish basic expectations on matters directly affecting client advisory services. Moreover, qualified custodians may have concerns about implementing certain protections in the absence of contractual privity between themselves and investment advisers. For example, qualified custodians may have privacy concerns for their clients in the absence of an agreement with the adviser governing provision of records to an independent public accountant. Weighing these factors, we believe that the composition of client protections realized via reasonable assurances and written agreements in the proposal strikes the correct balance in terms of investor protections and the cost of complying with the proposed rule.

3. Additional Accounting and Client Notification Requirements for Privately Offered Securities and Physical Assets that are Not Maintained with a Qualified Custodian

The proposed rule would require an investment adviser to implement certain safeguards for clients' privately offered securities and physical assets that cannot be maintained with a qualified custodian. The safeguards are designed to improve protection of these assets and to create transparency for an investor as to holdings of and transactions in these assets, thereby increasing the likelihood that a loss will be detected sooner, and misconduct will be deterred. These include requirements for the adviser to reasonably determine that ownership cannot be recorded and maintained in a manner in which a qualified custodian can maintain possession or

control of such assets;[565] for the adviser to reasonably safeguard the assets from loss, theft, misuse, misappropriation, or the adviser's financial reverses, including insolvency;[566] for the adviser to enter into a written agreement for an independent public accountant ("IPA") to verify any purchase, sale, or other transfer of beneficial ownership of such assets promptly upon receiving notice from the adviser, and for the IPA to notify the Commission within one business day upon finding any material discrepancies during the course of performing its procedures;[567] for the adviser to notify the IPA of any purchase, sale, or other transfer of beneficial ownership of such assets within one business day;[568] and for verification of the existence and ownership of such assets during an annual surprise examination or a financial statement audit.[569]

We considered whether these safeguards should be supplemented or replaced with additional accounting and client notification requirements, including periodic examinations of the assets; prompt delivery to the client of a written notice that the assets are not kept by a qualified custodian, with an explanation of how the client can verify the existence and ownership of those holdings; a summary of a client's transactions involving assets that are not maintained with a qualified custodian, to be issued on a quarterly or other periodic basis; or for the adviser to obtain an internal control report for assets not maintained with a qualified custodian.[570] We also considered requiring the independent public accountant engaged to perform the proposed transaction verifications to be PCAOB-registered. We believe the proposed safeguards are

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565 Proposed rule 223-1(b)(2)(i).

566 Proposed rule 223-1(b)(2)(ii).

567 Proposed rule 223-1(b)(2)(iii).

568 Proposed rule 223-1(b)(2)(iv).

569 Proposed rule 223-1(b)(2)(v).

570 *See* part II.D.5, Requests for Comment.

sufficient, and the costs of additional safeguards to advisers and clients alike may not be justified.

As previously noted, we lack precise information on the degree of homogeneity versus heterogeneity of assets held by advisers that cannot be maintained by a qualified custodian, and more prescriptive accounting and notification requirements could be more costly when the assets are more varied and unique,[571] when the custodian must rely on a third-party service provider to safeguard and inventory physical assets, or when the client engages in high-volume transactions.[572] Moreover, the benefits of these additional safeguards would be limited where the assets are of such a nature that loss or misappropriation is readily detectable.[573]

4. Additional Safeguards when Clients Assets are Not Maintained with a Qualified Custodian

As discussed above, we recognize that not all client assets for which an adviser may have custody can currently be maintained with qualified custodians.[574] We considered proposing several alternative additional protections designed to help protect client investments when they are not maintained at a qualified custodian. One such alternative we considered would have required advisers to implement at least one financial responsibility safeguard. Specifically, we considered requiring advisers having custody of client assets that they determined could not be maintained with a qualified custodian to either (i) maintain an insurance policy covering losses to the investment adviser or its clients resulting from the loss, misuse, theft, or misappropriation of

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571 *See* part III.D.3.b.

572 *See generally* parts III.D.3.c, III.D.3.d.

573 For example, unique, high-value, non-fungible assets, such as developed real estate.

574 *See* Section II.D, *supra*.

investments not maintained at a qualified custodian; or (ii) maintain a reserve bank account containing a specified amount of cash or certain qualified securities that could be used only to compensate clients for violations of the proposed rule.[575]

While this approach is similar to the types of fidelity bonds that broker-dealers, investment companies, ERISA fiduciaries, and some state-registered investment advisers are required to maintain,[576] we considered requiring advisers to maintain insurance coverage that

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575 In the past—though in different contexts—the Commission and Congress have considered various financial responsibility requirements for advisers, including requiring advisers to maintain insurance (in the form of fidelity bonds) or satisfy minimum capital requirements. The Commission most recently sought comment on these concepts in 2018 in conjunction with its proposed interpretation regarding the standard of conduct for investment advisers. *See* Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Release No. IA-4889, at 4 n.8 (Apr. 18, 2018) [83 FR 21203 (May 9, 2018)]. Comments received in response to this request were still under evaluation at the time the Commission adopted its final interpretation regarding the standard of conduct for investment advisers. *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, *supra* footnote 58. Previously, in 2003, the Commission requested comment on whether to require a fidelity bonding requirement for advisers as a way to increase private sector oversight of the compliance by funds and advisers with the Federal securities laws. *See* Compliance Programs of Investment Companies and Investment Advisers, Release Nos. IC-25925 and IA-2107 (Feb. 5, 2003) [68 FR 7037 (Feb. 11, 2003)]. The Commission decided not to adopt a fidelity bonding requirement at that time, but noted that it regarded such a requirement as a viable option should the Commission wish to further strengthen compliance programs of funds and advisers. *See* Compliance Programs of Investment Companies and Investment Advisers, Release Nos. IC-26299 and IA-2204 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)]. Also, in 1973, a Commission advisory committee recommended that Congress authorize the Commission to adopt minimum financial responsibility requirements for investment advisers, including minimum capital requirements. *See* Report of the Advisory Committee on Investment Management Services for Individual Investors, Small Account Investment Management Services, Fed. Sec. L. Rep. (CCH) No. 465, Pt. III, 64-66 (Jan. 1973). Three years later, in 1976, the Senate Committee on Banking, Housing and Urban Affairs considered a bill that, among other things, would have authorized the Commission to adopt rules requiring investment advisers with discretionary authority over client assets, or that advise registered investment companies, to meet financial responsibility standards. S. Rep. No. 94-910, 94th Cong. 2d Sess. (May 20, 1976) (reporting favorably S. 2849). S.2849 was never enacted, however. The issue of adviser financial responsibility was also considered by Congress in 1992, with both the Senate and House of Representatives passing bills that would have given the Commission the explicit authority to require investment advisers with custody of client assets to obtain fidelity bonds. S.226, 102d Cong., 2d Sess. (Aug. 12, 1992) and H.R. 5726, 102d Cong. Ed (Sept. 23, 1992). Differences in these two bills were never reconciled and thus neither became law.

576 *See, e.g.,* FINRA Rule 4360 (broker-dealers); 17 CFR 270.17g-1 (investment companies); 29 CFR 2580.412-1 (ERISA fiduciaries). Many state-registered investment advisers are required to maintain fidelity bonds. *See, e.g.*, Ala. Code 1975 § 8-6-3; Ark. Admin. Code 214.00.1-303.2; Ga. Code Ann., § 10-

would have been more comprehensive than a typical fidelity bond in order to address the risks the proposed rule is designed to mitigate. For example, we considered requiring an adviser to maintain an insurance policy covering losses to the investment adviser or its clients resulting from the loss, misuse, theft, or misappropriation of investments not maintained at a qualified custodian due to the adviser's negligence, recklessness, or intentional misconduct.

However, we recognize there could be legal and logistical challenges in implementing such a requirement. For example, fidelity bond policies generally only protect policyholders from direct losses suffered from a covered event (*e.g.*, theft of the insured's property by an employee), not third parties such as an adviser's clients, and even to the extent fidelity policies are written to specifically cover third-party property, there is disagreement as to whether the money a policyholder uses to compensate a third party qualifies as a loss covered under these policies.[577] Also, it could be difficult for an adviser to maintain appropriate coverage efficiently and effectively as they buy and sell various investments on behalf of their clients or as those investments increase and decrease in value. Finally, while this approach may provide some means for recovery if an adviser's clients are harmed, requiring this type of insurance coverage would likely require advisers to pay significant premiums, which they would likely pass along to clients through increased fees.

We similarly considered requiring an adviser to maintain a specified level of reserves based on the value of client investments not maintained by a qualified custodian or for which an

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5-40; *see also* NASAA Bonding Requirements for Investment Advisers Model Rule, *available at* https://www.nasaa.org/wp-content/uploads/2011/07/IA-Model-Rule-Bonding.pdf.

[577] *See* Adam D. Cornett & Andrew S. Kent, *Who Can Recover Under a Fidelity Policy?,* XX FID. L.J. 139, 139-41, 177-180 (2014) (citing *Retail Ventures, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.,* 691 F3d 821, 828-32 (6th Cir. 2012)).

adviser has an enhanced ability or authority to effect a change in beneficial ownership. Requiring an adviser to have sufficient liquid assets to cover these types of client investments would have provided a source of recovery when those client investments are lost, misused, stolen, or misappropriated due to the adviser's failure to adequately safeguard them. This approach would have resembled the capitalization requirements of other financial firms.[578] However, because the value of these client investments would vary based on market fluctuations as well as client transactions, designing a reserve requirement that would ensure that an adviser maintained adequate reserves to allow for full recovery at all times could be operationally challenging and costly. Further requiring advisers to maintain reserves sufficient to provide for full—or even meaningful—client recovery, may be prohibitively costly because advisers would need to set aside significant amounts of capital, potentially acting as a barrier to entry for new advisory firms or causing existing advisers to leave the market.

Another alternative we considered would have required an adviser to undergo an enhanced independent verification of assets not kept with a qualified custodian or when an adviser has one-way transfer authority over a client's account, irrespective of whether those assets are maintained with a qualified custodian. For assets not kept with a qualified custodian, the surprise examination would have been required to verify 100% of a client's assets, and it would have required the independent public accountant to verify the disposition of assets from one examination to the next. We have opted, instead, to propose limiting the assets an adviser is

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578 Broker-dealers are subject to minimum capitalization requirements under the net capital and customer protection rules. *See*, *e.g.*, 17 CFR 240.15c3-1 (net capital rule); 17 CFR 240.15c3-3 (customer protection rule). Some state-registered investment advisers are also subjected to minimum capitalization requirements. *See*, *e.g.*, Ark. Admin. Code 214.00.1-303.2; Ga. Code Ann., § 10-5-40; *see also* NASAA Minimum Financial Requirements for Investment Advisers Model Rule (2011), *available at* https://www.nasaa.org/wp-content/uploads/2011/07/IA-Model-Rule-Minimum-Financial-Requirements.pdf.

not required to maintain assets with a qualified custodian to shares of mutual funds, and certain physical assets and privately issued securities that the adviser has determined cannot be maintained in the possession or control of a qualified custodian. With respect to the latter category of assets, we are also proposing to require advisers to implement other protections to ensure they are adequately safeguarded, including, for example, more frequent asset verifications. We believe this approach is likely to result in more client assets being maintained by qualified custodians and better tailoring the protections for client assets that cannot be maintained with a qualified custodian. For one-way transfer authority, under this alternative, the surprise examination would have required the independent public accountant to evaluate whether each one-way transfer of client assets was authorized (*e.g.*, client authorized a cash withdrawal from the client's account to be transferred to a particular recipient). We were uncertain whether an independent public accountant would make such an evaluation, however, and if so, whether it would be cost-prohibitive for them to do so. We determined, instead, to promote transparency around all transactions for a client's evaluation in the proposal's approach. The proposed rule would promote this by eliminating accommodation reporting on a qualified custodian account statement, by limiting the circumstances in which advisers are not required to maintain client assets with a qualified custodian, by requiring an independent public accountant to verify transactions with respect to certain assets not maintained with a qualified custodian more frequently, and by eliminating the possibility that assets not kept with a qualified custodian might not be included in the sampling of assets verified under the current rule.

5. Designating Clearing Agencies and Transfer Agents as Qualified Custodians

The Commission considered expanding the definition of a qualified custodian to include clearing agencies that perform the function, under the Exchange Act,[579] of acting as central securities depositories ("CSDs"), as well as transfer agents.[580] Both CSDs and transfer agents are functionally similar to qualified custodians in several respects and are already subject to regulatory safeguards. These entities safeguard a significant volume of assets and are subject to Commission oversight through regulatory standards, registration requirements, supervision, and examination.[581] For example, among other requirements, CSDs must establish, implement, maintain, and enforce written policies and procedures reasonably designed to ensure the integrity of securities issues, and minimize and manage the risks associated with the safekeeping and transfer of securities; implement internal auditing and other controls to safeguard the rights of securities issuers and holders and prevent the unauthorized creation or deletion of securities, and conduct periodic and at least daily reconciliation of securities issues they maintain; and protect assets against custody risk.[582] Similarly, transfer agents are responsible for countersigning securities upon issuance, monitoring to prevent unauthorized issuance of securities, registering the transfer of securities, and effecting the exchange, conversion, and transfer of securities.[583]

Expanding the definition of a qualified custodian to include CSDs and transfer agents

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579 *See* Exchange Act section 3(a)(23)(A)(i), 15 U.S.C. 78c(a)(23)(A)(i); Rule 17Ad– 22(a)(3), 17 CFR 240.17Ad–22(a)(3).

580 See part II.C.1, Requests for Comment.

581 *See, e.g.,* Release No. 34–78963 (Sept. 28, 2016), 81 FR 70744, 70745-47 (Oct. 13, 2016) (summarizing authorities applicable to clearing agencies); Release No. 34–76743 (Dec. 22, 2015), 80 FR 81948, 81959-69 (Dec. 31, 2015) (summarizing authorities applicable to transfer agents).

582 *See* Rule 17Ad– 22(e)(11).

583 Exchange Act Section 3(a)(25), 15 U.S.C. 78c(a)(25).

could benefit investors by increasing the number of potential entities that provide custodial services in compliance with the rule, which could increase competition in the market for such services and reduce costs. In addition, different types of entities may be more or less suited to providing custodial services for certain types of assets, such as privately offered securities, so expanding the definition of a qualified custodian may reduce the costs associated with maintaining these assets with a qualified custodian by providing additional custodial options.

However, CSDs currently perform many functions at an aggregate or omnibus level for institutional participants, so they might need to build systems to account for and interact with individual clients (to, for example, directly furnish quarterly statements). The potential costs CSDs would incur were they to provide services as qualified custodians under this alternative might pose a significant barrier to entry, which could limit the degree to which expanding the definition of a qualified custodian would increase competition in the market for custodial services. Moreover, providing custodial services could significantly alter the risk management features of CSDs, which have been tailored for other purposes and are supported by an architecture that involves a more limited number of institutional participants.

While some transfer agents are currently used by mutual funds in lieu of a qualified custodian with respect to fund shares,[584] they might also have to develop systems and processes to enable them to custody assets other than fund shares. Transfer agents that are used by mutual funds may also have some systems and processes in place to interact with clients, such as those used to furnish quarterly statements, but other transfer agents might incur significant costs building such systems and processes. Like CSDs, the costs associated with providing custodial

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584 *See* Rule 206(4)-2(b)(1).

services might pose a significant barrier to entry for transfer agents, which could limit the degree to which expanding the definition of a qualified custodian would increase competition in the market for custodial services. In addition, while transfer agents are currently subject to regulatory safeguards, they are not currently subject to individual client protections that are as extensive as the entities we are including in the definition of a qualified custodian under the proposed rule. For example, they are not subject to the specific safeguarding requirements of Rule 206(4)-2(a), and their capitalization and risk management practices are oriented to the markets where they operate, not necessarily to the range and variety of clients and assets contemplated by the proposed rule.

G. Request for Comment

The Commission requests comment on all aspects of this initial economic analysis, including whether the analysis has: (i) identified all benefits and costs, including all effects on efficiency, competition, and capital formation; (ii) given due consideration to each benefit and cost, including each effect on efficiency, competition, and capital formation; and (iii) identified and considered reasonable alternatives to the proposed rule. We request and encourage any interested person to submit comments regarding the proposed rule, our analysis of the potential effects of the proposed rule, and other matters that may have an effect on the proposed rule. We request that commenters identify sources of data and information as well as provide data and information to assist us in analyzing the economic consequences of the proposed rule. We also are interested in comments on the qualitative benefits and costs we have identified and any benefits and costs we may not have discussed.

280. The proposed rule affects banks and savings associations, broker-dealers registered with the Commission, futures commission merchants registered with the

CFTC, and FFIs. How do rules and regulations of other financial regulators and of self-regulatory organizations affect these entities in their capacity as qualified custodians? How do these existing rules and regulations affect the benefits of the proposed rule and its costs?

281. The proposed rule would expand the scope of assets currently subject to the custody rule. To what extent do investors benefit from advisers having custody of assets newly scoped in under the proposed rule? What is the nature of those benefits? To what extent would those benefits be lost given the requirements of the proposed rule?

282. The proposed rule would explicitly identify discretionary trading authority as an arrangement that triggers the rule. To what extent do investors benefit from discretionary trading services offered by investment advisers? What is the nature of those benefits? To what extent would investment advisers no longer offer discretionary trading services given the requirements of the proposed rule?

283. The proposed rule would generally require that the investment adviser maintain client assets with a qualified custodian pursuant to a written agreement between the qualified custodian and the investment adviser (or between the adviser and client if the adviser is also the qualified custodian). To what extent are investment advisers currently party to custodial agreements? To what extent are the required provisions similar to, or different from, provisions in custodial agreements between investors and qualified custodians? Have we appropriately estimated the costs of the reasonable assurances and written agreement requirements? Do commenters agree that qualified custodians will have in incentive to provide written agreements that are

consistent with the requirements of the proposed rule? Have we appropriately identified the costs of the proposed required provisions?

284. To what extent do entities maintaining client physical assets currently enter into written agreements obligating the entity to comply with provisions the same as, or similar to, the provisions required under the proposed rule?

285. We state that existing regulatory requirements for qualified custodians with respect to asset segregation are similar to the requirements of the proposed rule and that, as a result, the costs of the proposed asset segregation requirements would be mitigated. Is this an accurate characterization of existing regulatory requirements? If not, how do existing regulatory requirements differ from those of the proposed rule?

286. We state that for those qualified custodians indemnifying the client against the risk of loss in the event of the qualified custodian's gross negligence, the insurance requirement of the proposed indemnification requirement would likely create a substantial increase in the cost of liability insurance. Is this an accurate characterization? How costly is insurance covering loss in the event of a qualified custodian's gross negligence? How costly is insurance covering loss in the event of a qualified custodian's simple negligence? For example, how much does it cost to insure, per $1,000 of covered assets, losses in the event of a qualified custodian's gross negligence? How much does it cost to insure, per $1,000 of covered assets, losses in the event of a qualified custodian's simple negligence? Do the per-dollar costs change as the amount of covered assets increases? If so, how? What other factor might affect the cost of liability insurance for qualified custodians? What

kinds of operational burdens might be associated with purchasing and maintaining liability insurance? To what extent do custodians currently have systems, processes, and liability insurance that are consistent with a simple negligence standard?

