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SERVING INDIVIDUAL INVESTORS
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SEC Issues Proposal on Safeguarding Advisory Client Assets

[34961]

February 16, 2023

TO: ICI Members SUBJECTS: Compliance
Investment Advisers
Operations RE: SEC Issues Proposal on Safeguarding Advisory Client Assets

On February 15, 2023, by a 4-1 vote, the SEC approved a proposal that would amend rule 206(4)-2 under the Investment Advisers Act to enhance investor protections relating to the safeguarding of advisory client assets. The proposal would:

- Expand the current custody rule to protect a broader array of client assets and advisory activities;
- Enhance the custodial protections that client assets receive; and
- Update related recordkeeping and reporting requirements for advisers.[1]

The proposal retains the exception for accounts of registered investment companies but requests comment on whether the Commission should continue to except accounts of RICs under the proposed rule.

The Commission requests comment on all aspects of the proposed rule, which comments will be due 60 days after the proposal is published in the Federal Register.

We summarize these proposed changes below.

Background

Rule 206(4)-2 under the Advisers Act (the "custody rule" or "current rule") regulates the custodial practices of advisers. The Commission most recently amended the custody rule in 2009 after several enforcement actions against investment advisers alleging fraudulent conduct that included, among other things, "misappropriation or other misuse of client assets involving certain affiliates of the adviser." 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").[2]

The SEC noted in the proposing release that “changes in technology, advisory services, and custodial practices create 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.”

Overview of the Proposal

The SEC proposed to amend and redesignate the custody rule as new rule 223-1 under the Advisers Act (the “safeguarding rule” or the “proposed rule”). The release notes that 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.” The SEC’s proposed amendments “are designed to modernize the scope of assets and activities that would trigger application of the rule.”

Scope of Rule

The proposing release notes that, “[l]ike 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 [Advisers] Act that has ‘custody’ of a client’s assets.” 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.” The proposed rule would change the current rule’s scope by “expanding[ing] the types of investments covered by the rule” and by making “explicit that the current rule’s defined term ‘custody’ includes discretionary authority.”

Scope of Assets

The release indicates that 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.” The SEC indicates that “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.” As a result, 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.”

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.” 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.”

Scope of Activities

The proposed rule would “explicitly include discretionary authority to trade within the definition of custody.” The SEC states that 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.” The rule would “continue to apply when an adviser’s related person has the ability to obtain client assets in connection with advisory services.”

The proposed rule would retain the three categories that serve as examples of custody under the current rule:

1. physical possession;
2. certain arrangements when the adviser is authorized or permitted to instruct the client's custodian (including, but not limited to, a general power of attorney or discretionary authority); and
3. circumstances when the adviser acts in certain capacities.

The release also states that the amended custody definition "would include any arrangement under which the adviser is authorized or permitted to withdraw or transfer beneficial ownership of client assets upon the adviser's instruction."

Qualified Custodian Protections

As under the current rule, "investment advisers with custody of client assets would be required to maintain those assets with a qualified custodian."[3]

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." However, in a change from the current rule, the adviser would have to enter a written agreement with the qualified custodian to provide it with custody of the client assets." The release notes that "[i]n 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."

Definition of Qualified Custodian

With the exception of proposed amendments to the definition of qualified custodian relating to banks, savings associations, and FFIs, the proposal does not seek to change the types of institutions that may serve as qualified custodians under the rule.

The proposed rule would add a requirement 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."

The proposal would require that "an FFI satisfy seven new conditions in order to serve as a qualified custodian for client assets under the proposed rule."[4]

Definition of "Possession or Control"

Unlike the current custody rule, the proposed 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." Further, "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."

Crypto Assets

With respect to crypto assets, the Commission acknowledges that, "proving exclusive control of a crypto asset may be more challenging than for assets such as stocks and bonds." The proposing release notes that "[w]hile 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." The SEC notes that under the proposed rule, "for example … 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." However, the release cautions that "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." Finally, the release says that:

Because we understand that most crypto assets, including crypto asset securities, trade on platforms that are not qualified custodians, this practice [of investors transferring their crypto assets, including crypto asset securities, or fiat currency to such an exchange prior to the execution of any trade] 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.

