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

SEC Release Nos. IA-6240; File No. S7-04-23
Safeguarding Advisory Client Assets

Dear Madam Secretary:

We appreciate the opportunity to respond to the Securities and Exchange Commission's (SEC or Commission) request for comments about its proposed rule, *Safeguarding Advisory Client Assets* (the Proposed Rule). We have limited our comments to certain aspects of the Proposed Rule to raise awareness and request clarification related to the proposed prompt verification procedures, the impact on the surprise examination requirements and audit provision, and the notification requirements, focusing on matters related to the role of the independent public accountant.

Proposed Prompt Verification Procedures

The Proposed Rule would require the investment adviser to notify the independent public accountant of any purchase, sale or other transfer of beneficial ownership of any assets not maintained with a qualified custodian within one business day. A written agreement is required between the investment adviser and the independent public accountant specifying that the independent public accountant verify the purchase, sale or other transfer of beneficial ownership of such assets promptly upon receiving the required notice. We identified potential implementation challenges with the proposed prompt verification procedures, which we discuss below.

Form and Framework of the Verification Procedures

We recommend the Commission prescribe the assurance framework to be applied to the verification procedures. As independent public accountants, we are required to perform engagements under the audit, attestation, or consulting standards and we believe the verification procedures outlined in the Proposed Rule would generally be attestation engagements. There is no concept of 'verification' under these standards, and the objective of these procedures suggests that an examination under the AICPA attestation standards¹ would be most appropriate. It would be helpful for the Proposed Rule to clarify the standards under which these engagements should be performed.

Under the attestation standards, we believe each individual transaction verification would likely be its own examination engagement with its own reporting requirements. As such, the required procedures for each individual examination engagement would include, for example, performing planning and risk assessment procedures, obtaining sufficient appropriate evidence to support the opinion in the examination report, evaluating the reliability of information produced by the entity, evaluating the use of specialists,

¹ AT-C Section 205 – *Assertion-Based Examination Engagements*, AT-C Section 105 - *Concepts Common to All Attestation Engagements*, and AT-C Section 315 – *Compliance Attestation*

supervising the work of other practitioners, and issuing a separate written report that complies with the attestation standards. Considering the potential volume of verifications to be performed for each individual client of the investment adviser, there would likely be challenges completing the robust requirements of an examination within the proposed timeframe. In addition, obtaining sufficient appropriate evidence upon being notified of a change in beneficial ownership may require more time than proposed due to the likely complex nature of the assets not maintained with a qualified custodian.

There also may be instances where the engagement would require the assistance of others, such as accountants in other jurisdictions or legal specialists, to assist the independent public accountant in performing the verification of transactions, such as instances involving foreign or legally complex assets. Because of the expected time to coordinate and supervise the work being performed by other accountants or specialists, a prompt verification may not be achieved. In contrast, surprise examinations performed under the current custody rule must be completed within 120 days of the selected examination date, which generally provides sufficient time to complete the examination procedures under the attestation standards.

Reporting on the Verification

Question 157 asks whether the Commission should require a reporting mechanism for the auditor to communicate the results of the ongoing verification procedures to the adviser. We recommend the Commission consider aligning any reporting requirements with those for examination engagements under the attestation standards.

Involvement of Independent Public Accountants

Question 155 asks whether the Proposed Rule should permit other persons or entities to perform the verification that the rule proposes be performed by the independent public accountant. We believe using independent public accountants should be required given the likely complex nature of assets not maintained with a qualified custodian, such accountants' professional experience performing verification procedures and the existence of an established reporting framework under the attestation standards which provide consistent verification procedures.

2009 Accounting Guidance

The 2009 Accounting Guidance² for the current custody rule focuses on funds and securities in which the prescribed form of verification is through confirmation with third parties. This guidance does not contain verification procedures for changes in beneficial ownership of other asset types contemplated by the Proposed Rule, such as physical assets and cryptocurrencies. Therefore, we recommend the guidance be enhanced with other types of verification procedures. We further recommend the Commission consider clarifying what constitutes a material discrepancy that would require notification by the independent public accountant. We are available to discuss any enhancements to the 2009 Accounting Guidance considered by the Commission in connection with the Proposed Rule.

² Advisers Act Release No. 2969, *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*

Alternatives to Prompt Verification Procedures

Question 158 asks whether, as an alternative to the notification and verification elements of the Proposed Rule, the Commission should instead require periodic examinations for privately offered securities and physical assets that are not maintained with a qualified custodian. We are supportive of the verification being performed periodically (e.g. quarterly or semi-annually). We believe a periodic verification would allow sufficient time for the independent public accountant to perform procedures in a timely manner.

The periodic verification approach also may better enable the independent public accountant to independently assess the completeness of all transactions requiring verification by requiring the investment adviser to provide a complete listing and roll forward of transactions during the period, which the accountant can then test. Tests of completeness may identify evidence of fraudulent activity because we believe an investment adviser with fraudulent intentions is less likely to notify the independent public accountant of its own fraudulent acts. Therefore, prompt verifications are less likely to identify material non-compliance.

In addition, independent public accountants customarily apply a risk-based approach for examination engagements, which uses materiality and sampling procedures to provide reasonable assurance to support the independent public accountant's opinion. While we acknowledge the Commission's concerns with using materiality and sampling in performing verifications, these concepts are grounded in professional standards for independent public accountants to provide reasonable assurance. We believe periodic verifications that include completeness and risk-based procedures would provide a cost beneficial alternative to prompt verifications.

Question 150 asks whether the Commission should 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 rather than requiring verification by an accountant promptly after each purchase, sale or other transfer, as proposed. We are supportive of the independent public accountant performing periodic interim audit procedures in conjunction with annual audits, instead of separate examination engagements, to satisfy the periodic verification for assets not maintained with a qualified custodian. This approach would allow accountants to comply with the written notification requirements for material discrepancies. However, it would not result in a written independent public accountant's report for the verification procedures.