IV. PAPERWORK REDUCTION ACT ANALYSIS

A. Introduction

Certain provisions of our proposal would result in new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[585] The proposed new rule 223-1 and related amendments to rules 206(4)-2 and 204-2 under the Act and Form ADV would have an impact on current collection of information burdens. Specifically, we are proposing new collection of information requirements under proposed rule 223-1 and corresponding amendments to currently approved collection of information burdens under: (i) "Rule 206(4)-2 under the Investment Advisers Act of 1940—Custody of Funds or Securities of Clients by Investment Advisers" (OMB number 3235-0241); (ii) "Rule 204-2 under the Investment Advisers Act of 1940" (OMB control number 3235-0278); and (iii) "Form ADV" (OMB control number 3235-0049). The Commission is submitting these collections of information to the OMB for review and approval in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

We discuss below these proposed amendments and new collection of information burdens. Responses provided to the Commission in the context of its examination and oversight

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585 44 U.S.C. 3501 *et seq*.

program concerning the proposed redesignation of rule 206(4)-2 as new rule 223-1, and corresponding amendments to rule 204-2 would be kept confidential subject to the provisions of applicable law. Responses to the disclosure requirements of the proposed amendments to Form ADV are not kept confidential.

B. Rule 223-1

Proposed rule 223-1, which will effectively replace current rule 206(4)-2 by a redesignation, states that an adviser registered or required to be registered under section 203 of the Act, shall take certain steps to safeguard the client assets of which the adviser has custody, and lays out five requirements with which advisers must comply.[586] Paragraph (a)(1) would require advisers to maintain client's assets at a qualified custodian in a specified manner pursuant to a written contract that contains enumerated elements. Paragraph (a)(1)(ii) would require an adviser to obtain reasonable assurances in writing from a qualified custodian that such custodian will exercise due care over client assets; will indemnify the client against risk of loss; not excuse any obligations to the client based upon the existence of any sub-custodial, securities depository, or other similar arrangements with regard to the client's assets; clearly identify and segregate client assets from the custodian's proprietary assets and liabilities; and not subject client assets to any right, charge, security interest, lien, or claim in favor of the qualified custodian or its related persons or creditors. Paragraph (a)(2) would require an investment adviser that opens an account with a qualified custodian on a client's behalf to notify the client of the account details. Paragraph (a)(3) would require an investment adviser to title or register a client's assets in the client's name or otherwise hold such assets for the benefit of that client; prohibit the

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586 Proposed rule 223-1.

commingling of client assets with the adviser's (or its related persons') assets; and require client assets generally to be held free of any right, charge, security interest, lien, or claim in favor of the adviser and its related persons or creditors. Paragraph (a)(4) would require an adviser that maintains custody of client assets to obtain independent verification from an independent public accountant at least once during a calendar year pursuant to a written agreement that provides for the filing of Form ADV-E.

Paragraph (b) lays out limited exceptions from certain requirements of the proposed rule, some which would change the current collections of information burdens of rule 206(4)-2. These include paragraphs (b)(2) excepting the requirement to maintain certain privately offered securities or physical assets with a qualified custodian in certain circumstances; (b)(3) excepting advisers from the independent verification of client assets maintained by a qualified custodian if an adviser has custody solely as a consequence of the authority to deduct advisory fees; (b)(4) exempting an adviser from the account statement and certain notification requirements, along with the independent verification requirement, when the advisory client undergoes a financial statement audit annually and upon liquidation in accordance with the rule; (b)(7) creating an exemption from the independent verification requirement if an adviser has custody of client assets solely because of a standing letter of authorization with the client; and (b)(8) excepting advisers from the independent verification of assets requirement under certain circumstances if custody exists solely because the adviser has discretionary authority with respect to those client assets that are maintained in accounts with a qualified custodian where the discretionary authority is limited to transacting in assets that settle exclusively on a delivery versus payment basis.

Each requirement to disclose or obtain information, deliver communications, or cause reporting by an independent public accountant constitutes a "collection of information" requirement under the PRA and is mandatory. Advisory clients would use this information to confirm proper handling of their accounts. The Commission's staff uses the information obtained through these collections in its enforcement, regulatory, and examination programs. The respondents to these collections of information requirements would be investment advisers that are registered or required to be registered with the Commission that have custody of client assets. As of September 2022, there were 15,160 investment advisers registered with the Commission and 8,724 advisers reported to have custody of client assets in Item 9 of Form ADV. Although not all investment advisers would be subject to this rule, we expect that most would be for two reasons: first, the proposed rule would be triggered by most services advisers commonly provide to their clients, such as trading on a discretionary basis; and second, the proposed rule's application to "assets" would apply to a broad array of client investments, not just to funds or securities as under the current rule. We, therefore, estimate that 13,944 which is the number of all registered advisers that currently report having discretionary authority, would be subject to the proposed rule.[587] The application of the provisions of the proposed rule—and thus the extent to which there are collections of information and their related burdens—would be contingent on a number of factors, such as the types of services the adviser provides, the number of clients to whom it provides those services, and the nature of the relevant assets. Because of the wide diversity of services and relationships offered by investment advisers, we expect that

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[587] This estimate is based on the 14,204 advisers who answer yes to Form ADV Item 8(C)(1) and have discretionary authority to determine the "securities to be bought or sold for a client's account." For purposes of this estimate, we have excluded 260 advisers answering yes to Form ADV Item 8(C)(1) but reporting that they solely advise investment company clients in response to Form ADV Item 5.D.(1)(d).

the obligations imposed by the proposed rule would, accordingly, vary substantially among advisers. However, we have made certain estimates of this data solely for the purpose of this PRA analysis.

1. Qualified Custodian Provision

a. Written Agreement

Under the proposed rule investment advisers would be required to enter into a written agreement with a qualified custodian to maintain possession or control of their clients' assets and to satisfy certain other requirements enumerated in the rule, subject to certain exceptions.[588] We estimate that nearly all of the 13,944 registered advisers that we estimate would be subject to the rule will be required to comply with this requirement.[589] We believe that an investment adviser would enter into a single agreement with each qualified custodian that provides custodial services for the adviser's clients, regardless of how many of the adviser's clients the qualified custodian provides custodial services for. Based on the information currently reported by advisers about qualified custodians on in Item 9.F of Form ADV, we estimate that each adviser would enter into approximately 4 written agreements.[590] We therefore estimate that, initially,

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588 Proposed rule 223-1(a)(1) (the proposed rule would require a written agreement between the adviser and client if the adviser is also the qualified custodian).

589 While some of these advisers may have custody of certain client assets that the proposed rule would except from the requirement to use a qualified custodian, we assume that these advisers likely also have at least some client assets that must be maintained with a qualified custodian under the proposed rule.

590 This estimate is based on responses to Form ADV, Part 1A, Item 9.F, which requires advisers to report the number of persons acting as qualified custodian. For all advisers responding to this question, the average number of persons acting as qualified custodians amounted to 4. We believe that it is possible that the proposed rule could result in advisers entering into agreements with a greater number of qualified custodians for custody services related to assets that advisers may not currently maintain with a custodian. At the same time, we believe that it is possible that current custodians will expand their services in order to provide custody services for asset types that they do not currently maintain for advisers. As a result, for the purposes of this analysis, we will rely on the average obtained from Form ADV Part 1A, Item 9.F. data.

advisers would enter into a total of 55,776 written agreements.[591] We estimate that each investment adviser and each qualified custodian that enters into an agreement would incur an internal burden of 1 hour each to prepare the written agreement, for a total initial burden hour estimate of 111,552[592] which we expect would mostly be attributable to the requirement to specify the investment adviser's agreed-upon level of authority to effect transactions in the custodial account as well as any applicable terms or limitations. Based on our estimates, there would be an initial cost to each respondent of this internal hour burden of $43,951,488 to draft and finalize these written agreements.[593]

Once these agreements are created they will require little, if any, modification, except in circumstances where the adviser's level of authority changes (which we estimate would occur approximately once per year). We estimate that these changes would take, on average, 10 minutes per written agreement. Therefore, we estimate that the yearly total internal burden of preparing the written agreement would be 9,482 hours,[594] and there would be an annual cost of this internal hour burden of $3,735,908.[595]

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591 This estimate is based on the following calculation: 13,944 advisers x 4 written agreements.

592 This estimate is based on the following calculation: 55,776 written agreements x 2 hours.

593 This estimate is based on the following calculation: 111,552 hours (for preparation and review of draft agreement) x $394 (blended rate for a compliance manager ($361) and a compliance attorney ($426)). Unless otherwise indicated in this section IV, all hourly wages used are from the Securities Industry and Financial Markets Association's Report on Management & Professional Earnings in the Securities Industry 2013 ("SIFMA Wage Report"), updated for 2023, modified to account for an 1800-hour work-year and inflation.

594 This estimate is based on the following calculation: 55,776 written agreements x .17 hours.

595 This estimate is based on the following calculation: 9,482 hours x $394 (blended rate for a compliance manager ($361) and a compliance attorney ($426)).

The written agreement proposed by the rule would require a qualified custodian to promptly, upon request, provide records relating to an adviser's clients' assets held in the account at the qualified custodian to the Commission or to an independent public accountant engaged for purposes of complying with the rule.[596] As noted above, we believe that advisers would enter into approximately 4 written agreements on average. We anticipate that 1,842[597] of the advisers party to these written agreements would be subject to the surprise examination requirement. For these advisers, we estimate that qualified custodians would be required to provide information to an independent public accountant once annually in connection with each adviser for which they have a written agreement under the rule. We estimate that it would take qualified custodians approximately 0.5 hours to provide the required information. Therefore, we estimate the internal annual hour burden for qualified custodians to provide this information to total 3,684 hours.[598] Further, we anticipate that 7,018 advisers to these written agreements would comply with the proposed rule's audit exception.[599] Because we estimate that 5 percent of pooled investment vehicles are liquidated annually at a time other than their fiscal year-end, for these advisers, we estimate that qualified custodians would be required to provide information to

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596 *See* proposed rule 223-1(a)(1)(i)(A).

597 *See infra* footnote 619 and accompanying text.

598 This estimate is based on the following calculation: 1,842 (advisers that we estimate will obtain a surprise examination) x 4 (average number of written agreements per adviser) x .5 hours.

599 Advisers to pooled investment vehicles: 4,961
20% of advisers with custody that have pension and profit sharing plan clients (3,068 x .20): 614
20% of advisers with custody that have charitable organization clients(3,205 x .20): 641
20% of advisers with custody that have state or municipal government entity clients (986 x .20) : 197
20% of advisers with custody that have corporations and other business entity clients (3,025 x .20): 605
Total advisers expected to use the audit provision (4,961 + 614 + 641 + 197 + 605): 7,018 advisers; *See also infra* footnote 654.

an independent public accountant 1.05 times annually. Therefore, we estimate that the total annual burden for respondents to provide information to independent public accountants for the audit related to these advisers would be 14,738 hours.[600] In the aggregate, we estimate the total annual burden for respondents to provide information to independent public accountants for the surprise examination and audit to amount to 18,422 hours.[601]

We estimate that the Commission would examine approximately 2,092 of the advisers required to enter into a written agreement under the rule, which is consistent with the number of advisers generally examined by Commission staff over the last three fiscal years.[602] As noted above, because we estimate that an adviser will on average maintain client assets with approximately four qualified custodians, we estimate that Commission will issue approximately 8,368 requests to qualified custodians under the rule. We believe that these information requests may be more customized and would take custodians approximately 1.5 hours to respond to, slightly longer than it would take a custodian to provide more standardized information requested by an independent public accountant. Accordingly, the internal burden hours for respondents to this collection of information would equal approximately 12,552 hours.[603] In

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600 This estimate is based on the following calculation: 7,018 (number of advisers using the audit exception) x 4 (average number of qualified custodians per adviser) x 1.05 (average number of audits annually) x .5 hours = burden for respondents to provide information to independent public accountants for the audit related to these advisers.

601 3,684 + 14,738 hours.

602 This estimate is based on the following calculation: 13,944 advisers subject to the rule and required to enter into a written agreement with a qualified custodian x 15% (the approximate number of registered advisers the Commission examined in each of fiscal years 2019, 2020, and 2021). *See* U.S. Securities and Exchange Commission, Division of Examinations, *2022 Examination Priorities* at 4 (Mar. 2022), available at https://www.sec.gov/files/2022-exam-priorities.pdf.

603 This estimate is based on the following calculation: 8,368 written agreements x 1.5 hours.

total, for the requirement to provide information to accountants and the Commission, we estimate the collection of information burden on respondents amounts to 30,974 hours annually.[604] Accordingly, we estimate that the annual internal monetized cost burden amounts to approximately $12,203,756.[605]

The proposed rule would require that the written agreement with the qualified custodian provide that the qualified custodian will send account statements (unless the client is an entity whose investors will receive audited financial statements as part of the financial statement audit process pursuant to the audit provision of the proposed rule), at least quarterly, to the client and the investment adviser, identifying the amount of each client asset in the custodial account at the end of the period as well as all transactions in the account during that period.[606] We estimate that the average burden for custodians to provide quarterly financial statements to advisers is limited. Because qualified custodians are already sending quarterly account statements to clients,[607] we estimate that one additional burden incurred would be in connection with qualified custodians adding advisers to their distribution lists. We estimate this would aggregate

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604 This estimate is based on the following calculation: 18,422 (hour burden to provide information to accountants) + 12,552 (hour burden to provide information to Commission).

605 This estimate is based on the following calculation: 30,974 (internal annual burden hours) x $394 (blended rate for a compliance manager ($361) and a compliance attorney ($426)).

606 Proposed rule 223-1(a)(1)(i)(B). The proposed requirement is similar to the approach in the current rule with regard to the investment adviser forming a reasonable belief after due inquiry that the qualified custodian sends account statements, at least quarterly, to the client. *See* custody rule 206(4)-2(a)(3).

607 *See* custody rule 206(4)-2(a)(3).

approximately 14,385 hours in initial burden hours.[608] We estimate that this initial internal burden equates to an initial internal monetized cost burden of approximately $4,869,322.50.[609]

We also believe that this proposed rule would result in a small additional burden in terms of modifications to quarterly statements related to including, at the client's request, information related to assets not maintained by the qualified custodian,[610] customizing the statements for any client that requests such assets to be included, and adding language that identifies those assets.[611] We estimate this would aggregate approximately 959 hours annually.[612] We estimate that this annual internal burden equates to an annual internal monetized cost burden of approximately $324,621.50.[613]

As discussed above, the proposed rule would require the written agreement to contain a provision requiring the qualified custodian, at least annually, to obtain and provide to the adviser a written internal control report that includes an opinion of an independent public accountant.[614]

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608 15 hours (development of distribution list) x 959 (estimated number of qualified custodians). We believe that any ongoing annual burden in connection with this requirement would be *de minimis.*

609 This estimate is based on the following calculation: 14,385 hours (estimated internal hour burden of preparing and distributing quarterly account statements) x $338.50 (blended rate for a programmer $316 and a compliance manager $361)).

610 *See* proposed rule 223-1(a)(1)(i)(B) ("Such account statements shall not identify assets for which the qualified custodian lacks possession or control, unless requested by the client and the qualified custodian clearly identifies any such assets that appear on the account statement").

611 *See id.* Since custodians are aware of the assets for which they are providing accommodation reporting, we believe that the custodian's removal of current accommodation reporting will be *de minimis*.

612 1 hour (modifications to account statements) x 959 (estimated number of qualified custodians).

613 This estimate is based on the following calculation: 959 hours (estimated internal hour burden of preparing and distributing quarterly account statements) x $338.50 (blended rate for a programmer $316 and a compliance manager $361)).

614 Proposed rule 223-1(a)(1)(i)(C).

We estimate that approximately 959 qualified custodians[615] would have to obtain an internal control report relating to custodial services, and would have to provide the report to the adviser. We understand that the cost to prepare an internal control report relating to custody would vary based on the size and services offered by the qualified custodian, but that on average an internal control report would cost approximately $750,000 per year.[616] We believe that 95% of custodians currently obtain internal control reports, and, therefore, estimate total aggregate monetized costs attributable to this section of the proposed rule to be $35,962,500 annually.[617]

b. Reasonable Assurances

The proposed rule would require an adviser to obtain reasonable assurances in writing from a qualified custodian regarding certain client protections.[618] As discussed above, one way that advisers are likely to satisfy this requirement is by seeking confirmation from a qualified custodian that the custodial agreement with the advisory client contains contractual language reflecting the reasonable assurances required by the rule. We estimate the amount of time it would take an adviser to request, and a qualified custodian to provide, information necessary to satisfy this requirement to be approximately 15 minutes, and we expect that any related changes

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615 This estimate was obtained by the following calculation: 8,724 (advisers reporting that they have custody) / 600 (total number of custodians reported in Form ADV Part 1A, Question 9.F. = 14.54 (mathematical average number of advisers served by each custodian obtained solely for the purpose of performing the calculation); 13,944 (advisers that we estimate would have to comply with the proposed rule) / 14.54 (average number of advisers served by each custodian) = 959.

616 We recognize, however, that as a result of the proposed rule's expansion to cover all assets, rather than funds and securities, the internal control reports currently obtained by qualified custodians may not fully reflect the type of report that would be obtained under the proposed rule.

617 This estimate is based on the following calculation: 959 (estimated number of qualified custodians operating under written agreements) x $750,000 (average cost of obtaining internal control report) x 5% (percent of custodians that we estimate are not currently obtaining internal control reports).

618 Proposed rule 223-1(a)(1)(ii).

a qualified custodian makes to a custodial agreement to reflect the reasonable assurances provided to the adviser would take approximately 1 hour. We believe this exchange is most likely to occur in the context of the negotiation and execution of the written agreement. Therefore, we estimate that the initial aggregate time burden for this collection of information would amount to 69,720 hours.[619] We believe that the initial monetized costs imposed by the proposed rule approximate $27,469,680.[620] We believe that most custodial agreements change very little from year to year, and therefore, we estimate the total annual internal hour burden to be 13,944.[621] We believe that the monetized costs imposed by the proposed rule would approximate $5,493,936 annually.[622]

2. Notice to Clients

The proposed rule, like the current rule, would require an investment adviser to notify its client in writing promptly upon opening an account with a qualified custodian on its behalf.[623] The notice is designed to alert a client to the existence of the qualified custodian that maintains possession or control of client assets and whom to contact regarding such assets. One change from the current rule is that the proposed rule would explicitly require that the notice include the custodial account number, an important detail that is not required under the current rule. However, we do not believe including a custodial account number to the notice would

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619 1.25 hours x 55,776 written agreements.

620 69,720 hours (estimated initial internal hour burden) x $394 (blended rate for a compliance manager ($361) and a compliance attorney ($426)).

621 55,776 written agreements x .25 hours.

622 13,944 (estimated annual internal hour burden) x $394 (blended rate for a compliance manager ($361) and a compliance attorney ($426)).

623 *See* proposed rule 223-1(a)(2).

significantly impact the costs incurred by advisers as they are already required to provide a nearly identical notice under the current rule. Therefore, we estimate that the initial burden of updating their processes and systems to ensure account numbers are included in the relevant notices is 1 hour with a total estimated monetized cost of $4,720,044.[624]

3. Annual Surprise Examination

The proposed safeguarding rule does not change the current rule's annual surprise exam requirement, but changes to other portions of the rule that expand the application of the rule to certain advisers or that provide exceptions to the surprise exam requirement would impact the number of advisers subject to this requirement if adopted. The current rule requires each registered investment adviser that has custody of client funds or securities to undergo an annual surprise examination by an independent public accountant to verify client assets pursuant to a written agreement with the accountant that specifies certain duties. We estimate that 1,842 advisers would be subject to the surprise examination requirement upon its redesignation under the proposal.[625]

For purposes of estimating the collection of information burden, we have divided the estimated 1,842 advisers into three subgroups. First, we estimate that 381 advisers have custody because they serve as qualified custodians for their clients, or they have a related person that

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[624] The initial burden hours are calculated as follows (14,204 advisers with discretionary authority – 260 advisers to investment company clients in response to Form ADV Item 5.D.(1)(d) = 13,944 advisers) x 1 hour x blended rate for a compliance manager ($361) and a programmer ($316) = $338.50) = $4,720,044.

