

SEC proposal

Focus on investment management

February 22, 2023



SEC proposes amendments to the Custody Rule.

Source and applicability

- SEC Proposed Rule, Safeguarding Advisory Client Assets
- Investment advisers registered (or required to be registered) with the SEC under the Advisers Act

Fast facts, impacts, actions

The proposed amendments would redesignate the Custody Rule as the Safeguarding Rule, with certain new provisions that are intended to enhance investor protections in three areas.

Modernize scope	Update recordkeeping and reporting
Expand the scope beyond client funds and securities to include all client assets of which adviser has custody.	Require adviser to keep additional, detailed records of trade and transaction activity and position information for each client account of which it has custody.
Include an adviser's discretionary authority to trade client assets in the definition of 'custody'.	Amend Form ADV to align adviser's reporting with the proposed safeguarding rule's requirements and to improve accuracy of custody-related data.
Enhance custodial protections	
<ul style="list-style-type: none">Require qualified custodians to have 'possession or control' of client assets under a written agreement that includes certain commitments and reasonable assurances and specifies adviser's level of authority.Require adviser to obtain a written internal control report from all qualified custodians on an annual basis.Require adviser to have a reasonable belief that an independent public accountant (IPA) will perform the surprise examination pursuant to agreement between adviser and its IPA.Amend the exception of the requirement to maintain client assets with a qualified custodian to include certain physical assets and require adviser and its IPA to satisfy new provisions when the exception is used.Expand the availability of 'the audit provision' to satisfy the surprise examination requirement and require a written agreement between adviser (or the entity) and its auditor requiring the auditor to notify the SEC on the auditor's termination or issuance of a modified opinion when the audit provision is used.Require a more robust set of requirements for a foreign financial institution to serve as a qualified custodian.	

Comments are due within 60 days of publication in the Federal Register, which could be as soon as the end of April.

Background

Adopted in 1962 to regulate the custodial practices of investment advisers, the Custody Rule requires investment advisers registered (or required to be registered) with the SEC to safeguard client funds and securities in their possession or where they have authority to obtain possession of them. The Custody Rule was designed to protect these assets from the adviser's own insolvency or bankruptcy, and from the assets being lost, misused, stolen or misappropriated.

The SEC amended the Custody Rule over time as custodial and advisory practices have changed. Since the Custody Rule was last amended in 2009, changes and developments in technology, advisory services and custodial packages have put client assets at a greater risk of loss. The proposed amendments are intended to strengthen protections under the Custody Rule to address these developments.

Summary of updated and new guidance

The SEC proposed to amend certain provisions of the Custody Rule including the following.

Custody Rule (existing provisions)	Safeguarding Rule (proposed provisions)	
Modernize the scope of assets and activities that would trigger application of the rule		
The scope is limited to client funds and securities of which an adviser has custody.	The scope of the rule would be expanded beyond client funds and securities to include any client assets of which an adviser has custody. Assets would be defined to mean 'funds, securities, or other positions held in a client's account', which is intended to include cryptocurrency assets and accommodate innovations in the market for various investment types that develop in the future, irrespective of their status as funds or securities.	
Custody is defined to mean "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them."	The Custody Rule's definition of custody would generally be preserved; however, the proposed amendments would also explicitly include an adviser's discretionary authority to trade client assets within the definition of custody.	
Enhance custodial protections that client assets receive under the rule		
An adviser is required to maintain funds and securities with a qualified custodian, with limited exceptions.	<p>A new provision would require qualified custodians to have 'possession or control' of client assets under a written agreement, meaning the qualified custodian would be required to participate in any change in beneficial ownership of those assets.</p> <ul style="list-style-type: none">Participation would include effectuating the transaction involved in the change in beneficial ownership.Involvement would be a condition precedent to the change in beneficial ownership. <p>The written agreement would specify the adviser's agreed-upon level of authority to effect transactions in the account, and would require the following commitments from the qualified custodian, which the adviser must reasonably believe have been implemented:</p>	