Impact on the Surprise Examination Requirements and Audit Provision

Like the current custody rule, the Proposed Rule would require investment advisers to undergo an annual surprise examination or to rely on the audit provision. We have provided additional considerations below relating to the impact of the Proposed Rule on the surprise examination and the audit provision.

2009 Accounting Guidance

Under the current custody rule, investment advisers with custody, subject to certain exceptions, must undergo an annual surprise examination by an independent public accountant. Under the Proposed Rule, Rule 204-2(b) would require a more detailed and broader scope of books and records to be maintained than the existing requirements for investment advisers that have custody of client securities or funds. We recommend the 2009 Accounting Guidance be enhanced to clarify whether the independent public accountant's report on the surprise examination should express an opinion on the investment adviser's

compliance solely with the transaction and position information under proposed Rule 204-2(b)(2)(v), rather than compliance with proposed Rule 204-2(b) in its entirety.

Custodial Account Records

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. We are supportive of the Proposed Rule requiring the investment adviser to enter into a written agreement with the qualified custodian to promptly, upon request, provide records to the independent public accountant, because we believe it would help facilitate the independent public accountant's ability to obtain custodial account records and improve the reliability of the evidence used by the independent public accountant.

Expansion of the Audit Provision

Similar to the current custody rule, an investment adviser that obtains an audit of an entity's financial statements at least annually and upon an entity's liquidation under the Proposed Rule would be deemed to have complied with the surprise examination requirement. One of the primary differences between the audit provision under the current custody rule as compared to the Proposed Rule is the expanded availability of the audit provision from 'pooled investment vehicle' clients to 'entity'. While we are supportive of this expansion, we recommend that the Commission define the term 'entity' to reduce or eliminate potential confusion around which types of entities are subject to the Proposed Rule. We also recommend that the definition be narrow enough so that it only encompasses the activity contemplated under the Proposed Rule that should be verified and subject to audit procedures. We further recommend the Commission provide clarity on when the expanded audit provision can be used, including illustrative examples.

Form of the Financial Statements and Distribution

Under the Proposed Rule, the audited financial statements must be prepared in accordance with US Generally Accepted Accounting Principles (US GAAP). Further, the Proposed Rule introduces a requirement for the financial statements of non-US entities or entities with non-US managers to contain information substantially similar to statements prepared in accordance with US GAAP and for material differences from US GAAP to be reconciled. Lastly, 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 US GAAP or supplementary US GAAP disclosures (as applicable), are required to be distributed to the entity's investors (or their independent representatives).

We agree that continuing to require investment advisers to prepare the audited financial statements in accordance with US GAAP (or other standards that are substantially similar to US GAAP) is beneficial because it produces comparable information for investors and other financial statement users. Further, we are supportive of allowing additional time to distribute financial statements of certain funds, including 'fund of funds' and 'fund of funds of funds', in instances when the preparation of their financial statements depends on the timing of the distribution of the financial statements of the underlying fund(s). We recommend that the Commission consider expressly allowing the audited financial statements to be distributed beyond the prescribed period of 120 (or 180 or 260) days if a reasonably unforeseeable

circumstance necessitates a longer period. Such a revision would be consistent with the SEC staff's guidance included in Q&A VI.9 of the SEC's *Staff Responses to Questions About the Custody Rule*.

Notification Requirements

Under the Proposed Rule, there are a number of notification requirements that impact the role of the independent public accountant.

Form ADV-E

Question 231 asks whether the independent public accountant should be required to file Form ADV-E in a similar manner as independent public accountants who complete surprise examinations. We are supportive of the approach taken in the Proposed Rule to not include a requirement for an independent public accountant to file a Form ADV-E in connection with the audit provision. If an independent public accountant is required to file a Form ADV-E for audited financial statements in a manner similar to the existing requirements for surprise examinations, we recommend the requirement to add an audit report or a copy of the audited financial statements be limited to the financial statements that are required to be publicly filed.

Question 154 asks whether the rule should 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. We are supportive of the approach taken in the Proposed Rule to not include a requirement for an independent public accountant to file a certificate on Form ADV-E stating that it has verified transactions involving assets not maintained with a qualified custodian and describing the nature and extent of its verification. We believe the independent public accountant's issuance of a written audit report or examination report is sufficient to acknowledge the completion of the verification procedures.

Change in Independent Public Accountant

The Proposed Rule also introduces a requirement for there to be a written agreement between the investment adviser or the audited entity and the independent public accountant performing the audit requiring the independent public accountant to notify the Commission upon the independent public accountant's termination. We recommend that the Commission consider requiring the investment adviser (as opposed to the independent public accountant) to notify the Commission of a change in independent public accountant consistent with the requirement for a registrant that files periodic reports under the Securities Exchange Act of 1934 to report such events on Form 8-K. We believe the investment adviser will generally be in a better position to provide timely notification to the Commission of a change in independent public accountant resulting from dismissal or termination of the engagement, as in those circumstances, the independent public accountant may be dependent on notification from the investment adviser of such change. Further, consistent with those existing regulations, we recommend the independent public accountant be required to notify the Commission when the investment adviser fails to fulfill the notification requirement.

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We appreciate the opportunity to respond to the request for comments on the Proposed Rule and would welcome any opportunity to further discuss. If you have any questions regarding our comments or other information included in this letter, please do not hesitate to contact Timothy Jinks ((212) 954-7223 or tjinks@kpmg.com) or Eric Goldberg ((213) 533-3013 or egoldberg@kpmg.com).

Very truly yours,

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