[625] Based on data from the Investment Adviser Registration Depository ("IARD") of the advisers that report having discretion, of the 1,842 advisers indicated in response to Item 9.C.(3) that an independent public accountant conducts an annual surprise examination of client funds and securities. The calculations in this section regarding the annual surprise exam represent information as of June 2022 and incorporate Form ADV filings received through the (IARD) through August 31, 2022.

serves as qualified custodian for clients, in connection with advisory services the adviser provides to the clients.[626] We estimate that these advisers are subject to an annual surprise examination with respect to 100 percent of their clients (or 9,006 clients per adviser) based on the assumption that all of their clients maintain custodial accounts with the adviser or its related person.[627] We estimate that each adviser will spend an average of 0.02 hours for each client to create a client contact list for the independent public accountant. The estimated total annual aggregate burden with respect to the surprise examination requirement for this group of advisers is 68,626 hours.[628]

The second group of advisers, estimated at 835, are those that have custody because they have broad authority to access client assets held at an independent qualified custodian, such as through a power of attorney or acting as a trustee for a client's trust.[629] Based on our staff's experience, advisers that have access to client assets through a power of attorney, acting as trustee, or similar legal authority typically do not have access to all of their client accounts, but rather only to a small percentage of their client accounts pursuant to these special arrangements.

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626 Based on IARD data, 381 advisers indicated that an independent public accountant prepares an internal control report because the adviser or its affiliate acts as a qualified custodian (in response to Item 9.C.(4)). Similarly, 76 advisers indicated that they act as a qualified custodian (in response to Item 9.D.(1), and 321 advisers indicated that their related person(s) act as qualified custodian(s) (in response to Item 9.D.(2)). 76 + 321 = 397.

627 We base our estimate on IARD data of the average number of clients of all the advisers that will be subject to the surprise examination requirement under the rule. To derive our estimate, we utilized the winsorization method, by setting all values for advisers (above the 99th percentile of number of clients) at the number of clients at the 99th percentile. The method lessens the effect of outliers on client estimates.

628 381 advisers x 9,006 (average number of clients subject to the surprise examination requirement) x 0.02 hour = 68,626 hours.

629 This estimate is based on the total number of advisers subject to surprise examinations less those described above in the first group (custody as a result of serving as, or having a related person serving as, qualified custodian) less those described below in the third group (custody as a result of solely managing private funds). (1,842 – 381) – 626 = 835 advisers.

We estimate that these advisers will be subject to an annual surprise examination with respect to 5 percent of their clients (or 450 clients per adviser) who have these types of arrangements with the adviser.[630] We estimate that each adviser will spend an average of 0.02 hours for each client to create a client contact list for the independent public accountant. The estimated total annual aggregate burden with respect to the surprise examination requirement for this group of advisers is 7,515 hours.[631]

A third group of advisers provides advice to pooled investment vehicles that are not undergoing an annual audit and therefore would undergo the surprise examination with respect to those pooled investment vehicle clients. Based on current IARD data, we estimate that 626 advisers manage private funds and undergo surprise examinations.[632] We estimate that each adviser managing private funds has an average of 6 pooled investment vehicle clients with an average of 14 investors. We estimate that advisers to these pooled investment vehicles will spend 1 hour for the pool and 0.02 hours for each investor in the pool to create a contact list for the independent public accountant, for an estimated total annual burden with respect to the surprise examination requirement for these advisers of 4,808 hours.[633]

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630 Based on the IARD data, we estimate that the average number of clients of advisers subject to the surprise examination requirement is 9,006. 9,006 x 0.05 = 450 clients per adviser.

631 835 advisers x 450 clients x 0.02 hours = 7, 515 hours.

632 Based on IARD data, we estimate that 626 advisers manage private funds and undergo a surprise examination (responses to Items 7.B. and 9.C.(3)).

633 ((626 advisers x 6 pools) x 1 hour = 3,756 hours) + ((626 x 6 pools x 14 investors) x .02 hours = 1,052 hours) = 4,808 hours

These estimates bring the total annual aggregate burden with respect to the surprise examination requirement for all three groups of advisers to 80,949 hours.[634] This estimate does not include the collection of information discussed below relating to the written agreement required by paragraph (a)(4) of the rule.

Related to the surprise exam, the current custody rule and the redesignated safeguarding rule require that an adviser subject to the surprise examination requirement must enter into a written agreement with the independent public accountant engaged to conduct the surprise examination and specify certain duties to be performed by the independent public accountant.[635] We estimate that each adviser will spend 0.25 hour to add the required provisions to the written agreement, with an aggregate of approximately 461 hours for all advisers that undergo surprise examinations.[636] Therefore the total annual burden in connection with the surprise examination is estimated at 81,410 hours under the rule.[637] We estimate the monetized burden related to the surprise exam is $27,623,345.[638]

C. Exceptions

The proposal contains several exceptions that will result in a new "collection of information" requirement within the meaning of the PRA and would have an impact on the current collection of information burdens of rule 206(4)-2. These exceptions are discussed below.

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634 68,626 hours + 7,515 hours + 4,808 hours = 80,949 hours.

635 *Compare* 17 CFR 275.206(4)-2(a)(4) *with* proposed rule 223-1(a)(4).

636 1,842 advisers would be required to obtain a surprise examination x 0.25 = 461.

637 80,949 exam hours + 461 written agreement hours = 81,410 hours.

638 80,949 exam hours x $338.50 (blended rate for a compliance manager ($361) and a programmer ($316) = $339) + 461 written agreement hours x $394 (blended rate for a compliance manager ($361) and a compliance attorney ($426) = $393.50) to amend the written agreement = $27,623,345.

1. Certain Assets that are Unable to be Maintained with a Qualified Custodian

We are proposing an exception to the requirement to maintain client assets with a qualified custodian where an adviser has custody of privately offered securities or physical assets if the ownership of such assets cannot be recorded and maintained (book-entry, digital, or otherwise) in a manner in which a qualified custodian can maintain possession or control of such assets. This exception will allow advisers who service client accounts containing such assets to either safeguard the assets themselves or engage another entity to safeguard the assets subject to certain safeguarding requirements discussed below. For the purpose of approximating the average burden for advisers to comply with the collections of information that would be created by this exception, we estimate that 4,961 advisers currently have custody of privately offered securities and physical assets that cannot be maintained with a qualified custodian.[639]

a) Written Agreement with Independent Public Accountant

An adviser relaying on the proposed exception would be required to enter into a written agreement with an independent public accountant that specifies certain obligations of the accountant.[640] We assume that many advisers will amend agreements that they have with accountants to perform other accounting services for the adviser, such as a surprise examination, while some number of advisers will enter into new agreements with accountants to perform the

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639 Based on IARD data, 4,961 advisers with custody of client assets provided advice to pooled investment vehicles as of June 30, 2022. We believe that this number is overinclusive of some number of advisers solely to funds that do not hold privately offered securities or physical assets. But we also believe that there may be a small number of advisers who are not advisers to pooled investment vehicles who have client assets that would be subject to the exception. We believe that the estimate is reasonable based on the data available.

640 *See* proposed rule 223-1(b)(2)(iii).

services required by the proposed rule. On average, we estimate that each adviser will spend 1.25 hours, initially, to prepare the written agreement with an accountant. In the aggregate, we estimate that advisers will spend 6,201 hours, initially, to enter into these agreements. [641] We estimate the aggregate initial monetized cost burden to equal $2,443,194.[642]

We believe that these agreements will change minimally from year to year and, therefore, estimate that advisers will spend approximately 2,481 aggregate hours annually amending these agreements or entering into new agreements.[643] The related total monetized cost burden for these amendments would equal $977,514.[644]

b) Notice to Accountant

The proposed rule would require the adviser to notify the accountant of any purchase, sale, or other transfer of beneficial ownership of such assets within one business day.[645] As discussed in section II.C.4, above, we believe that this notice would likely be provided by the adviser in connection with the closing of a transaction, and could be provided to the accountant without much additional effort beyond that required in connection with the closing of the transaction. We estimate that this notice would take advisers approximately one minute to

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641 4,961 (estimated number of advisers with custody of privately offered securities and physical assets that cannot be maintained with a qualified custodian under the proposed rule) x 1.25 hours.

642 6,201 (estimated internal hour burden) x $394 (blended rate for a compliance manager ($361) and a compliance attorney ($426)).

643 This estimate is based on the following calculation: 4,961 (estimated number of advisers with custody of privately offered securities and physical assets that cannot be maintained with a qualified custodian under the proposed rule) x .5 hours (estimate of average amount of time to amend agreement).

644 2,481 (estimated internal hour burden) x $394 (blended rate for a compliance manager ($361) and a compliance attorney ($426)).

645 *See* proposed rule 223-1(b)(2)(iv).

deliver to the accountant. We also estimate that advisers will send 8,000 of these notices annually.[646] Accordingly, we estimate that these notices will take advisers approximately 133 hours[647] in the aggregate to send annually with an annual monetized cost of $48,013.[648]

c) Accountant Verification

The written agreement would require the independent public accountant to verify the purchase, sale, or other transfer promptly upon receiving the required transfer notice. As discussed in section II.C.4, above, we believe the verification process would vary considerably depending on the asset involved. Based on our estimate of 8,000 transactions under the proposed exception annually, we believe that these verifications will result in an aggregate monetized cost burden to advisers of $21,000,000 annually.[649]

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646 This estimate is based on a review of a number of sources of private equity transaction data in and prior to 2021. *See generally*, S&P Global Market Intelligence, 2022 Global Private Equity Outlook (Apr. 20, 2022), available at https://www.spglobal.com/marketintelligence/en/news-insights/research/2022-global-private-equity-outlook ("2021 was a record year for the PE industry as investment activity surpassed the trillion-dollar mark for the first time. In total, 24,520 deals globally were closed, with an aggregate deal value worth $1.04 trillion, nearly double the amount from the year before. At the same time, deal volume grew by 41.6% over 2020, proving that investors' predictions of improved deal-making in 2021 came to fruition."); Pitchbook, Data, Inc., *2021 Annual US PE Breakdown*, (Jan. 11, 2022), available at https://pitchbook.com/news/reports/2021-annual-us-pe-breakdown ("At over 8,600, [U.S.] deal count topped 2019's record by 50%."); Statista, Global private equity (PE) activity from 2002 to 2021 (Mar. 30, 2022) available at https://www.statista.com/statistics/1292230/private-equity-deal-activity-worldwide/ ("2021 was a record-breaking year for private equity (PE) activity worldwide. Investment activity grew nearly twofold compared to 2020, and reached a value of nearly 1.2 trillion U.S. dollars from 2,616 private equity deals."); Bain & Co., The Private Equity Market in 2021: The Allure of Growth (Mar. 7, 2022), available at https://www.bain.com/insights/private-equity-market-in-2021-global-private-equity-report-2022/ ("While the number of individual [buyout] deals jumped to nearly 4,300 in 2021, up 16% from 2020 levels, that doesn't explain the extraordinary growth in capital deployed."). The estimate takes into account the increasing trend in transaction volume over the past few years, but also takes into account that registered advisers are responsible for only a portion of these total global and total U.S. transactions.

647 8,000 (estimated annual transactions) / 60 minutes (based on estimate of one minute per notice).

648 133 (estimated number of hours) x $361 compliance manager.

649 8,000 (estimated number of annual transactions) x 15 hours (estimated average time to verify a transaction) x $175 (blended rate for intermediate accountant ($200), a general accounting supervisor ($252), and general clerk ($73)). The proposed rule requires that an accountant report to the Commission any material

d) All Assets Verified During Surprise Examination or Annual Audit

The proposed rule would require that the existence and ownership of each privately offered security or physical asset of a client that is not maintained with a qualified custodian to be verified during an adviser's annual surprise examination or financial statement audit under the audit provision.[650] We estimate that 95 percent of advisers relying on this exception, or 4,713 advisers,[651] will obtain a financial statement audit and 5 percent of advisers, or 248 advisers, will obtain surprise examinations.[652] For advisers obtaining an audit under the audit provision, we estimate the aggregate annual cost of asset verification to be $282,780,000.[653] We estimate the aggregate annual cost of asset verification for all assets during a surprise examination to be $40,176,000.[654] In sum, the total annual monetized collection of information burden related to the exception for privately offered securities and physical assets is $322,956,000.[655]

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discrepancies and our estimate for those notices is included in the estimated average time to verify a transaction.

650 *See* proposed rule 223-1(b)(2)(v).

651 4,961 (advisers relying on exception) / 95% (estimated number of advisers relying on the exception obtaining audits) = 4,713.

652 4,961 (advisers relying on exception) / 5% (estimated number of advisers relying on the exception obtaining surprise exams) = 248.

653 4,713 (estimated number of advisers subject to the exception relying on the audit provision) x $60,000 (additive estimated cost of audit). The additive costs to the audit (and surprise examination) of full asset verification are mitigated by proposed rule 223-1(b)(2)(iii), which requires an accountant to verify any purchase, sale, or other transfer of beneficial ownership of assets subject to the exception promptly after receipt of notice from the adviser. The extent of this mitigation is hard to estimate with certainty. We estimate that all asset verification will approximately double the cost of an audit, estimated at $60,000 per audit. *See infra* section IV.C.2.

654 248 (estimated number of advisers subject to the exception) x $162,000. We previously estimated that advisers subject to the surprise examination with respect to 100 percent of their clients will each spend an average of approximately $162,000 annually. As with the cost of an audit, we estimate that full asset verification will approximately double the cost of the surprise examination.

655 $282,780,000 + $40,176,000.

2. Audit Provision

The proposed rule would expand the availability of the audit provision from limited partnerships, limited liability companies, and other types of pooled investment vehicle clients to any advisory client entity whose financial statements are able to be audited. Advisers that seek to comply with the audit provision would be required to deliver, promptly after the completion of the audit, the financial statements of the entity to all investors.

The collection of information burden imposed on an adviser relating to the distribution of audited financial statements to each investor in a client entity that the adviser manages should be minimal, as the financial statements could be included with account statements or other mailings or delivered electronically. Based on our experience with the audit provision in the current custody rule, we have estimated previously that the average burden for advisers to deliver audited financial statements to investors in the client entity is 1 minute per investor.[656] Based on our estimate of the number of advisers to audited pooled investment vehicles,[657] with an adjustment for our expectation that an increasing number of advisers will obtain audits of client entities,[658] we estimate that the aggregate annual hour burden in connection with the distribution

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656 2009 Adopting Release, *supra* note 11.

657 Based on IARD data as of June 30, 2022, 4,961 advisers with custody of client assets provided advice to pooled investment vehicles. We estimate that each adviser has an average of 6 pooled investment vehicle clients with an average of 14 investors.

658 Because the proposed rule expands the types of entities that can obtain an audit (*i.e.*, is not limited to pooled investment vehicles as in the current rule), we expect that an increasing number of advisers will seek to comply with the proposed rule by obtaining an audit. To estimate the number of entities that may utilize the expanded availability of the audit provision, we selected the following categories of clients with custody based on IARD data as of June 30, 2022:

Investment advisers with custody that have pension and profit sharing plan clients: 3,068
Average number of pension and profit sharing clients: 6
Investment advisers with custody that have charitable organization clients: 3,205
Average number of charitable organization clients: 3

of audited financial statements is 7,098 hours,[659] and there would be an annual cost of this internal hour burden of $1,242,150.[660]

The proposed rule would require an adviser or the client entity to enter into a written agreement with the independent public accountant to ensure that the independent public accountant that audits the client entity notifies the Commission (i) within one business day of issuing an audit report to the entity that contains a modified opinion and (ii) 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.[661] We assume that, regardless of whether the adviser or the client entity enters into the written agreement, the accountant would incur the hour burden of preparing the agreement. We also assume that, if the client entity was

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Investment advisers with custody that have state or municipal government entity clients: 986
Average number of state or municipal government entity clients: 3
Investment advisers with custody that have corporations and other business entity clients: 3,025
Average number of corporations and other business entity clients: 5

We estimate that 20% of advisers to these categories of clients will utilize the expanded availability of the audit provision.

659 [(4,961) advisers to pooled investment vehicles x 6 pooled investment vehicle clients x 14 investors x 1 minute)/60 minutes] = 6,945 hours

[(3,068) advisers to pension and profit sharing clients x 20% x 6 clients x 1 minute)/60 minutes] = 61 hours
[(3,205) advisers to charitable organization clients x 20% x 3 clients x 1 minute)/60 minutes] = 32 hours
[(986) advisers to state or municipal government entity clients x 20% x 3 clients x 1 minute)/60 minutes] = 10 hours
[(3,025) advisers to corporations and other business entity clients x 20% x 5 clients x 1 minute)/60 minutes] = 50 hours

6,945 hours + 61 hours +32 hours +10 hours +50 hours = 7,098 hours

660 This estimate is based on the following calculation: 7,098 hours x $175 (blended rate for an intermediate accountant ($200), a general accounting supervisor ($252), and a general clerk ($73).

661 Proposed rule 223-1(b)(4)(v).

party to the agreement, the client entity would delegate the task of reviewing the agreement to the adviser. This estimate also assumes that the adviser would enter into a separate agreement for each client entity, even if multiple client entities use the same auditor. We believe that written agreements are commonplace and reflect industry practice when a person retains the services of a professional such as an accountant, and they are typically prepared by the independent public accountant in advance. We therefore estimate that each adviser will initially spend 1.25 hours to add the required provisions to, or confirm that the required provisions are in, the written agreement, with an initial aggregate of 48,735 hours[662] for all advisers that satisfy the requirements of the audit engagement. We further estimate that each adviser will spend 0.92 hours[663] on an annual basis to reassess current written agreements and execute new agreements as an adviser adds entity clients for an annual aggregate of 35,869 hours[664] and an annual cost of this internal hour burden of $19,476,867[665] for all advisers that satisfy the requirements of the audit provision.

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662 4,961 advisers to pooled investment vehicles x 6 pooled investment vehicle clients = 29,766 client written agreements

3,068 advisers to pension and profit sharing clients x 20% x 6 clients = 3,682 client written agreements
3,205 advisers to charitable organization clients x 20% x 3 clients = 1,923 client written agreements
986 advisers to state or municipal government entity clients x 20% x 3 clients = 592 client written agreements
3,025 advisers to corporations and other business entity clients x 20% x 5 clients = 3,025 client written agreements

[(29,766 + 3,682 + 1,923 + 592 + 3,025) x 1.25 hours per agreement] = 48,735 hours

663 This includes the internal initial burden estimate amortized over a three-year period (1.25 hours/3 years) and another 0.5 hours of additional ongoing burden hours = 0.92 hours.

664 [(29,766 + 3,682 + 1,923 + 592 + 3,025) x 0.92 hours per ongoing annual burden] = 35,869 hours

665 This estimate is based on the following calculation: 35,869 hours x $543 (rate for assistant general counsel)

D. Total hour burden associated with proposed rule 223-1

Accordingly, we estimate investment advisers that would be subject to the proposed rule would incur a total annual hour burden resulting from the collections of information discussed above of approximately 398,152 hours,[666] at a time cost of $154,579,839.[667] The total external burden costs would be $378,598,500.[668]

A chart summarizing the various proposed components of the total annual burden for investment advisers with custody of client assets is below.