Custody Rule (existing provisions)	Safeguarding Rule (proposed provisions)
	<ul style="list-style-type: none"> to provide certain reasonable assurances to ensure clients receive certain standard custodial protections when an adviser has custody of their assets; to provide promptly, on request, records relating to clients' assets held in the account at the qualified custodian to the SEC or the auditor; and to obtain a written internal control report that includes an opinion of an auditor regarding the adequacy of the qualified custodian's controls. <p>The adviser also would be required to obtain reasonable assurances in writing from the qualified custodian that certain client protections specified in the proposed rule will be provided to the advisory client, including the reasonable assurance that the qualified custodian will segregate all client assets from its proprietary assets and liabilities.</p>
<p>An adviser that acts as a qualified custodian or maintains the client's funds or securities at a related party custodian is required to obtain a written internal control report.</p>	<p>An adviser would have to obtain a written internal control report from all qualified custodians on an annual basis, regardless of whether the adviser acts as a qualified custodian or maintains the client's funds or securities at a related party custodian.</p>
<p>An adviser with custody, subject to certain exceptions, must undergo an annual surprise examination by an independent public accountant (IPA). 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 its IPA.</p>	<p>The surprise examination requirement would be amended to state that the adviser must reasonably believe that a written agreement has been implemented (i.e. the adviser must ensure the surprise examination occurs and the requirements of the rule are met). Entering into the contract with the IPA alone would not satisfy the requirement.</p>
<p>Certain privately offered securities are excluded from the requirement to maintain client securities with a qualified custodian.</p>	<p>This exclusion would be modified to change 'certain privately offered securities' to 'certain assets unable to be maintained with a qualified custodian,' which would amend the scope exclusion to include certain physical assets as well.</p> <p>An adviser would be required to reasonably determine, and document in writing, that ownership cannot be recorded and maintained in a manner in which a qualified custodian can maintain possession or control of such assets. The adviser would also be required to reasonably safeguard the assets from loss, theft, misuse, misappropriation or its financial reverses, including its insolvency.</p> <p>A written agreement would be required between the adviser (or the entity) and its IPA whereby the adviser would be required to notify the IPA to perform a verification of any</p>

Custody Rule (existing provisions)	Safeguarding Rule (proposed provisions)
	<p>purchase, sale or other transfer of beneficial ownership of such assets within one business day.</p> <p>The IPA would be required to:</p> <ul style="list-style-type: none"> • verify the transaction promptly, on receiving notice of the activity from the adviser; and • notify the SEC within one business day on finding any material discrepancies during the course of performing its procedures. <p>Further, the IPA would be required to verify the existence and ownership of each of the client's privately offered securities or physical assets that are not maintained with a qualified custodian during the annual surprise examination or as part of a financial statement audit.</p>
<p>A pooled investment vehicle is not required to comply with the notice to clients and delivery of account statements requirements and can satisfy the surprise examination requirement if the adviser obtains an audit of the pooled investment vehicle at least annually and on the entity's liquidation ('the audit provision').</p>	<p>This provision would be amended to change 'pooled investment vehicle' to 'entity', which would expand the availability of the audit provision as a means of satisfying the surprise examination requirement.</p> <p>The financial statements of foreign entities would have to be prepared in accordance with US GAAP or the entity would have to maintain information substantially similar to statements prepared in accordance with US GAAP and material differences with US GAAP reconciled.</p> <p>Further, a written agreement would be required between the adviser (or the client entity) and its auditor that would require the auditor to notify the SEC:</p> <ul style="list-style-type: none"> • within four business days of resignation or dismissal from, or other termination of, the engagement, or on removing itself or being removed from consideration for being reappointed as auditor of the client entity; and • within one business day of issuing an audit report to the entity that contains a modified opinion.
<p>A qualified custodian can include a foreign financial institution (FFI) that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets.</p>	<p>A more robust set of requirements would be imposed for an institution to be an FFI that is eligible to serve as a qualified custodian, such as requiring the FFI to hold financial assets for its customers in an account designed to protect such assets from creditors of the FFI in the event of insolvency or failure of the FFI.</p>

Update recordkeeping and reporting

The proposed amendments would update related recordkeeping and reporting requirements for advisers, as follows.

- **The Investment Adviser Recordkeeping Rule.** Require advisers to keep additional, more detailed records of trade and transaction activity and position information for each client account of which it has custody.
- **Form ADV.** Amend Part 1A, Schedule D, and the Instructions and Glossary of Form ADV to align advisers' reporting obligations with the proposed safeguarding rule's requirements and to improve the accuracy of custody-related data that is publicly filed.

Transition period and compliance dates

The SEC proposed a transition period to provide time for advisers to comply with the proposed amendments if they are adopted. Accordingly, the SEC proposed the following compliance dates.

Adviser size	Compliance date
Advisers with more than \$1 billion in regulatory assets under management (RAUM), as defined in the proposed amendments	One year following the effective date
Advisers with up to \$1 billion in RAUM	18 months following the effective date

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