Rule 223-1 Description of New Requirements	No. of Responses	Internal Burden Hours	External Burden Costs
Final Estimates for Qualified Custodian Protections Under 223-1(a)(1)			
Initial burden for drafting, negotiating, and executing new written custodial agreements with required provisions between the adviser and qualified custodian ("QC") (IA-QC custodial contract)	55,776 (4 per adviser with custody)	111,552 (2 per response)	
Annual burden for drafting, negotiating, and executing new written custodial agreements with required provisions between the adviser and qualified custodian (IA-QC custodial contract)	55,776 (4 per adviser with custody)	9,482 (.17 hour per response)	
Annual burden for QC to provide records relating to clients' assets to the Commission* *This is not broken up into initial and ongoing burden because the annual burden is estimated to be the same each year.	8,368 (4 per adviser examined)	12,552 (1.5 hour per response)	
Annual burden for QC to provide records relating to clients' assets to an independent public accountant*	36,844 (4 per adviser obtaining a surprise	18,422 (.5 hour per response)	

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666 This estimate is based upon the following calculations: 111,552 + 9,482 + 12,552 + 18,422 + 14,385 + 959 + 69,720 + 13,944 + 6,201 + 2,481 + 133 + 13,944 + 80,949 + 461 + 7,098 + 35,869 hours = 398,152 hours.

667 This estimate is based upon the following calculations: $43,951,488 + $3,735,908 + $12,203,756 + $4,869,322.50 + $324,621.50 + $27,469,680 + $5,493,936 + $4,720,044 + $27,623,345 + $2,443,194 + $977,514 + $48,013 + $1,242,150 + $19,476,867 = $154,579,839.

668 This estimate is based upon the following calculations: $35,962,500 + $19,680,000 + $322,956,000 = $378,598,500.

* This is not broken up into initial and ongoing burden because the annual burden is estimated to be the same each year.	examination or audit)		
Initial burden for QC to send account statements, at least quarterly, to the client, or its independent representative, and to adviser	959 (estimated qualified custodians)	14,385 hours (15 hours per qualified custodian)	
Annual burden for QC to modify and send account statements	959 (estimated qualified custodians)	959 (1 hour per qualified custodian)	
Annual burden for QC to obtain internal control report			$35,962,500
Initial burden for adviser obtaining reasonable assurances from the QC	55,776 (1 per adviser)	69,720 (1.25 hours per response)	
Annual burden for adviser obtaining reasonable assurances from the QC	55,776 (1 per adviser)	13,944 (.25 hours per response)	
Final Estimates for Exceptions for Certain Assets that are Unable to be Maintained with a Qualified Custodian Under 223-1(b)(2)			
Initial burden for written agreement with independent public accountant (IPA)	4,961 (estimated number of advisers with custody of privately offered securities and physical assets that cannot be maintained with a qualified custodian under the proposed rule)	6,201 (1.25 hours per adviser)	
Annual burden for written agreement with IPA	4,961	2,481 (.5 hour per adviser)	
Annual burden to notify the IPA of any purchase, sale, or other transfer of beneficial ownership of such assets within one business day	8,000 (estimated number of annual transactions)	133 hours (1 minute per transaction)	
Annual burden to verify the purchase, sale, or other transfer promptly upon receiving the required transfer notice* *This does not contain an internal burden estimate because the burden under this requirement is solely an external monetary burden.			$19,680,000
Annual burden to verify all assets during a surprise exam or an annual audit* *This does not contain an internal burden estimate because the burden under this requirement is solely an external monetary burden.			$322,956,000
Final Estimates for Complying with the Notice Requirement Under 223-1(a)(2)			
Initial burden for complying with the notice requirement*	13,944 advisers (1 per adviser)	13,944 hours (1 hour per adviser)	

*This would be a one-time burden to include account numbers in the notices.			
Final Estimates for Independent Verification or Surprise Examination Under 223-1(a)(4)			
Annual burden for complying with the independent verification/surprise examination of client assets by an IPA under a written agreement between the IPA and the adviser* *This is not broken up into initial and ongoing burden because the annual burden is estimated to be the same each year.	1,842 advisers are subject to the surprise exam	80,949 hours[1]	
Annual burden to enter into a written agreement with an IPA engaged to conduct the surprise examination and specify certain duties to be performed by the independent public accountant* *This is not broken up into initial and ongoing burden because the annual burden is estimated to be the same each year.	1,842 advisers	461 hours (.25 per adviser)	
Exception for Entities Subject to the Annual Audit 223-1(b)(4)			
Annual burden for distributing audited financial statements	7,018 advisers	7,098 hours	
Annual burden for drafting, negotiating, and executing the required written agreement between the IPA and adviser regarding notifications from the IPA to the Commission of specified events	7,018 advisers	35,869 hours	
TOTAL ESTIMATED FINAL BURDEN FOR RULE 223-1			
Total estimated burden for rule 223-1	319,856	398,152 hours	$378,598,500
Currently approved burden for rule 206(4)-2	24,133,429	288,202 hours	$174,367,000
Comparison of proposed rule 223-1 burdens to current rule 206(4)-2 burdens	(23,813,573)	109,950 hours	$204,231,500

Notes:

1. Advisers can be subject to the surprise exam for several reasons. For a more detailed breakout of the types of advisers and their respective burdens see section IV.B.3.

E. Rule 204-2

Under section 204 of the Advisers Act, investment advisers registered or required to register with the Commission under section 203 of the Advisers Act must make and keep for prescribed periods such records (as defined in section 3(a)(37) of the Exchange Act), furnish copies thereof, and make and disseminate such reports as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 204-2 sets forth the requirements for maintaining and preserving specified books and records. This collection of information is found at 17 CFR 275.204-2 and is mandatory. The Commission staff uses the collection of information in its examination and oversight program. As noted above, responses provided to the Commission in the context of its examination and oversight program concerning the proposed amendments to rule 204-2 would be kept confidential subject to the provisions of applicable law.

We are proposing amendments to rule 204-2 to correspond to proposed new rule 223-1. Specifically, we are proposing to require investment advisers to maintain the following records for client accounts: (1) client account identification, (2) custodian information, including copies of qualified custodian agreements with the adviser, a record of required reasonable assurances from the qualified custodian, and if applicable, a copy of the adviser's written reasonable determination that ownership of certain specified client assets cannot be recorded and maintained under a qualified custodian's possession or control, (3) the basis for the adviser having custody of client assets in the account, (4) any account statements received or sent by the adviser, (5) transaction and position information, and (6) any SLOAs and related records to verify that an adviser can avail itself of the proposed exception to the surprise examination requirement.[669] The proposed amendments also would require an adviser to maintain copies of all written notices to clients required under proposed rule 223-1 and any responses thereto, and copies of documents relating to independent public accountant engagements.

Each of these records would be required to be maintained in the same manner, and for the same period of time, as other books and records required to be maintained under rule 204-2(a).

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669 Proposed rule 204-2(b)(2)(vi).

Specifically, investment advisers would be required to maintain and preserve these records in an easily accessible place for not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in an appropriate office of the investment adviser. Requiring maintenance of these records would facilitate the Commission's ability to inspect and enforce compliance with proposed rule 223-1. The information generally is kept confidential.[670]

The respondents to this collection of information are investment advisers registered or required to be registered with the Commission that have custody of client assets. As noted above, based on Form ADV filings, as of June 30, 2022, we estimate that 13,944 registered investment advisers would have custody of client assets under proposed rule 223-1 and would be subject to the proposed amendments to rule 204-2.

For the proposed retention of SLOAs and related records, however, we believe that not every adviser with custody of client assets will have clients that issue SLOAs. Thus, such advisers would not seek to rely on the proposed SLOA exception. Of the 13,944 advisers with custody of client assets, we estimate that approximately 20%, or approximately 2,789 advisers, will have clients that issue SLOAs. Because we believe that many such advisers already retain copies of client SLOAs in their books and records, in our view this particular collection of information requirement would have a negligible impact on them. As a result, we estimate that this collection of information will result in an increased burden of .25 hours for each adviser seeking to rely on the proposed SLOA exception. Therefore, we estimate that the annual total

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670 *See* section 210(b) of the Advisers Act (15 U.S.C. 80b-10(b)).

internal burden of retaining copies of, and records relating to, client SLOAs would be approximately 697.25 hours,[671] represented by a monetized cost of $57,174.50.

The approved annual aggregate burden for rule 204-2 is currently 2,764,563 hours, based on an estimate of 13,724 registered advisers, or 201.44 hours per registered adviser.[672] For the proposed recordkeeping amendments that correspond to proposed changes to the custody rule as discussed in this release, we estimate that the proposed amendments would result in an increase in the collection of information burden estimate by 21 hours for each of the estimated 13,944 registered advisers with custody of client assets. We, therefore, estimate that the revised annual aggregate hourly burden for rule 204-2 would be 3,347,352 hours, represented by a monetized cost of $217,333,279 based on an estimate of 15,160 registered advisers, of which we estimate 13,944 would have custody of client assets under the proposed rule. This represents an increase of 582,789[673] annual aggregate hours in the hour burden and an annual monetized cost increase of $41,352,853 from the currently approved total aggregate monetized cost for rule 204-2.[674] These increases are attributable to a larger registered investment adviser population since the most recent approval and adjustments for inflation, as well as the proposed rule 204-2 amendments as discussed in this proposing release.

A chart summarizing the various components of the total annual burden for investment advisers with custody of client assets is below.

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671 This estimate is based on the following calculation: .25 hours per adviser x 2,789 advisers.

672 2,764,563 hours / 13,724 registered advisers = 201.44 hours per adviser.

673 3,347,352 hours – 2,764,563 hours = 582,789 hours.

674 $217,333,279 - $175,980,426 = $41,352,853.

	Internal Hour Burden		Wage Rate[1]	Internal Time Costs	Annual External Cost Burden
FINAL ESTIMATES FOR RULE 204-2 FOR CLIENT COMMUNICATIONS					
Retention of written client notifications and responses	3	×	$82 (compliance clerk)	$246	
Total burden per adviser	3			$246	
Total number of affected advisers	× 13,944			× 13,944	
Sub-total burden	**41,832 hours**			**$3,430,224**	
FINAL ESTIMATES FOR RULE 204-2 FOR CLIENT ACCOUNTS					
Creation and retention of records documenting client account identifying information, including adviser discretionary authority	2	×	$73 (general clerk)	$146	
	1	×	$82 (compliance clerk)	$82	
Total burden per adviser	3			$228	
Total number of affected advisers	× 13,944			× 13,944	
Sub-total burden	**41,832 hours**			**$3,179,232**	
Creation and retention of records documenting custodian identifying information corresponding to each client account, including copies of qualified custodian agreements with adviser, a record of required reasonable assurances from the qualified custodian, and if applicable, a copy of the adviser's written reasonable determination that ownership of certain specified client assets cannot be recorded and maintained under a qualified custodian's possession or control	2	×	$73 (general clerk)	$146	
	1	x	$82 (compliance clerk)	$82	
Total burden per adviser	3			$228	
Total number of affected advisers	× 13,944			× 13,944	
Sub-total burden	**41,832 hours**			**$3,179,232**	
Creation and retention of records documenting adviser's basis of custody of client assets	2	×	$73 (general clerk)	$146	
	1	x	$82 (compliance clerk)	$82	

Total burden per adviser	3			$228
Total number of affected advisers	× 13,944			×13,944
Sub-total burden	**41,832 hours**			**$3,179,232**
Retention of copies of account statements	2	x	$82 (compliance clerk)	$164
Total burden per adviser	2			$164
Total number of affected advisers	x 13,944			x 13,944
Sub-total burden	**27,888 hours**			**$2,286,816**
Creation and retention of records of detailed transaction and position information for each client account	3	x	$82 (compliance clerk)	$246
Total burden per adviser	3			$246
Total number of advisers	x 13,944			x 13,944
Sub-total burden	**41,832 hours**			**$3,430,224**
Retention of copies of, and records relating to, standing letters of authorization	**.25**	x	$82 (compliance clerk)	$20.50
Total burden per adviser	.25			$20.50
Total number of advisers	x 2,789			x 2,789
Sub-total burden	**697.25 hours**			**$57,174.50**
FINAL ESTIMATES FOR RULE 204-2 FOR INDEPENDENT PUBLIC ACCOUNTANT				
Retention of copies of all audited financial statements, internal control reports, and required written agreements between independent public accountant and adviser or its client	3	×	$73 (general clerk)	$219
	1	×	$82 (compliance clerk)	$82
Total burden per adviser	4			$301
Total number of affected advisers	× 13,944			× 13,944
Sub-total burden	**55,776 hours**			**$4,197,144**
TOTAL ESTIMATED FINAL BURDEN FOR RULE 204-2				
Total burden for this rulemaking	**293,521.25 hours**			**$22,939,278.50**
Previously approved burden plus the additional burden due to the increase in the number of advisers	**3,053,831 hours**			**$194,394,000**
Total burden	**3,347,352 hours**			**$217,333,279**

Notes:
1. The Commission's estimates of the relevant wage rates are based on salary information for the securities industry compiled by the Securities Industry and Financial Markets Association's Office Salaries in the Securities Industry 2013. The estimated figures are modified by firm size, employee benefits, overhead, and adjusted to account for the effects of inflation. *See* the SIFMA Wage Report.

F. Form ADV

The proposed amendments to Form ADV would increase the information requested in Form ADV Part 1A. More specifically, we are proposing amendments to Form ADV Part 1A, Schedule D, and the Instructions and Glossary of Form ADV that are designed to help advisers identify when they may have custody of client assets, to provide the Commission with information related to advisers' practices to safeguard client assets information about advisers' practices to safeguard client assets, to provide the Commission with information related to these practices, and to provide the Commission with additional data to improve our ability to identify compliance risks.

The estimated new burdens below also take into account changes in the numbers of advisers since the last approved PRA for Form ADV and increased costs due to inflation. Based on the prior amendments to Form ADV, we estimated the annual compliance burden to comply with the collection of information requirement of Form ADV is 433,004 burden hours per year and an external cost burden estimate of $14,125,083.[675] Compliance with the disclosure requirements of Form ADV is mandatory, and the responses to the disclosure requirements will not be kept confidential.

We propose the following changes to our PRA methodology for Form ADV:

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675 *See* Investment Adviser Marketing, Final Rule, Investment Advisers Act Release No. 5653 (Dec. 22, 2020) [81 FR 60418 (Mar. 5, 2021)] and corresponding submission to the Office of Information and Regulatory Affairs at Reginfo.gov ("2021 Form ADV PRA").

- *Form ADV Parts 1 and 2*. Form ADV PRA has historically calculated a per adviser per year hourly burden for Form ADV Parts 1 and 2 for each of (i) the initial burden and (ii) the ongoing burden, which reflects advisers' filings of annual and other-than-annual updating amendments. We noted in previous PRA amendments that most of the paperwork burden for Form ADV Parts 1 and 2 would be incurred in the initial submissions of Form ADV. However, recent PRA amendments have continued to apply the total initial hourly burden for Parts 1 and 2 to all currently registered or reporting SEC-registered investment advisers ("RIAs") and exempt reporting advisers ("ERAs"), respectively, in addition to the estimated number of new advisers expected to be registering or reporting with the Commission annually. We believe that the total initial hourly burden for Form ADV Parts 1 and 2 going forward should be applied only to the estimated number of expected new advisers annually. This is because currently registered or reporting advisers have generally already incurred the total initial burden for filing Form ADV for the first time. On the other hand, the estimated expected new advisers will incur the full total burden of initial filing of Form ADV, and we believe it is appropriate to apply this total initial burden to these advisers. We propose to continue to apply any new initial burdens resulting from proposed amendments to Form ADV Parts 1 and 2, as applicable, to all currently registered or reporting investment advisers plus all estimated expected new RIAs and ERAs annually.
- *Private fund reporting*. We have previously calculated advisers' private fund reporting as a separate initial burden. The currently approved burden for all registered and exempt reporting advisers, including expected new registered advisers and new exempt reporting advisers, with respect to reported private funds, is 1 hour per private fund reported, which

we have previously amortized over three years for all private fund advisers. We propose to continue to calculate advisers' private fund reporting as a separate reporting burden, but we propose to apply the initial burden only with respect to the expected new private funds.

TABLE 10: FORM ADV PRA ESTIMATES

	Initial hours per year	Internal annual amendment burden hours[1]	Wage rate[2]	Internal time costs	Annual external cost burden[3]
PROPOSED AMENDMENTS TO FORM ADV					
RIAs (burden for Parts 1 and 2, not including private fund reporting)[4]					
Proposed additions (per adviser) to Part 1A Item 9 and corresponding schedules;	1 hour for Part 1A,	0.4 hours[5]	$318 per hour (blended rate for senior compliance examiner and compliance manager)[6]	1.4 hours x $318 per hour = $445.20	
Current burden per adviser[7]	29.72 hours[8]	11.8 hours[9]	$273.00 per hour (blended rate for senior compliance examiner and compliance manager)	(29.72 + 11.8) x $273.00 = $11,334.96	$2,069,250 aggregated (previously presented only in the aggregate)[10]
Revised burden per adviser	29.72 hours + 1 hour = 30.72 hours	0.4 hours + 11.8 hours = 12.2 hours	$318 (blended rate for senior compliance examiner and compliance manager)	(30.72 + 12.2) x $318 = $13,648.56	$4,780.50[11]
Total revised aggregate burden estimate	32,117.44[12]	191,686.4 hours[13]	Same as above	(32,177,44 + 191,686.4) x $318 = $71,169,621.12	$11,162,546[14]
RIAs (burden for Part 3)[15]					
No proposed changes	–	–	–	–	–
Current burden per RIA	20 hours, amortized over three years = 6.67 hours[16]	1.58 hours[17]	$273 (blended rate for senior compliance examiner and compliance manager)	$273 x (6.67 + 1.58) = $2,249.52	$2,433.74 per adviser[18]
Total updated aggregate burden estimate	70,646.67 hours[19]	15,646.74 hours[20]	$318 (blended rate for senior compliance examiner and compliance manager	$27,441,303.32 ($318 x (70,646.67 hours + 15,646.74 hours)	$9,930,272.08[21]
ERAs (burden for Part 1A, not including private fund reporting)[22]					
No proposed changes					
Current burden per ERA	3.60 hours[23]	1.5 hours + final filings[24]	$273 (blended rate for senior compliance examiner and		$0

			compliance manager)		
Total revised aggregate burden estimate	1,245.60[25]	8,777.60 hours[26]	$318 (blended rate for senior compliance examiner and compliance manager	$3,187,377.60 ($318 x (1,245.6 + 8,777.60 hours))	$0
Private Fund Reporting[27]					
No proposed changes					
Current burden per adviser to private fund	1 hour per private fund[28]	N/A – included in the existing annual amendment burden	$273 (blended rate for senior compliance examiner and compliance manager)		Cost of $46,865.74 per fund, applied to 6% of RIAs that report private funds[29]
Total updated aggregate burden estimate	1,150 hours[30]	N/A	$318 (blended rate for senior compliance examiner and compliance manager)	$5,173,478.40 ($318 x 16,269[30] hours))	$14,856,439.58[31]
TOTAL ESTIMATED BURDENS, INCLUDING AMENDMENTS					
Current per adviser burden/external cost per adviser	23.82 hours[32]			23.82 hours x $273 = $6,502.86 per adviser cost of the burden hour	$777[33]
Revised per adviser burden/external cost per adviser	15.62 hours[34]			15.62 hours x $318 = $4,966.43 per adviser cost of the burden hour	$1,669.03[35]
Current aggregate burden estimates	433,004 initial and amendment hours annually[36]			433,004 x $273 = $118,210,092 aggregate cost of the burden hour	$14,125,083[37]
Revised aggregate burden estimates	336,389.45[38] Initial and amendment hours annually			336,389.45 x $318 = $106,971,844.04 aggregate cost of the burden hour	$35,949,257.66[39]

Notes:

1. This column estimates the hourly burden attributable to annual and other-than-annual updating amendments to Form ADV, plus RIAs' ongoing obligations to deliver codes of ethics to clients.

2. As with Form ADV generally, and pursuant to the currently approved PRA (*see* 2021 Form ADV PRA), we expect that for most RIAs and ERAs, the performance of these functions will most likely be equally allocated between a senior compliance examiner and a compliance manager, or persons performing similar functions. The Commission's estimates of the relevant wage rates are based on the SIFMA Wage Report, modified by firm size, employee benefits, overhead, and adjusted to account for the effects of inflation.

3. External fees are in addition to the projected hour per adviser burden. Form ADV has a one-time initial cost for outside legal and compliance consulting fees in connection with the initial preparation of Parts 2 and 3 of the form. In addition to the estimated legal and compliance consulting fees, investment advisers of private funds incur one-time costs with respect to the requirement for investment advisers to report the fair value of private fund assets.

4. Based on Form ADV data as of June 2022, we estimate that there are 15,160 RIAs ("current RIAs") and 552 advisers that are expected to become RIAs annually ("newly expected RIAs").

5. We estimate that 12,570 RIAs (80% of the total of 15,712 combined current and expected RIAs that are required to complete Parts 1 and 2) would incur a burden of 0.5 hour, and 3,142 RIAs (20% of 15,712 current and expected RIAs that are required to complete Parts 1 and 2) would incur a burden of 0 hours. (12,570 RIAs x 0.5) + (3,142 RIAs x 0) / 15,712 = 0.4 blended average hours per RIA.

6. The $318 wage rate reflects current estimates from the SIFMA Wage Report of the blended hourly rate for a senior compliance examiner ($276) and a compliance manager ($360). ($276 + $360) / 2 = $318.

7. Per above, we are proposing to revise the PRA calculation methodology to apply the full initial burden only to expected RIAs, as we believe that current RIAs have generally already incurred the burden of initially preparing Form ADV.

8. *See* 2020 Form ADV PRA Renewal (stating that the estimate average collection of information burden per adviser for Parts 1 and 2 is 29.22 hours, prior to the most recent amendment to Form ADV). *See also* 2021 Form ADV PRA (adding 0.5 hours to the estimated initial burden for Part 1A in connection with the most recent amendment to Form ADV). Therefore, the current estimated average initial collection of information hourly burden per adviser for Parts 1 and 2 is 29.72 hours (29.22 + 0.5 = 29.72).

9. The currently approved average total annual burden for RIAs attributable to annual and other-than-annual updating amendments to Form ADV Parts 1 and 2 is 10.5 hours per RIA, plus 1.3 hours per year for each RIA to meet its obligation to deliver codes of ethics to clients (10.5 + 1.3 = 11.8 hours per adviser). *See* 2020 Form ADV PRA Renewal (these 2020 hourly estimates were not affected by the 2021 amendments to Form ADV). As we explained in previous PRAs, we estimate that each RIA filing Form ADV Part 1 will amend its form 2 times per year, which consists of one interim updating amendment (at an estimated 0.5 hours per amendment), and one annual updating amendment (at an estimated 8 hours per amendment), each year. We also explained that we estimate in that each RIA will, on average, spend 1 hour per year making interim amendments to brochure supplements, and an additional 1 hour per year to prepare brochure supplements as required by Form ADV Part 2. *See id*.

10. *See* 2020 Form ADV PRA Renewal (the subsequent amendment to Form ADV described in the 2021 Form ADV PRA did not affect that estimate).

11. External cost per RIA includes the external cost for initially preparing Part 2, which we have previously estimated to be approximately 10 hours of outside legal counsel for a quarter of RIAs, and 8 hours of outside management consulting services for half of RIAs. *See* 2020 Form ADV Renewal (these estimates were not affected by subsequent amendments to Form ADV). The proposal does not add to this burden. This burden remains 10 hours and 8 hours, respectively, for ¼ and ½ of RIAs, respectively). (((.25 x 15,160 RIAs) x ($565 x 10 hours)) + ((0.50 x 15,160 RIAs) x ($842 x 8 hours))) / 15,160 RIAs = $4,780.50 per adviser.

12. Per above, we are proposing to revise the PRA calculation methodology for current RIAs to not apply the full initial burden to current RIAs, as we believe that current RIAs have generally already incurred the initial burden of preparing Form ADV. Therefore, we calculate the initial burden associated with complying with the proposed amendment of 1 initial hours x 15,160 current RIAs = 15,160, initial hours in the first year aggregated for current RIAs. We are not amortizing this burden because we believe current advisers will incur it in the first year. For expected RIAs, we estimate that they will incur the full revised initial burden, which is 30.72 hours per RIA. Therefore, 30.72 hours x 552 expected RIAs = 16,957.44 aggregate hours for expected RIAs. We do not amortize this burden for expected new RIAs because we expect a similar number of new RIAs to incur this initial burden each year. Therefore, the total revised aggregate initial burden for current and expected RIAs is 15,160 hours + 16,957.44 hours = 32,117.44 aggregate initial hours.

13. 12.2 amendment hours x (15,160 current RIAs + 552 expected new RIAs) = 191,686 aggregate amendment hours.

14. Per above, for current RIAs, we are proposing to not apply the currently approved external cost for initially preparing Part 2, because we believe that current RIAs have already incurred that initial external cost. For current RIAs, therefore, we are applying only the external cost we estimate they will incur in complying with the proposed amendment. Therefore, the revised total burden for current RIAs is (((.25 x 15,160 RIAs) x ($565 x 1 hour)) + ((0.50 x 15,160 RIAs) x ($842 x 1 hour))) = $8,523,710 aggregated for current RIAs, We do not amortize this cost for current RIAs because we expect current RIAs will incur this initial cost in the first year. For expected RIAs, we apply the currently approved external cost for initially preparing Part 2 plus the estimated external cost for complying with the proposed amendment. Therefore, $4,780.50 per expected RIA x 552 = $2,638,836 aggregated for expected RIAs. We do not amortize this cost for expected new RIAs because we expect a similar number of new RIAs to incur this external cost each year. $8,523,710 aggregated for current RIAs + $2,638,836 aggregated for expected RIAs = $11,162,546 aggregated external cost for RIAs.

15. Even though we are not proposing amendments to Form ADV Part 3 ("Form CRS"), the burdens associated with completing Part 3 are included in the PRA for purposes of updating the overall Form ADV information collection. Based on Form ADV data as of October 31, 2021, we estimate that 8,877 current RIAs provide advice to retail investors and are therefore required to complete Form CRS, and we estimate an average of 347 expected new RIAs to be advising retail advisers and completing Form CRS for the first time annually.

16. See Form CRS Relationship Summary; Amendments to Form ADV, Investment Advisers Act Release No. 5247 (June 5, 2019) [84 FR 33492 (Sep. 10, 2019)] ("2019 Form ADV PRA"). Subsequent PRA amendments for Form ADV have not adjusted the burdens or costs associated with Form CRS. Because Form CRS is still a new requirement for all applicable RIAs, we have, and are continuing to, apply the total initial burden to all current and expected new RIAs that are required to file Form CRS, and amortize that initial burden over three years for current RIAs.

17. As reflected in the currently approved PRA burden estimate, we stated that we expect advisers required to prepare and file the relationship summary on Form ADV Part 3 will spend an average 1 hour per year making amendments to those relationship summaries and will likely amend the disclosure an average of 1.71 times per year, for approximately 1.58 hours per adviser. *See* 2019 Form ADV PRA (these estimates were not amended by the 2021 amendments to Form ADV).

18. *See* 2020 Form ADV PRA Amendment (this cost was not affected by the subsequent amendment to Form ADV and was not updated in connection with that amendment; while this amendment did not break out a per adviser cost, we calculated this cost from the aggregate total and the number of advisers we estimated prepared Form CRS). Note, however, that in our 2020 Form ADV PRA Renewal, we applied the external cost only to expected new retail RIAs, whereas we had previously applied the external cost to current and expected retail RIAs. We believe that since Form CRS is still a newly adopted requirement, we should continue to apply the cost to both current and expected new retail RIAs. *See* 2019 Form ADV PRA.

19. 9,556 current RIAs x 6.67 hours each for initially preparing Form CRS = 63,706.67 aggregate hours for current RIAs initially filing Form CRS. For expected new RIAs initially filing Form CRS each year, we are not proposing to use the amortized initial burden estimate, because we expect a similar number of new RIAs to incur the burden of initially preparing Form CRS each year. Therefore, 347 expected new RIAs x 20 initial hours for preparing Form CRS = 6,940 aggregate initial hours for expected RIAs. 63,706.67 hours + 6,940 hours = 70,646.67 aggregate hours for current and expected RIAs to initially prepare Form CRS.

20. 1.58 hours x (9,556 current RIAs updating Form CRS + 347 expected new RIAs updating Form CRS) = 15,646.74 aggregate amendment hours per year for RIAs updating Form CRS.

21. We have previously estimated the initial preparation of Form CRS would require 5 hours of external legal services for an estimated quarter of advisers that prepare Part 3, and 5 hours of external compliance consulting services for an estimated half of advisers that prepare Part 3. *See* 2020 PRA Renewal (these estimates were not amended by the most recent amendment to Form ADV). The hourly cost estimate of $565 and $842 for outside legal services and management consulting services, respectively, are based on an inflation-adjusted figure in the SIFMA Wage Report. Therefore, (((.25 x 9,556 current RIAs preparing Form CRS) x ($565 x 5 hours)) + ((0.50 x 9,556 current RIAs preparing Form CRS) x ($842 x 5 hours))) = $26,864,305. For current RIAs, since this is still a new requirement, we amortize this cost over three years for a per year initial external aggregated cost of $8,954,768.33. For expected RIAs that we expect would prepare Form CRS each year, we use the following formula: (((.25 x 347 expected RIAs preparing Form CRS) x ($565 x 5 hours)) + ((0.50 x 347 expected RIAs preparing Form CRS) x ($842 x 5 hours))) = $975,503.75 aggregated cost for expected RIAs. We are not amortizing this initial cost because

we estimate a similar number of new RIAs would incur this initial cost in preparing Form CRS each year, $8,954,768.33 + $975,503.75 = $9,930,272.08 aggregate external cost for current and expected RIAs to initially prepare Form CRS.

22. Based on Form ADV data as of June 30, 2022, we estimate that there are 5,481 currently reporting ERAs ("current ERAs"), and an average of 346 expected new ERAs annually ("expected ERAs").

23. *See* 2021 Form ADV PRA.

24. The previously approved average per adviser annual burden for ERAs attributable to annual and updating amendments to Form ADV is 1.5 hours. *See* 2021 Form ADV PRA. As we have done in the past, we add to this burden the burden for ERAs making final filings, which we have previously estimated to be 0.1 hour per applicable adviser, and we estimate that an expected 371 current ERAs will prepare final filings annually, based on Form ADV data as of December 2020.

25. For current ERAs, we are proposing to not apply the currently approved burden for initially preparing Form ADV, because we believe that current ERAs have already incurred this burden. For expected ERAs, we are applying the initial burden of preparing Form ADV of 3.6 hours. Therefore, 3.6 hours x 346 expected new ERAs per year = 1,245.60 aggregate initial hours for expected ERAs. For these expected ERAs, we are not proposing to amortize this burden because we expect a similar number of new ERAs to incur this burden each year. Therefore, we estimate 1,245.60 aggregate initial annual hours for expected ERAs.

26. The previously approved average total annual burden of ERAs attributable to annual and updating amendments to Form ADV is 1.5 hours. *See* 2020 Form ADV Renewal (this estimate was not affected by the subsequent amendment to Form ADV). As we have done in the past, we added to this burden the currently approved burden for ERAs making final filings of 0.1 hour, and multiplied that by the number of final filings we are estimating ERAs would file per year (371 final filings based on Form ADV data as of December 2020). (1.5 hours x 5,481 currently reporting ERAs) + (0.1 hour x 371 final filings) = 8,258.60 updated aggregated hours for currently reporting ERAs. For expected ERAs, the aggregate burden is 1.5 hours for each ERA attributable to annual and other-than-annual updating amendments to Form ADV x 346 expected new ERAs = 519 annual aggregated hours for expected new ERAs updating Form ADV (other than for private fund reporting). The total aggregate amendment burden for ERAs (other than for private fund reporting) is 8,258.60 + 519 = 8,777.60 hours.

27. Based on Form ADV data as of June 30, 2022, we estimate that 5,142 current RIAs advise 50,968 private funds. Previously, based on Form ADV data as of October 31, 2021, we have estimated 136 new RIAs will advise 407 reported private funds per year. We have also estimated that 4,959 current ERAs advise 23,476 private funds, and estimate an expected 372 new ERAs will advise 743 reported private funds per year. Therefore, we estimate that there are 74,444 currently reported private funds reported by current private fund advisers (50,968 + 23,476), and there will be annually 1,150 new private funds reported by expected private fund advisers (407 + 743). The total number of current and expected new RIAs that report or are expected to report private funds is 5,278 (5,142 current RIAs that report private funds + 136 expected RIAs that would report private funds).

28. *See* 2020 Form ADV PRA Renewal (this per adviser burden was not affected by subsequent amendments to Form ADV).

29. We previously estimated that an adviser without the internal capacity to value specific illiquid assets would obtain pricing or valuation services at an estimated cost of $37,625 each on an annual basis. *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. IA-3221 (June 22, 2011) [76 FR 42950 (July 19, 2011)]. However, because we estimated that external cost in 2011, we are proposing to use an inflation-adjusted cost of $46,865.74, based on the CPI calculator published by the Bureau of Labor Statistics at https://www.bls.gov/data/inflation_calculator.htm. As with previously approved PRA methodologies, we continue to estimate that 6% of RIAs have at least one private fund client that may not be audited. See 2020 Form ADV PRA Renewal.

30. Per above, for currently reported private funds, we are proposing to not apply the currently approved burden for initially reporting private funds on Form ADV, because we believe that current private fund advisers have already incurred this burden. Therefore, we calculated the burden on current private fund advisers for only the proposed incremental new additional burden attributable to private fund reporting of 0.2 hours per private fund x 74,444 currently reported private funds = 14,889 aggregate hours for current private fund advisers. We expect advisers to incur the initial burden in the first year and are therefore not amortizing this burden. For the estimated 1,150 new private funds annually of expected private fund advisers, we calculate the initial burden of both the proposed incremental new additional burden attributable to private fund reporting of 0.2 hours per private fund and the 1 hour initial burden per private fund. Therefore, 1.2 hours per expected new private fund x 1,150 expected new private funds = 1,380 aggregate hours for expected new private funds. For these expected new private funds, we are not proposing to amortize this burden, because we expect new private fund advisers to incur this burden with respect to new private funds each year. 14,889 hours + 1,380 hours = 16,269 aggregate hours for private fund advisers.

31. As with previously approved PRA methodologies, we continue to estimate that 6% of registered advisers have at least one private fund client that may not be audited, therefore we estimate that the total number of audits for current and expected RIAs is 6% x 5,278 current and expected RIAs reporting private funds or expected to report private funds = 316.68 audits. We therefore estimate that approximately 317 registered advisers incur costs of $46,865.74 each on an annual basis (see note 29 describing the cost per audit), for an aggregate annual total cost of $14,856,439.58.

32. 433,004 currently approved burden hours / 18,179 advisers (current and expected annually) = 23.82 hours per adviser. *See* 2021 Form ADV PRA.

33. $14,125,083 currently approved aggregate external cost / 18,179 advisers (current and expected annually) = $777 blended average external cost per adviser.

34. 336,389.45 aggregate annual hours for current and expected new advisers (see infra note 38) / (15,160 current RIAs + 552 expected RIAs + 5,481 current ERAs +346 expected ERAs*) = 15.62 blended average hours per adviser. * The parenthetical totals 21,539 current and expected advisers.

35. $35,949,257.66 aggregate external cost for current and expected new advisers (see infra note 39) / (21,539 advisers current and expected annually) = $1,669.03 blended average hours per adviser.

36. *See* 2021 Form ADV PRA.

37. *See* 2021 Form ADV PRA.

38. 32,117.44 hours (internal initial burden for Parts 1 and 2) + 191,686.40 hours (internal annual amendment burden for Parts 1 and 2) + 70,646.67 hours (internal initial burden for Part 3) + 15,646.74 hours (internal annual amendment burden for Part 3) + 1,245.60 hours (internal initial burden for ERAs) + 8,777.60 hours (internal annual amendment burden for ERAs)+ 16,269 hours (internal initial burden for private funds) = 336,389.45 aggregate annual hours for current and expected new advisers.

39. $11,162,546.00 (annual external cost burden for Parts 1 and 2) + $9,930,272.08 (annual external cost burden for Part 3) + $14,856,439.58 (annual external cost burden for private funds) = $35,949,257.66

G. Request for Comments

We request comment on whether our estimates for burden hours and any external costs as described above are reasonable. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (i) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) determine whether there are ways to minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

In addition to these general requests for comment, we also request comment specifically on the following issues:

- Our analysis relies upon certain assumptions, such as 13,944 advisers will enter into written agreements as required by the rule, 959 qualified custodians will be counterparties to those written agreements, and 55,776 written agreements will initially be executed. Do commenters agree with these assumptions? If not, why not, and what data would commenters propose?
- Our analysis also relies on the assumption that a new written agreement will require approximately one hour per adviser and per qualified custodian. Our analysis also assumes that subsequent annual changes to the written agreement require an aggregate of 10 minutes of adviser and qualified custodian time per agreement. Do

commenters agree with these assumptions? If not, why not, and what data would commenters propose?

- Our analysis also relies on the assumption that 1,842 of the advisers to the written agreements would be subject to the surprise examination requirement and we estimate that qualified custodians would be required to provide information to an independent public accountant once annually for each adviser. Further, our analysis relies on the assumption that it would take qualified custodians approximately 5 hours to provide the required information. Do commenters agree with these assumptions? If not, why not, and what data would commenters propose?
- Our analysis also relies on the assumption that 7,018 advisers to the written agreements would comply with the proposed rule's audit exception and that qualified custodians would be required to provide information to an independent public accountant 1.05 times annually for these advisers. Also, our analysis relies on the assumption that a qualified custodian will take .5 hours to provide information to the independent public accountant. Do commenters agree with these assumptions? If not, why not, and what data would commenters propose?
- Our analysis also relies on the assumption that the Commission would examine approximately 2,092 of the advisers required to enter into a written agreement under the rule and assume that the Commission will issue approximately 8,368 requests to qualified custodians under the rule. Additionally, we assume qualified custodians would take 1.5 hours to respond to the information requested by an independent public accountant. Do commenters agree with these assumptions? If not, why not, and what data would commenters propose?

- Our analysis also relies on the assumption that it would take qualified custodians 15 hours each to update distribution lists to add advisers to the distribution of quarterly statements and one hour per each qualified custodian to make modifications and send quarterly account statements annually. Do commenters agree with this assumption? If not, why not, and what data would commenters propose?
- Our analysis also relies on the assumption that, on average, an internal control report for a qualified custodian costs approximately $750,000. Further, our analysis relies on the assumption that 95% of custodians currently obtain internal control reports. As a result, our analysis assumes an annual external cost burden of obtaining internal control reports to be $35,962,500. Do commenters agree with this assumption? If not, why not, and what data would commenters propose?
- Our analysis also relies on the assumptions that it would take 15 minutes for an adviser to obtain the proposed reasonable assurances requirements from a qualified custodian and one hour to update any written agreement, if necessary, to reflect the reasonable assurances. Further, we estimate that the exchange is most likely to occur in the context of the negotiation and execution of the written agreement. Additionally, our analysis relies on the assumption that it will take approximately .25 hours to update the reasonable assurances annually. Do commenters agree with these assumptions? If not, why not, and what data would commenters propose?
- Our analysis relies on the assumption that each of the 1,842 advisers expected to undergo a surprise examination under the proposed rule will spend 0.25 hour to enter into a written agreement with the independent public accountant engaged to conduct the surprise examination. Our analysis also relies on the assumption that these

advisers can be categorized into three groups for purposes of the calculation of the burden. Do commenters agree with these assumptions? If not, why not, and what data would commenters propose?

- Our analysis relies on the assumption that 381 advisers subject to the surprise examination requirement have custody because they serve as qualified custodians for their clients, or they have a related person that serves as qualified custodian for clients. Additionally, our analysis relies on the assumption that these advisers are subject to an annual surprise examination with respect to 100 percent of their clients (or 9,006 clients per adviser) based on the assumption that all of their clients maintain custodial accounts with the adviser or its related person. Our analysis assumes that each adviser will spend an average of 0.02 hours for each client to create a client contact list for the independent public accountant to conduct the asset verification. Do commenters agree with these assumptions? If not, why not, and what data would commenters propose?
- Our analysis relies on the assumption that 834 advisers subject to the surprise examination requirement have custody because they have broad authority to access client assets held at an independent qualified custodian, such as through a power of attorney or acting as a trustee for a client's trust. Also, our analysis assumes that these advisers will be subject to an annual surprise examination with respect to 5 percent of their clients (or 450 clients per adviser) who maintain these types of arrangements with the adviser. In addition, our analysis assumes that each adviser will spend an average of 0.02 hours for each client that is subject to these arrangements to create a client contact list for the independent public accountant. Do

commenters agree with these assumptions? If not, why not, and what data would commenters propose?

- Our analysis relies on the assumption that 626 advisers manage private funds and undergo surprise examinations. For these advisers, our analysis relies on the assumption that each adviser managing private funds has an average of 6 pooled investment vehicle clients with an average of 14 investors. Our analysis relies on the assumption that these advisers will spend 1 hour for the pool and 0.02 hours for each investor in the pool to create a contact list for the independent public accountant. Do commenters agree with these assumptions? If not, why not, and what data would commenters propose?
- Our analysis relies on the assumption that 4,961 advisers currently have custody of privately offered securities and physical assets that cannot be maintained with a qualified custodian. Our analysis further relies on the assumption that there will be approximately 8,000 purchases, sales, or other transfers of beneficial ownership of assets subject to the exception in proposed rule 223-1(b)(2). Do commenters agree with these assumptions? If not, why not, and what data would commenters propose?
- Our analysis relies on the assumption that it would take each adviser 1.25 hours, initially, to prepare the written agreement with an accountant for verification of assets under proposed rule 223-1(b)(2)(iii). Additionally, our analysis relies on the assumption that these agreements will change minimally from year to year and that advisers will spend approximately .5 hours annually amending these agreements or entering into new agreements. Do commenters agree with these assumptions? If not, why not, and what data would commenters propose?

- Our analysis also relies on the assumption that the adviser's required notice to an accountant under proposed rule 223-1(b)(2)(iv) would likely be provided by the adviser in connection with the closing of a transaction, and would take advisers approximately one minute to deliver to the accountant. Do commenters agree with this assumption? If not, why not, and what data would commenters propose?
- Our analysis relies on the assumption that accountant verifications of transfers of beneficial ownership will have an annual cost burden of $19,680,000 to advisers. Do commenters agree with this assumption? If not, why not, and what data would commenters propose?
- Our analysis also relies on the assumption that the additional cost of asset verification for all assets during a surprise examination or audit under the audit provision aggregates to $322,956,000 annually. Do commenters agree with this assumption? If not, why not, and what data would commenters propose?
- Our analysis relies on the assumption that distributions of audited financial statements to investors in the client entity will take advisers approximately 1 minute per investor. Our analysis relies on the assumption that there are 4,961 advisers to audited pooled investment vehicles, with an upward adjustment to 7,018 to account for our expectation that an increasing number of advisers will obtain audits of client entities. Do commenters agree with these assumptions? If not, why not, and what data would commenters propose?
- Our analysis relies on the assumption that each of the 7,018 advisers that rely on the audit provision will spend 1.25 hours to add the provisions required under proposed rule 223-1(b)(4)(v) to the written agreement with the independent public accountant.

Our analysis also relies on the assumption that each adviser will spend 0.92 hours on an annual basis to reassess these written agreements and execute new agreements as an adviser adds entity clients. Do commenters agree with these assumptions? If not, why not, and what data would commenters propose?

- Our analysis also relies on the assumption that of the 13,944 advisers with custody of client assets, we estimate that approximately 20%, or approximately 2,789 advisers, will have clients that issue SLOAs. Further, our analysis assumes that many such advisers already retain copies of client SLOAs in their books and records and we assume, therefore, that this collection of information will result in an increased burden of only .25 hours for each adviser seeking to rely on the proposed SLOA exception. Do commenters agree with these assumptions? If not, why not, and what data would commenters propose?
- Our analysis relies on the assumption that 12,570 advisers (80% of the total of 15,712 combined current and expected advisers that are required to complete Parts 1 and 2 of the Form ADV) would incur an additional burden of 5 hour under the proposed amendments to Form ADV Part 1A, and 3,142 advisers (20% of 15,712 current and expected advisers that are required to complete Parts 1 and 2 of Form ADV) would incur a burden of 0 hours. Do commenters agree with these assumptions? If not, why not, and what data would commenters propose?

The agency is submitting the proposed collections of information to OMB for approval. Persons wishing to submit comments on the collection of information requirements of the proposed amendments should direct them to the Office of Management and Budget, Attention Desk Officer for the Securities and Exchange Commission, Office of Information and

Regulatory Affairs, Washington, DC 20503, and should send a copy to Vanessa A. Countryman, Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549 1090, with reference to File S7-04-23. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this release; therefore, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File S7-04-23, and be submitted to the Securities and Exchange Commission, Office of FOIA Services, 100 F Street NE, Washington, DC 20549-2736.

V. INITIAL REGULATORY FLEXIBILITY ANALYSIS

The Commission has prepared the following Initial Regulatory Flexibility Analysis ("IRFA") in accordance with section 3(a) of the Regulatory Flexibility Act ("RFA").[676] It relates to: (i) new rule 223-1 under the Advisers Act; (ii) proposed rule 204(d)-1; (iii) proposed amendments to rule 204-2; and (iv) proposed amendments to Form ADV Part 1A.

A. Reason for and Objectives of the Proposed Action

1. Proposed rule 223-1

We are proposing amendments to the custody rule, which we adopted in 1962 and amended in 2003 and 2009. The current custody rule generally requires an adviser to:

- Maintain client funds and securities with a qualified custodian (broker-dealers, banks or savings associations, futures commission merchants, and certain foreign financial institutions);

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676 5 U.S.C. 603(a).

- Have a reasonable basis upon due inquiry for believing qualified custodians send account statements directly to advisory clients;
- Undergo an annual surprise examination by an independent public accountant to verify that a sampling of client funds and securities exists or have the audited financial statements of a pooled investment vehicle prepared in accordance with generally accepted accounting principles and distributed to investors in the pool; and
- Obtain a report of the internal controls of related person qualified custodians relating to custody from an independent public accountant.

The proposed changes to the custody rule are designed to recognize the expansion in products and services investment advisers offer to their clients, evolution in the types of investments and ways of evidencing their ownership, and developments in the market for custodial services. We have accounted for these advancements by clarifying the rule's scope and implementing more impactful and tailored protections. Specifically, the rule would subject investment advisers to requirements pertaining to the use of a qualified custodian, delivery of notices to clients, segregation of client assets, and independent public accountant assessments. The rule would also subject investment advisers to requirements relating to the safeguarding of client assets that are not able to be maintained by a qualified custodian. Importantly, the proposal maintains the core purpose of protecting client assets from loss, misuse, theft, misappropriation, and the insolvency or financial reverses of the adviser. We believe that modernized rules would help advisers better recognize and protect against vulnerabilities to advisory client assets and would improve our oversight and risk-assessment abilities. The reasons for, and objectives of, the proposed amendments are discussed in more detail in sections

I and II, above. The burdens of these requirements on small advisers are discussed below as well as above in sections III and IV, which discuss the burdens on all advisers. The professional skills required to meet these specific burdens are also discussed in section IV.

2. Proposed rule 204-2

We also are proposing amendments to rule 204-2 to correspond to proposed rule 223-1. Specifically, we are proposing to require investment advisers to maintain the following records for client accounts: (1) client account identification, (2) custodian identification, (3) the basis for the adviser having custody of client assets in the account, (4) any account statements received or sent by the adviser, (5) transaction and position information, and (6) any standing letters of authorization and records relating thereto. The proposed amendments also would require an adviser to maintain copies of all written notices to clients required under proposed rule 223-1 and any responses thereto, and copies of documents relating to independent account engagements.

Although the current rule requires certain recordkeeping relating to investment advisers' custody rule compliance, the proposal would align the recordkeeping requirements with proposed rule 223-1. We are proposing to amend the current rule to require advisers to retain documentation that would allow the Commission examination staff to verify advisers' compliance with proposed rule 223-1, particularly in the categories of client communications, client accounts, and independent public account engagements, and reliance on the proposed rule's exceptions. The proposed recordkeeping rules are designed to work in concert with proposed rule 223-1 so that a complete custodial record with respect to client assets is maintained and preserved. This would help facilitate the Commission's inspection and enforcement capabilities, including assessing compliance with rules, and therefore, it would provide important investor protections.

3. Proposed amendments to Form ADV

We are also proposing to amend Item 9 of Part 1A, Schedule D, and the Instructions and Glossary of Form ADV to improve information available to us and to the general public about advisers' practices in safeguarding client assets. We are proposing amendments to Form ADV to align reporting obligations with the proposed changes to the custody rule and to help advisers identify when they may have custody of client assets, to provide the Commission with information related to advisers' practices to safeguard client assets, and to provide the Commission with additional data to improve our ability to identify compliance risks. More accurate and comprehensive information would inform the Commission's examination initiatives and would allow the Commission and its staff to better assess risks specific advisers pose to investors.

The proposed revisions would require an adviser to report the amount and number of clients falling into each category of custody (*i.e.*, direct or indirect) and to require advisers to report similar information about client assets over which they have custody resulting from (1) having the ability to deduct advisory fees; (2) having discretionary trading authority; (3) serving as a general partner, managing member, trustee (or equivalent) for clients that are private funds; (4) serving as a general partner, managing member, trustee (or equivalent) for clients that are not private funds; (5) having a general power of attorney over client assets or check-writing authority; (6) having a standing letter of authorization; (7) having physical possession of client assets; (8) acting as a qualified custodian; (9) a related person with custody that is operationally

independent; and (10) any other reason.[677] Amendments to the form would require an adviser to indicate whether it is relying on any of the exceptions from the safeguarding rule and, if so, to indicate on which exception(s) the adviser is relying. We are also proposing to require advisers to report whether client assets for which the adviser triggers the rule are maintained at a qualified custodian and the number of clients and approximate amount of assets not maintained with a qualified custodian. Advisers would also be required to report certain identifying information about the qualified custodians and independent public accountants. The reasons for and objectives of, the proposed amendments to Form ADV are discussed in more detail in section II.I above. The burdens of these requirements on small advisers are discussed below as well as above in our Economic Analysis and Paperwork Reduction Act Analysis, which discuss the burdens on all advisers. The professional skills required to meet these specific burdens are also discussed in Section IV.

B. Legal Basis

The Commission is proposing new rule 223-1 and to redesignate rule 206(4)-2 pursuant to the authority set forth in sections 206(4), 211(a), and 223 of the Advisers Act [15 U.S.C. 80b-6(4),80b-11(a), and 80b-23]; to proposed rule 204(d)-1 pursuant to authority set forth in sections 204, 211(a), and 223 of the Advisers Act [15 U.S.C. 80b-4 and 80b-11(a)]; to amend rule 204-2 pursuant to the authority set forth in sections 204, 211, and 223 of the Advisers Act [15 U.S.C. 80b-4, 80b-11, 80b-23]; and to amend Form ADV pursuant to the authority set forth in sections

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677 Proposed Form ADV, Part 1A, Item 9.A.(2). Advisers are currently required to report information with respect to funds and securities over which their related persons have custody, including the dollar amount and number of clients whose funds or securities are in the adviser's custody and whether any related person has custody of any clients' cash or bank accounts or securities and the relevant dollar amount and number of clients. *See* Form ADV, Part 1A Item 9.A.(2) through, Item 9.B. Based on its responses, an adviser is also required to report additional custody-related information in Schedule D of Form ADV, Part 1A.

203(c)(1), 204, 211(a), and 223 of the Advisers Act [15 U.S.C. 80b-3(c)(1), 80b-4, 80b-11(a), and 80b-23].

C. Small Entities Subject to the Rule and Rule Amendments

In developing these proposals, we have considered their potential impact on small entities that would be subject to the proposed amendments. The proposed amendments would affect many, but not all, investment advisers registered with the Commission, including some small entities.

Under Commission rules, for the purposes of the Advisers Act and the RFA, an investment adviser generally is a small entity if it: (1) has assets under management having a total value of less than $25 million; (2) did not have total assets of $5 million or more on the last day of the most recent fiscal year; and (3) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had total assets of $5 million or more on the last day of its most recent fiscal year.[678] Our proposed new rules and amendments would not affect most investment advisers that are small entities ("small advisers") because they are generally registered with one or more state securities authorities and not with the Commission. Under section 203A of the Advisers Act, most small advisers are prohibited from registering with the Commission and are regulated by state regulators. Based on IARD data, we estimate that as of June 30, 2022, approximately 522 SEC-registered advisers are small entities under the RFA.[679]

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678 Advisers Act rule 0-7(a).

679 Based on SEC-registered investment adviser responses to Items 5.F. and 12 of Form ADV.

1. Small entities subject to amendments to the custody rule

As discussed above in section III (the Economic Analysis), the Commission estimates that based on IARD data as of June 30, 2022, approximately 13,944 investment advisers would be subject to the new rule 223-1 under the Advisers Act, the related proposed amendments to rule 204-2 under the Advisers Act, and the related proposed amendments to Form ADV.[680]

Of the approximately 522 SEC-registered advisers that are small entities under the RFA, 321 would be subject to the new rule 223-1, the corresponding amendments to rule 204-2, and the amendments to Form ADV. This is because, as discussed above in the PRA, we estimate that all small entities that have custody would be subject to the requirements of the proposed rule.[681]

D. Projected Reporting, Recordkeeping and Other Compliance Requirements

1. Proposed rule 223-1

Proposed rule 223-1 would impose certain reporting and compliance requirements on certain investment advisers, including those that are small entities. All registered investment advisers that have custody of client assets, which we estimate to be 13,944 advisers, would be required to comply with the proposed safeguarding rule's segregation, qualified custodian protection, notice to client, and independent verification requirements. Although all of these advisers would also be subject to the qualified custodian requirements, some would satisfy these requirements by entering into contracts with qualified custodians, while others would satisfy them by satisfying conditions of a limited exception for investments in privately offered securities and physical assets. The proposed requirements and rule amendments, including compliance, reporting, and recordkeeping requirements, are summarized in this IRFA (section

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680 *See supra* note 553.

681 *See* PRA discussion *supra* section IV.

V.A., above). All of these proposed requirements are also discussed in detail, above, in sections I and II, and these requirements and the burdens on respondents, including those that are small entities, are discussed above in sections III and IV (the Economic Analysis and Paperwork Reduction Act Analysis, respectively) and below. The professional skills required to meet these specific burdens are also discussed in section IV.

As discussed above, there are approximately 522 small advisers currently registered with us, and we estimate that 480 of those small advisers registered with us would be subject to amendments to the safeguarding rule (92% of all registered small advisers).[682] As discussed above in our Paperwork Reduction Act Analysis in section IV above, the proposed amendments to rule 223-1 under the Advisers Act would create a new annual burden of approximately 28.4 hours per adviser, or 9,116 hours in aggregate for small advisers.[683] We therefore expect the annual monetized aggregate cost to small advisers associated with our proposed amendments to the safeguarding rule would be $5,371,008.[684]

2. Proposed amendments to rule 204-2

Proposed amendments to rule 204-2 would require investment advisers to maintain the following records for client accounts: (1) client account identification, (2) custodian identification, (3) the basis for the adviser having custody of client assets in the account, (4) any account statements received or sent by the adviser, (5) transaction and position information, and (6) any standing letters of authorization and records relating thereto. The proposed amendments

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682 *See supr*a note 582 and accompanying text.

683 396,041 hours / 13,944 advisers subject to the proposed rule = 28.4 hours per adviser. 28.4 hours x 480 small advisers = 13,632 hours.

684 13,632 aggregate small adviser hours x $394 (blended rate for a compliance manager ($361) and a compliance attorney ($426)) =$5,371,008.

also would require an adviser to maintain copies of all written notices to clients required under proposed rule 223-1 and any responses thereto, and copies of documents relating to independent account engagements. Each of these records would correspond to proposed rule 223-1, and also would be required to be maintained in the same manner, and for the same period of time, as other books and records required to be maintained under rule 204-2(a).

As discussed above, there are approximately 522 small advisers currently registered with us. We estimate that 92% percent of all advisers registered with us that have investment discretion over client assets (and thus deemed custody of such assets)[685] would be subject to proposed rule 223-1 and corresponding amendments to the books and records rule. As discussed above in our Paperwork Reduction Act Analysis in section IV.E above, the proposed amendments to rule 204-2 under the Advisers Act would increase the annual burden by approximately 21 hours per affected adviser, or 10,080 hours in aggregate for small advisers with custody of client assets.[686] We therefore believe the annual monetized aggregate cost to small advisers associated with our proposed amendments would be $3,971,520.[687]

3. Proposed amendments to Form ADV

Proposed amendments to Form ADV would impose certain reporting and compliance requirements on certain investment advisers, including those that are small entities, requiring them to provide information about their practices in safeguarding client assets. The proposed requirements and rule amendments, including recordkeeping requirements, are summarized

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685 522 small advisers x 92% = 480 small advisers with custody.

686 21 hours x 480 small advisers with custody = 10,080 hours.

687 10,080 aggregate small adviser hours x $394 (blended rate for a compliance manager ($361) and a compliance attorney ($426)) = $3,971,520.

above in this IRFA (section V.A). All of these proposed requirements are also discussed in detail, above, in section II, and these requirements and the burdens on respondents, including those that are small entities, are discussed above in sections III and IV (the Economic Analysis and Paperwork Reduction Act Analysis) and below. The professional skills required to meet these specific burdens are also discussed in section IV.

Our Economic Analysis (section III above) discusses these costs and burdens for respondents, which include small advisers. As discussed above in our Paperwork Reduction Act Analysis in section IV.F above, the proposed amendments to Form ADV would increase the annual burden for advisers (other than exempt reporting advisers, who would not be required to respond to the new Form ADV questions we are proposing) by approximately 1.4 hours per adviser, or 730.8 hours in aggregate for small advisers (other than exempt reporting advisers).[688] We therefore expect the annual monetized aggregate cost to small advisers (other than exempt reporting advisers, for whom there would be no additional cost) associated with our proposed amendments would be $232,394.40.[689]

E. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission believes that there are no rules that duplicate, overlap, or conflict with the proposed rule amendments.

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688 1.4 hours x 522 small advisers = 730.8 hours.

689 730.8 hours x $318 = $232,394.40. *See supra* Table 10 for a discussion of who we believe would perform this function, and the applicable blended rate.

F. Significant Alternatives

1. Proposed new rule 223-1 and amendments to rule 204-2 and Form ADV

The RFA directs the Commission to consider significant alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. We considered the following alternatives for small entities in relation to proposed new rule 223-1 and the corresponding proposed amendments to rule 204-2 under the Advisers Act and to Form ADV: (i) differing compliance or reporting requirements that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the proposed rule for such small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the proposals, or any part thereof, for such small entities.

Regarding the first and fourth alternatives, the Commission believes that establishing different compliance or reporting requirements for small advisers, or exempting small advisers from the proposed rule, or any part thereof, would be inappropriate under these circumstances. Because the protections of the Advisers Act are intended to apply equally to clients of both large and small firms, it would be inconsistent with the purposes of the Advisers Act to specify differences for small entities under proposed rule 223-1 and corresponding changes to rule 204-2 and Form ADV. As discussed above, we believe that the proposed safeguarding rule would result in multiple benefits to clients. For example, segregation requirements and the imposition of certain minimum standard requirements for assets maintained at a qualified custodian would provide investors with additional safeguards to protect their assets from the financial reverses, including insolvency, of an investment adviser and to prevent client assets from being lost, misused, stolen, or misappropriated. We believe that these benefits should apply to clients of

smaller firms as well as larger firms. In addition, as discussed above, our staff would use the corresponding information that advisers would report on the proposed amended Form ADV for risk-assessment and to help prepare for examinations of investment advisers. Establishing different conditions for large and small advisers that have custody of client assets would negate these benefits. Though we are not exempting small advisers from portions of the proposals, we believe that the exception from the surprise examination requirement for discretionary authority for client assets that settle exclusively on a DVP basis will mitigate the creation of new burdens for many advisers, particularly smaller advisers. We also have requested comment on whether we should provide different compliance dates for differing types of advisers including smaller advisers.

Regarding the second alternative, we believe the current proposal is clear and that further clarification, consolidation, or simplification of the compliance requirements is not necessary. As discussed above: the proposed rule would provide a requirement to segregate client assets to prevent them from potential misuse or misappropriation; would require that advisers maintain a written agreement with or obtain reasonable assurances from qualified custodians concerning certain minimal safeguarding requirements that we believe are critical to providing important protections for advisory client assets; and would provide certain limited exceptions from requirements to maintain assets with a qualified custodian or obtain an independent verification of assets. These provisions would address a number of safeguarding risks for assets maintained at a qualified custodian that the current rule does not address while extending the protections of the rule from "funds and securities" to "assets" to account for new and evolving financial products that may be maintained in client accounts. The proposed provisions would strengthen investment advisers' safeguarding practices, which we believe currently has gaps.

Further, we believe our proposal would allow the Commission examination staff to verify all advisers' compliance with the proposed amendments to rule 204-2, particularly in the categories of client communications, client accounts, and independent public account engagements, and reliance on the exceptions to proposed new rule 223-1. The proposed recordkeeping rules are designed to work in concert with proposed new rule 223-1 so that a complete custodial record with respect to client assets is maintained and preserved. This would help facilitate the Commission's inspection and enforcement capabilities, including assessing compliance with rules, and therefore, it would provide important investor protections.

Regarding the third alternative, we determined to use a combination of performance and design standards in the current proposal. The general requirement to maintain assets with a qualified custodian would apply to all advisers to establish certain minimum standard requirements under the proposed safeguarding rule, subject to narrowly tailored exemptions and exceptions from certain requirements (*e.g.*, the surprise exam) if certain conditions are met. By design, these exemptions and exceptions address specific circumstances to ensure safekeeping of client assets, but also to provide relief from certain requirements in circumstances where an adviser's ability to misuse or misappropriate client assets are limited. The corresponding changes to rule 204-2 and Form ADV also are narrowly tailored to address proposed new rule 223-1.

G. Solicitation of Comments

We encourage written comments on the matters discussed in this IRFA. We solicit comment on the number of small entities subject to proposed new rule 223-1 and related amendments to rules 206(4)-2 and 204-2, and Form ADV, as well as the potential impacts discussed in this analysis; and whether the proposal could have an effect on small entities that

has not been considered. We request that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of such impact.

VI. CONSIDERATION OF IMPACT ON THE ECONOMY

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[690] we must advise OMB whether a proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results in or is likely to result in (1) an annual effect on the economy of $100 million or more; (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effects on competition, investment or innovation. We request comment on the potential effect of the proposed amendments on the U.S. economy on an annual basis; any potential increase in costs or prices for consumers or individual industries; and any potential effect on competition, investment or innovation. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

VII. STATUTORY AUTHORITY

The Commission is proposing new rule 223-1 by a redesignation of rule 206(4)-2 of the Advisers Act under the authority set forth in sections 206(4), 211(a), and 223 of the Advisers Act [15 U.S.C. 80b-6(4), 80b-11(a), and 80b-23]. The Commission is proposing corresponding amendments to rule 204-2 under the Advisers Act under the authority set forth in 206(4), 211(a), and 223 of the Advisers Act [15 U.S.C. 80b-6(4), 80b-11(a), and 80b-23]. The Commission is proposing to amend Form ADV pursuant to the authority set forth in sections 203(c)(1), 204, 211(a), and 223 of the Advisers Act [15 U.S.C. 80b-3(c)(1), 80b-4,80b-11(a), and 80b-23].

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690 Public Law 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

List of Subjects in 17 CFR Parts 275 and 279

Reporting and recordkeeping requirements; Securities

Text of Proposed Rules and Rule and Form Amendments

For the reasons set out in the preamble, title 17, chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

1. The authority citation for part 275 is revised to read, in part, as follows:

Authority: 15 U.S.C. 80b-2(a)(11)(G), 80b-2(a)(11)(H), 80b-2(a)(17), 80b-3, 80b-4, 80b-4a, 80b-6(4), 80b-6a, and 80b-11, unless otherwise noted.

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Section 275.204-2 is also issued under 15 U.S.C. 80b-6.

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Section 275.223-1 is also issued under 15 U.S.C. 80b-18b.

2. Amend § 275.204-2 by:

a. Removing and reserving paragraphs (a)(8) and (a)(17)(iii).

b. Revising paragraph (b).

The revisions read as follows:

§ 275.204-2 - Books and records to be maintained by investment advisers.

* * * * *

(b) If an investment adviser subject to paragraph (a) of this section is subject to § 275.223-1 (Rule 223-1) of this chapter, the investment adviser shall make and keep true, accurate, and current the following books and records:

(1) Client *communications.* A copy of all written client notifications required under § 275.223-1(a)(2) (Rule 223-1(a)(2)), and any responses thereto.

(2) Client *accounts*. For each client account:

(i) Account *identification*. A record of the advisory account name, client contact information (including name, mailing address, phone number, e-mail address), and advisory account number, client type (as identified in Item 5.D of Form ADV), or other identifying information used by the investment adviser to identify the account, and copies of all account opening records. The record must show the advisory account inception date, whether the investment adviser has discretionary authority (as defined by § 275.223-1(d)(4) (Rule 223-1(d)(4)) with respect to any client assets in the account, whether the investment adviser has authority to deduct advisory fees from the account, and, if applicable, the termination date of the account, asset disposition upon termination, and the reason for the termination.

(ii) Custodian *identification*. A record that identifies and matches, for each client of which the adviser has custody of client assets, the account name and account number, or any other identifying information, from any person or entity, including any qualified custodian, that maintains client assets to the corresponding advisory account record for each client required by paragraph (b)(2)(i) of this section. To the extent applicable, the record must contain a copy of the required written agreement with each qualified custodian under § 275.223-1(a)(1)(i) (Rule 223-1(a)(1)(i)), including any amendments thereto, and copies of all records received from the qualified custodian thereunder relating to client assets. The record must also reflect the basis for the reasonable assurances that the investment adviser obtains from the qualified custodian under § 275.223-1(a)(1)(ii) (Rule 223-1(a)(1)(ii)). To the extent applicable, the record must contain a copy of the investment adviser's required written reasonable determination that ownership of

certain specified client assets cannot be recorded and maintained (book-entry, digital, or otherwise) in a manner in which a qualified custodian can maintain possession or control (as defined by § 275.223-1(d)(8) (Rule 223-1(d)(8)) of such assets, as required under § 275.223-1(b)(2) (Rule 223-1(b)(2)).

(iii) *Basis for being subject to Rule 223-1*. A memorandum or other record that indicates the basis of the investment adviser's custody (as defined in § 275.223-1(d)(3) (Rule 223-1(d)(3)) of the client's assets (as defined by § 275.223-1(d)(1) (Rule 223-1(d)(1)), including whether a related person (as defined by § 275.223-1(d)(11) (Rule 223-1(d)(11)) holds the investment adviser's client assets (or has any authority to obtain possession of them) in connection with the investment adviser's advisory services.

(iv) *Account statements*. Copies of each account statement delivered by the qualified custodian to the client and to the investment adviser pursuant to § 275.223-1(a)(1)(i)(B) (Rule 223-1(a)(1)(i)(B)), copies of any account statement delivered by the investment adviser to the client, including copies of any account statement delivered by the investment adviser to the client containing the required notification under § 275.223-1(a)(2) (Rule 223-1(a)(2)). If the client is a pooled investment vehicle, the record must also reflect the delivery of account statements, notices, or financial statements (as applicable) to all investors in such client pursuant to § 275.223-1(c) (Rule 223-1(c)).

(v) Transaction *and position information*.

(A) A detailed record of all trade and transaction activity for each such client account that includes the date and price or amount of all purchases, sales, receipts, deliveries (including one-way delivery of assets, and free receipt and delivery of securities and certificate numbers, as applicable), deposits, transfers, withdrawals, cash flows, corporate action activity, maturities,

expirations, expenses, income posted to the account, and all other debits and credits to or from the account.

(B) Copies of confirmations of all trades effected by or for the account of each client that show the date and price of each trade, and any instruction received by the investment adviser concerning transacting in the client's assets (as defined by Rule 223-1(d)(1)).

(C) A record for each asset (as defined by Rule 223-1(d)(1)) in which each client has a position, which record shall show the name of such client having any interest in such asset, the amount or interest of such client, and the location of such asset.

(D) A memorandum describing the basis upon which the adviser has determined that the presumption that any related person is not operationally independent under § 275.223-1(d)(7) has been overcome.

(vi) *Standing letters of authorization*. Copies of, and records relating to, any standing letter of authorization (as defined in § 275.223-1(d)(12) (Rule 223-1(d)(12)) issued by a client to the investment adviser.

(2) *Independent public accountant*.

(i) Copies of all audited financial statements prepared pursuant to § 275.223-1(b)(4) (Rule 223-1(b)(4)).

(ii) A copy of any internal control report:

(A) Obtained by a qualified custodian and received by an investment adviser pursuant to § 275.223-1(a)(1)(i)(C) (Rule 223-1(a)(1)(i)(C)); and

(B) Obtained by the investment adviser if the investment adviser is also the client's qualified custodian.

(iii) A copy of any written agreement between the independent public accountant and the investment adviser or its client, as applicable, required under Rule 223-1.

* * * * * *

§ 275.206(4)-2 [Removed]

3. Section 275.206(4)-2 is removed.

4. Section 275.223-1 is added to read as follows:

§ 275.223-1 Safeguarding client assets.

(a) Safekeeping *required*. If you are an investment adviser registered or required to be registered under section 203 of the Act (15 U.S.C. 80b–3), you shall take the following steps to safeguard client assets of which you have custody:

(1) Qualified *custodian*.

(i) *Written agreement*. A qualified custodian must maintain possession or control of your client's assets pursuant to a written agreement between you and the qualified custodian (or between you and the client if you are also the qualified custodian) that must provide the following provisions, which you must reasonably believe have been implemented:

(A) The qualified custodian will promptly, upon request, provide records relating to your clients' assets held in the account at the qualified custodian to the Commission or to an independent public accountant engaged for purposes of complying with paragraph (a)(4), (b)(1), or (b)(4) of this section;

(B) The qualified custodian will send account statements, at least quarterly, to the client, or its independent representative, and to you, identifying the amount of each client asset in the account at the end of the period and setting forth all transactions in the account during that period, including investment advisory fees. Such account statements shall not identify assets for

which the qualified custodian lacks possession or control, unless requested by the client and the qualified custodian clearly identifies any such assets that appear on the account statement;

(C) At least annually, the qualified custodian will obtain, and provide to you a written internal control report that includes an opinion of an independent public accountant as to whether controls have been placed in operation as of a specific date, are suitably designed, and are operating effectively to meet control objectives relating to custodial services (including the safeguarding of the client assets held by that qualified custodian during the year), and

(1) If you are the qualified custodian, or if the qualified custodian is a related person, the independent public accountant that prepares the internal control report must verify that client assets are reconciled to a custodian other than you or your related person and be registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the Public Company Accounting Oversight Board in accordance with its rules;

(D) Specifies your agreed-upon level of authority to effect transactions in the account as well as any applicable terms or limitations, and permits you and the client to reduce that authority; and

(ii) *Reasonable assurances obtained by adviser.* You must obtain reasonable assurances in writing from the qualified custodian (or, if you are also the qualified custodian, the written agreement required by paragraph [(a)(1)(i)] of this section must provide) that the custodian will comply with the following requirements, and you must maintain an ongoing reasonable belief that the custodian is complying with these requirements:

(A) The qualified custodian will exercise due care in accordance with reasonable commercial standards in discharging its duty as custodian and will implement appropriate

measures to safeguard client assets from theft, misuse, misappropriation, or other similar type of loss;

(B) The qualified custodian will indemnify the client (and will have insurance arrangements in place that will adequately protect the client) against the risk of loss of the client's assets maintained with the qualified custodian in the event of the qualified custodian's own negligence, recklessness, or willful misconduct;

(C) The existence of any sub-custodial, securities depository, or other similar arrangements with regard to the client's assets will not excuse any of the qualified custodian's obligations to the client;

(D) The qualified custodian will clearly identify the client's assets as such, hold them in a custodial account, and will segregate all client assets from the qualified custodian's proprietary assets and liabilities; and

(E) The qualified custodian will not subject client assets to any right, charge, security interest, lien, or claim in favor of the qualified custodian or its related persons or creditors, except to the extent agreed to or authorized in writing by the client.

(2) *Notice to clients*. If you open an account with a qualified custodian on your client's behalf, you must promptly notify the client, or its independent representative, in writing of the qualified custodian's name, address, and account number, and the manner in which the client's assets are maintained, when the account is opened and following any changes to this information. If you send account statements to a client to which you are required to provide this notice, include in the notification provided to that client and in any subsequent account statement you send that client a statement urging the client to compare the account statements from the custodian with those from the adviser.

(3) *Segregation of client assets*. The client's assets must:

(i) Be titled or registered in the client's name or otherwise held for the benefit of that client;

(ii) Not be commingled with your assets or your related persons' assets; and

(iii) Not be subject to any right, charge, security interest, lien, or claim of any kind in favor of you, your related persons, or your creditors, except to the extent agreed to or authorized in writing by the client.

(4) *Independent verification*. The client assets of which you have custody are verified by actual examination at least once during each calendar year by an independent public accountant, provided that, if you, or a related person in connection with advisory services you provide to clients, maintain client assets pursuant to this section as a qualified custodian, the independent public accountant must be registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the Public Company Accounting Oversight Board in accordance with its rules. The independent verification must be performed pursuant to a written agreement between you and the accountant, at a time that is chosen by the accountant without prior notice or announcement to you and that is irregular from year to year. The written agreement must provide for the first examination to occur within six months of becoming subject to this paragraph, except that, if you maintain client assets pursuant to this section as a qualified custodian, the agreement must provide for the first examination to occur no later than six months after obtaining your internal control report. The written agreement, which you must reasonably believe has been implemented, must require the accountant to:

(i) File a certificate on Form ADV-E (17 CFR 279.8) with the Commission within 120 days of the time chosen by the accountant in paragraph (a)(4) of this section, stating that it has examined the assets and describing the nature and extent of the examination;

(ii) Upon finding any material discrepancies during the course of the examination, notify the Commission within one business day of the finding, by electronic means directed to the Division of Examinations; and

(iii) Upon resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed, file within four business days Form ADV-E accompanied by a statement that includes:

(A) The date of such resignation, dismissal, removal, or other termination, and the name, address, and contact information of the accountant; and

(B) An explanation of any problems relating to examination scope or procedure that contributed to such resignation, dismissal, removal, or other termination.

(b) *Exceptions.*

(1) *Shares of mutual funds*. With respect to shares of an open-end company as defined in section 5(a)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a-5(a)(1)) ("mutual fund"), you may use the mutual fund's transfer agent in lieu of a qualified custodian for purposes of complying with paragraph (a) of this section.

(2) *Certain assets unable to be maintained with a qualified custodian*. You are not required to comply with paragraph (a)(1) of this section with respect to client assets that are privately offered securities or physical assets, provided:

(i) You reasonably determine, and document in writing, that ownership cannot be recorded and maintained (book-entry, digital, or otherwise) in a manner in which a qualified custodian can maintain possession or control of such assets;

(ii) You reasonably safeguard the assets from loss, theft, misuse, misappropriation, or your financial reverses, including your insolvency;

(iii) An independent public accountant, pursuant to a written agreement between you and the accountant,

(A) verifies any purchase, sale, or other transfer of beneficial ownership of such assets, promptly, upon receiving the notice required by paragraph (b)(2)(iv) of this section; and

(B) notifies the Commission by electronic means directed to the Division of Examinations within one business day upon finding any material discrepancies during the course of performing its procedures;

(iv) You notify the independent public accountant engaged to perform the verification required by paragraph (b)(2)(iii) of this section of any purchase, sale, or other transfer of beneficial ownership of such assets within one business day; and

(v) The existence and ownership of each of the client's privately offered securities or physical assets that are not maintained with a qualified custodian are verified during the annual independent verification conducted pursuant to paragraph (a)(4) of this section or as part of a financial statement audit performed pursuant to paragraph (b)(4) of this section.

(3) *Fee deduction*. Notwithstanding paragraph (a)(4) of this section, you are not required to obtain an independent verification of client assets maintained by a qualified custodian if:

(i) You have custody of the client assets solely as a consequence of your authority to make withdrawals from client accounts to pay your advisory fee;

(ii) If the qualified custodian is a related person, you can rely on paragraph (b)(6) of this section.

(4) *Entities subject to annual audit*. You are not required to comply with paragraphs (a)(1)(i)(B) and (a)(2) of this section and you shall be deemed to have complied with paragraphs (a)(4) of this section with respect to the account of a limited partnership (or limited liability company, or another type of pooled investment vehicle or any other entity) if it undergoes a financial statement audit as follows at least annually and upon liquidation:

(i) The audit is performed by an independent public accountant that is registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the Public Company Accounting Oversight Board in accordance with its rules;

(ii) The audit meets the definition in 17 CFR 210.1-02(d) (Rule 1-02(d) of Regulation S-X), the professional engagement period of which shall begin and end as indicated in Regulation S-X Rule 2-01(f)(5); and

(iii) Audited financial statements are prepared in accordance with U.S. Generally Accepted Accounting Principles ("U.S. GAAP") or, in the case of financial statements of entities organized under non-U.S. law or that have a general partner or other manager with a principal place of business outside the United States, contain information substantially similar to statements prepared in accordance with U.S. GAAP and material differences with U.S. GAAP are reconciled;

(iv) Within 120 days (or 180 days in the case of a fund of funds or 260 days in the case of a fund of funds of funds) of an entity's fiscal year end, the entity's audited financial statements,

including any reconciliations to U.S. GAAP or supplementary U.S. GAAP disclosures, as applicable, are distributed to investors in the entity (or their independent representatives); and

(v) Pursuant to a written agreement between the independent public accountant and the adviser or the entity, the independent public accountant that completes the audit notifies the Commission by electronic means directed to the Division of Examinations:

(A) Within one business day of issuing an audit report to the entity that contains a modified opinion, and

(B) 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.

(5) *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).

(6) *Certain related persons*. Notwithstanding paragraph (a)(4) of this section, you are not required to obtain an independent verification of client assets if:

(i) You have custody under this rule solely because a related person holds, directly or indirectly, client assets, or has any authority to obtain possession of them, in connection with advisory services you provide to clients; and

(ii) Your related person is operationally independent of you.

(7) *Standing letters of authorization*. Notwithstanding paragraph (a)(4) of this section, you are not required to obtain an independent verification of client assets if you have custody of client assets solely because of a standing letter of authorization.

(8) *Discretionary authority*. Notwithstanding paragraph (a)(4) of this section, you are not required to obtain an independent verification of client assets if you have custody of client assets solely because you have discretionary authority with respect to those assets, provided this exception applies only for client assets that are maintained with a qualified custodian in accordance with paragraph (a)(1) of this rule and for accounts where your discretionary authority is limited to instructing your client's qualified custodian to transact in assets that settle exclusively on a delivery versus payment basis.

(9) *Reliance on multiple exceptions*. Notwithstanding the use of "solely" in paragraphs (b)(3), (b)(6), (b)(7), and (b)(8) of this section, the exceptions in paragraphs (b)(3), (b)(6), (b)(7), and (b)(8) of this section are not mutually exclusive.

(c) *Delivery to pooled investment vehicle clients*. To satisfy the requirements of paragraph (a)(1), (a)(2), (b)(1), or (b)(4), the account statements, notices, or financial statements (as applicable) must be sent to all of the investors in each pooled investment vehicle client, provided that, if an investor is a pooled investment vehicle that is controlling, controlled by, or under common control with ("a control relationship") you or your related persons, the sender must look through that pool (and any pools in a control relationship with you or your related persons) in order to send to investors in those pools.

(d) *Definitions*. For the purposes of this section:

(1) *Assets* means funds, securities, or other positions held in the client's account.

(2) *Control* means the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise. Control includes:

(i) Each of your firm's officers, partners, or directors exercising executive responsibility (or persons having similar status or functions) is presumed to control your firm;

(ii) A person is presumed to control a corporation if the person:

(A) Directly or indirectly has the right to vote 25 percent or more of a class of the corporation's voting securities; or

(B) Has the power to sell or direct the sale of 25 percent or more of a class of the corporation's voting securities;

(C) A person is presumed to control a partnership if the person has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital of the partnership;

(D) A person is presumed to control a limited liability company if the person:

(1) Directly or indirectly has the right to vote 25 percent or more of a class of the interests of the limited liability company;

(2) Has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital of the limited liability company; or

(3) Is an elected manager of the limited liability company; or

(E) A person is presumed to control a trust if the person is a trustee or managing agent of the trust.

(3) *Custody* means holding, directly or indirectly, client assets, or having any authority to obtain possession of them. You have custody if a related person holds, directly or indirectly, client assets, or has any authority to obtain possession of them, in connection with advisory services you provide to clients. Custody includes:

(i) Possession of client assets (but not of checks drawn by clients and made payable to third parties) unless you receive them inadvertently and you return them to the sender promptly but in any case within three business days of receiving them;

(ii) Any arrangement (including, but not limited to a general power of attorney or discretionary authority) under which you are authorized or permitted to withdraw or transfer beneficial ownership of client assets upon your instruction; and

(iii) Any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives you or your supervised person legal ownership of or access to client assets.

(4) *Discretionary authority* means the authority to decide which assets to purchase and sell for the client.

(5) *Independent public accountant* means a public accountant that meets the standards of independence described in 17 CFR 210.2-01 (rule 2-01 of Regulation S-X).

(6) *Independent representative* means a person that:

(i) Acts as agent for an advisory client, including in the case of a pooled investment vehicle, for limited partners of a limited partnership (or members of a limited liability company, or other beneficial owners of another type of pooled investment vehicle) and by law or contract is obliged to act in the best interest of the advisory client or the limited partners (or members, or other beneficial owners);

(ii) Does not control, is not controlled by, and is not under common control with you; and

(iii) Does not have, and has not had within the past two years, a material business relationship with you.

(7) *Operationally independent*: for purposes of paragraph (b)(6) of this section, a related person is presumed not to be operationally independent unless each of the following conditions is

met and no other circumstances can reasonably be expected to compromise the operational independence of the related person:

(i) Client assets in the custody of the related person are not subject to claims of the adviser's creditors;

(ii) Advisory personnel do not have custody or possession of, or direct or indirect access to client assets of which the related person has custody, or the power to control the disposition of such client assets to third parties for the benefit of the adviser or its related persons, or otherwise have the opportunity to misappropriate such client assets;

(iii) Advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision; and

(iv) Advisory personnel do not hold any position with the related person or share premises with the related person.

(8) *Possession or control* means holding assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets, the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership, and the qualified custodian's involvement is a condition precedent to the change in beneficial ownership.

(9) *Privately offered securities* means securities:

(i) Acquired from the issuer in a transaction or chain of transactions not involving any public offering;

(ii) That are uncertificated; and the ownership of which can only be recorded on the non-public books of the issuer or its transfer agent in the name of the client as it appears in the records you are required to keep under Rule 204-2; and

(iii) That are transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.

(10) *Qualified custodian* means:

(i) A bank as defined in section 202(a)(2) of the Advisers Act (15 U.S.C. 80b-2(a)(2)) or a savings association as defined in section 3(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(b)(1)) that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act (12 U.S.C. 1811), provided that the bank or savings association holds the client assets in an account designed to protect such assets from creditors of the bank or savings association in the event of the insolvency or failure of the bank or savings association;

(ii) A broker-dealer registered under section 15(b)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(b)(1)), holding the client assets in customer accounts;

(iii) A futures commission merchant registered under section 4f(a) of the Commodity Exchange Act (7 U.S.C. 6f(a)), holding the client assets in customer accounts, but only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; and

(iv) A foreign financial institution that:

(A) Is incorporated or organized under the laws of a country or jurisdiction other than the United States, provided that you and the Commission are able to enforce judgments, including civil monetary penalties, against the foreign financial institution;

(B) Is regulated by a foreign country’s government, an agency of a foreign country’s government, or a foreign financial regulatory authority as defined in section 202(a)(24) of the

Investment Advisers Act of 1940 [15 U.S.C. 80b-2(a)(24)] as a banking institution, trust company, or other financial institution that customarily holds financial assets for its customers;

(C) Is required by law to comply with anti-money laundering and related provisions similar to those of the Bank Secrecy Act [31 U.S.C. 5311, *et seq.*] and regulations thereunder;

(D) Holds financial assets for its customers in an account designed to protect such assets from creditors of the foreign financial institution in the event of the insolvency or failure of the foreign financial institution;

(E) Has the requisite financial strength to provide due care for client assets;

(F) Is required by law to implement practices, procedures, and internal controls designed to ensure the exercise of due care with respect to the safekeeping of client assets; and

(G) Is not operated for the purpose of evading the provisions of this rule 223-1.

(11) *Related person* means any person, directly or indirectly, controlling or controlled by you, and any person that is under common control with you.

(12) *Standing letter of authorization* means an arrangement among you, the client, and the client's qualified custodian in which you are authorized, in writing, to direct the qualified custodian to transfer assets to a third-party recipient on a specified schedule or from time to time, provided:

(i) The client's qualified custodian is not your related person;

(ii) The client's authorization includes the client's signature, the third-party recipient's name, and either its address or account number at a custodian to which the transfer should be directed; and

(iii) You have no ability or authority to designate or change any information about the third-party recipient, including name, address, and account number.

(13) *U.S. generally accepted accounting principles (U.S. GAAP)* means accounting principles recognized by the Commission as generally accepted in accordance with section 19(b) of the Securities Act of 1933 (15 U.S.C. 77s).

PART 279—FORMS PRESCRIBED UNDER THE INVESTMENT ADVISERS ACT OF 1940

5. The authority citation for part 279 continues to read as follows:

Authority: The Investment Advisers Act of 1940, 15 U.S.C. 80b-1, *et seq.*, Pub. L. 111-203, 124 Stat. 1376.

6. Amend Form ADV (referenced in § 279.1) by:

a. In General Instructions, revising the second sub-bullet point paragraph to the first bullet point paragraph under Instruction 4 related to Other-than-annual amendments;

b. In Glossary of Terms, revising the definitions of items 12 (Custody) and 13 (Discretionary Authority or Discretionary Basis);

c. In Glossary of Terms, add new items defining the terms Assets, Operationally Independent, Qualified Custodian, and Standing Letter of Authorization and redesignating the items accordingly;

d. In Part 1A, revising Item 9;

e. In Schedule D, adding Section 9.C.1; and revising Section 9.C.3.

The additions and revisions read as follows:

NOTE: The text of Form ADV does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM ADV (Paper Version)

UNIFORM APPLICATION FOR INVESTMENT ADVISER REGISTRATION AND REPORT BY EXEMPT REPORTING ADVISERS

Form ADV General Instructions

* * * * *

4. When am I required to update my Form ADV?

* * * * *

- Other-than-annual amendments: In addition to your annual updating amendment,
    - If you are registered with the SEC or a *state securities authority*, you must amend Part 1A, 1B, 2A and 2B (as applicable) of your Form ADV, including corresponding sections of Schedules A, B, C, D, and R, by filing additional amendments (other-than-annual amendments) promptly, if:
        - you are adding or removing a relying adviser as part of your umbrella registration;
        - information you provided in response to Items 1 (except 1.O. and Section 1.F. of Schedule D), 3, 9 (except 9.A.(2) and 9.D.(2), unless your response to Item 9.D.(1) changed)), or 11 of Part 1A or Items 1, 2.A. through 2.F., or 2.I. of Part 1B or Sections 1 or 3 of Schedule R becomes inaccurate in any way;

* * * * *

GLOSSARY OF TERMS

* * * * *

Assets: For purposes of Item 9 and related sections of Schedule D, has the same meaning as defined in Rule 223-1.

* * * * *

Custody: Has the same meaning as in Rule 223-1.

* * * * *

Discretionary Authority, Discretionary Basis, or Discretionary Trading Authority: Your firm has discretionary authority or manages assets on a discretionary basis or has discretionary trading authority if it has the authority to decide which assets to purchase and sell for the client without consulting the client. Your firm also has discretionary authority if it has the authority to decide which investment advisers to retain on behalf of the client without consulting the client.

* * * * *

Operationally Independent: For the purposes of Item 9 and related sections of Schedule D, has the same meaning as in Rule 223-1.

* * * * *

Qualified Custodian: Has the same meaning as in Rule 223-1.

* * * * *

Standing Letter of Authorization: Has the same meaning as in Rule 223-1.

PART 1A

* * * * *

a. Item 9 Custody

In this Item, we ask whether you or a related person has *custody* of *client assets* and about your custodial practices.

A. (1) Do you have *custody* of *client assets* (excluding *clients* that are investment companies registered pursuant to the Investment Company Act of 1940 or business development companies that elect to be regulated as such) either directly or because a *related person* has custody of *client assets* in connection with advisory services that you provide to the *client*:

☐ Yes

☐ No

You must answer "yes" to Item 9.A.(1) if you reported discretionary RAUM in Item 5.F.(2)(a); answered "yes" to Item 8.C.(1) indicating you have discretionary authority over client assets; or if you have the ability to deduct your advisory fee directly from client accounts. If you answered "no" to Item 9.A.(1), do not complete the remainder of Item 9.

(2) As of your most recent fiscal year end, what is the approximate amount of *client assets* (rounded to the nearest $1,000) of which you directly or a *related person* in connection with advisory services that you provide to the *client* have *custody* and for how many *clients* attributable to each of the following?

Basis for Custody	Direct Custody by Adviser		Indirect Custody through a *Related Person*	
	(i) Approximate Amount of *Client Assets*	(ii) Number of *Clients*	(iii) Approximate Amount of *Client Assets*	(iv) Number of *Clients*
(a) Ability to deduct your advisory fees from *client* accounts				
(b) *Discretionary Authority*				
(c) Serving as a general partner, managing member, trustee (or equivalent) for *clients* that are *private funds*				
(d) Serving as a general partner, managing member, trustee (or equivalent) for *clients* that are not *private funds*				
(e) Having general power of attorney or check-writing authority				

(f) Having a *standing letter of authorization*				
(g) Having physical possession of *client* assets				
(h) Acting as a *qualified custodian*				
(i) Through a *related person* that is *operationally independent*	XXXXXX	XXXXXX		
(j) Other				
(k) Total				

Because an adviser may have custody for more than one reason in the table above, the sum of (a) – (j) may not equal the amount in (k) Total.

B. (1) Are you relying on any of the exceptions in rule 223-1(b) to comply with rule 223-1?

☐ Yes

☐ No

(2) If you answered "yes" to Item 9.B.(1), on which exceptions in rule 223-1(b) are you relying (check all that apply).

☐ Shares of Mutual Funds (Rule 223-1(b)(1))

☐ Certain Assets Unable to be Maintained with a *Qualified Custodian* (Rule 223-1(b)(2))

If you checked the box above, list in Section 9.C.(3) of Schedule D the accountants performing the verification required by Rule 223-1(b)(2)(iii)(A).

☐ Fee Deduction (Rule 223-1(b)(3))

☐ Entities Subject to Annual Audit (Rule 223-1(b)(4))

If you checked the box above, list in Section 9.C.(3) of Schedule D the accountants that performed the audit required by rule 223-1(b)(4). You do not have to list independent public accountant information in Section 9.C of Schedule D if you already provided this information with respect to the private funds you advise in Section 7.B.(1) and that accountant only performs audits required by rule 223-1(b)(4) for those private funds.

☐ Certain *Related Persons* (Rule 223-1(b)(6))

☐ *Standing Letters of Authorization* (Rule 223-1(b)(7))

☐ *Discretionary Authority* (Rule 223-1(b)(8))

C. (1) Are any *client assets* of which you or a *related person* have *custody* maintained by a *qualified custodian* in accordance with rule 223-1 under the Advisers Act?

☐ Yes

☐ No

If you answered "yes" to Item 9.C.(1) you must complete Section 9.C.(1) of Schedule D for each Qualified Custodian, including yourself or a related person, that maintains your client assets.

D. (1) Are any *client assets* of which you or a *related person* have *custody* ***not*** maintained by a *qualified custodian* in accordance with rule 223-1 under the Advisers Act?

☐ Yes

☐ No

(2) If you answered "yes" to item 9.D.(1), what are the number *clients* and approximate amount of *client assets* (rounded to the nearest $1,000) not maintained by a *qualified custodian?*

(i) $_____(ii) No. of *clients*: _____

E. (1) Are you required to obtain a surprise examination in accordance with rule 223-1(a)(4) under the Advisers Act?

☐ Yes

☐ No

If you are an adviser to pooled investment vehicle(s) or other entities relying on the audit provision under rule 223-1(b)(4) and do not otherwise need to obtain a surprise

examination for other clients, indicate "No" in response to Item 9.E.(1). If you responded "Yes" to Item 9.E.(1), list in Section 9.C.(3) of Schedule D the accountant engaged to perform the surprise examination required by rule 223-1(a)(4).

* * * * *

Schedule D

* * * * *

SECTION 9.C.(1) Qualified Custodian

You must complete the following information for each *qualified custodian* that maintains your *clients*' *assets*. You must complete a separate Schedule D Section 9.C.(1) for each *qualified custodian*.

Check only one box:

☐ Add ☐ Delete ☐ Amend

(1) Full legal name of the *qualified custodian*: _____

(2) The location of the *qualified custodian's* office responsible for the services provided:

_____

_____ (number and street)

_____

_____ (city) (state/country) (zip+4/postal code)

(3) *Qualified custodian's* regulatory contact information:

_____

_____

Name

_____

_____

Telephone Number, including country code

_____

_____

E-mail Address

_____

_____

Number and street (if different from above)

_____

_____

City, state/country and zip+4/postal code (if different from above)

(4) Type of entity:

☐ Broker/Dealer
SEC Registration Number: _____
☐ U.S. Bank or Savings Association
☐ Futures Commission Merchant
☐ Foreign Financial Institution
Primary Regulator/Country: _____

(5) Legal Entity Identifier (if applicable): _____

(6) Number of *clients* and approximate amount of *client assets* (rounded to the nearest $1,000) held at the *qualified custodian* listed above:
(i) Number of *clients*: _____
(ii) Approximate amount of *client assets*: $_____

(7) Is the *qualified custodian* listed above a *related person*? ☐ Yes ☐ No

(i) If so, provide the following information about the independent public accountant that prepared the internal control report required by Rule 223-1(a)(1)(i)(C).

(1) Name of the independent public accountant: _____

(2) The location of the independent public accountant's office responsible for the services provided:

_____
_____ (number and street)

_____
_____ (city) (state/country) (zip+4/postal code)

(3) Is the independent public accountant registered with the Public Company Accounting Oversight Board?

☐ Yes ☐ No

If "yes," Public Company Accounting Oversight Board-Assigned Number:_____

(4) If "yes" to (3) above, is the independent public accountant subject to regular inspection by the Public Company Accounting Oversight Board in accordance with its rules?

☐ Yes ☐ No

(5) Did the internal control report prepared by the independent public accountant identified above contain an unqualified opinion?

☐ Yes ☐ No ☐ Report Not Yet Received for Most Recent Fiscal Year End

* * * * *

SECTION 9.C.(3) Independent Public Accountants

You must complete the following information for each independent public accountant engaged to perform a surprise examination, a financial statement audit of an entity whose assets you manage, or the verification of *client assets* required under rule 223-1(b)(2)(iii)(A). You must complete a separate Schedule D Section 9.C.(3) for each independent public accountant.

Check only one box:

☐ Add ☐ Delete ☐ Amend

(1) Name of the independent public accountant: _____

(2) The location of the independent public accountant's office responsible for the services provided:

_____
_____ (number and street)

_____
_____ (city) (state/country) (zip+4/postal code)

(3) Is the independent public accountant registered with the Public Company Accounting Oversight Board?

☐ Yes ☐ No

If "yes," Public Company Accounting Oversight Board-Assigned Number:_____

(4) If "yes" to (3) above, is the independent public accountant subject to regular inspection by the Public Company Accounting Oversight Board in accordance with its rules?

☐ Yes ☐ No

(5) The independent public accountant is engaged to:

A. ☐ perform a surprise examination
B. ☐ perform an audit
C. ☐ perform the verification required by Rule 223-1(b)(2)(iii)(A).

(6) Since *the end of your most recent fiscal year*, did all of the reports prepared by the independent public accountant identified above contain unqualified opinions?

☐ Yes ☐ No ☐ Report Not Yet Received for Most Recent Fiscal Year End

If you check "Report Not Yet Received for Most Recent Fiscal Year End," you must promptly file an amendment to your Form ADV to update your response when the accountant's report is available.

* * * * *

By the Commission.

Dated: February 15, 2023

Vanessa A. Countryman

Secretary.