Minimum Custodial Protections

The proposed rule would "promote minimum standard custodial protections for advisory clients whose advisers have custody of client assets." The proposed rule "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)," and "would further require the adviser to obtain reasonable assurances in writing from the custodian regarding certain vital protections for the safeguarding of client assets."

According to the proposing release, "[t]he 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 Commission also notes that "[t]he 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."[5]

The release notes that some of the noted 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."

The contractual terms of the written agreement "would address recordkeeping, client account statements, internal control reports, and the adviser's agreed-upon level of authority to effect transactions in the account." [6] 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."[7]

The proposed written agreement would contain two provisions not expressly addressed in the current custody rule. The first 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 second 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."

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

The Commission notes that while the "bulk of advisory client assets are able to be maintained by qualified custodians," it is not "universally the case, particularly for two types of assets: certain physical assets and certain privately offered securities."

In a discussion of privately offered securities, the release states:

We understand that advisers with trading authority of privately offered securities that do not settle DVP [delivery versus payment] often have custody of these securities because of the broad, general power of attorney-like authority required to trade these securities. 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" from the qualified custodian requirement.[8]

The release goes on to note that "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."

As a result, the Commission is "proposing to reform the privately offered securities exception to address … concerns about the lack of protections and transparency that could result when privately offered securities … 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."[9] 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" provided it meets certain conditions.[10]

Segregation of Assets

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.

Investment Adviser Delivery of Notice to Clients

The proposed rule, like the current 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. The release indicates that 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."

Amendments to the Surprise Examination Requirement

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." Currently, this 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." In a change from the current rule, the SEC is proposing an amendment "requiring that an adviser 'must reasonably believe' that the 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)."

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."

Entities Subject to Audit

Similar to the current 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." In order for an 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 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."[11]

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."

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." The proposed rule would define a standing letter of authorization "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."

Amendments to the Investment Adviser Recordkeeping Rule

The proposal also seeks to "update and enhance recordkeeping requirements for advisers that would work in concert with the proposed rule."

The proposed amendments "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."[12]

The proposed amendments would also add new recordkeeping requirements to address independent public accountant engagements.[13]

Changes to Form ADV

Additionally, the SEC proposed 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.[14]

Existing Staff No-Action Letters and Other Staff Statements

The release notes that "[s]taff 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."

Transition Period and Compliance Date"

If the proposals are adopted, the SEC is "proposing a one-year transition period to provide time for advisers to come into compliance." For advisers with more than $1 billion in regulatory assets under management ("RAUM") the proposed compliance date of any adoption of the proposal would be one year following the rules' effective dates. For advisers with up to $1 billion in RAUM, the proposed compliance date of any adoption of the proposal would be 18 months following the rules' effective dates.

The release notes that "[u]nder this proposal, advisers could continue to rely on current rule 206(4)-2, rule 204-2, and Form ADV until the compliance date."

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Notes

[1] Safeguarding Advisory Client Assets, SEC Release No. IA-6240; (Feb. 15, 2023) (the "proposal" or the "proposing release"), available at https://www.sec.gov/rules/proposed/2023/ia-6240.pdf. Chair Gensler and Commissioners Crenshaw, Lizárraga and Uyeda voted for the proposal, and Commissioner Peirce voted against it. Commissioner statements regarding the proposal are available at https://www.sec.gov/news/speeches-statements.

[2]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).

[3] 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.

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

1. 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;
2. Regulated by a foreign country's government, an agency of a 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;
3. 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;
4. 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;
5. Having the requisite financial strength to provide due care for client assets;
6. 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
7. Not operated for the purpose of evading the provisions of the proposed rule.

[5] The proposed rule recognizes that there are certain fundamental protections that should be provided to a custodial customer when the adviser has custody:

1. A qualified custodian should exercise due care and implement appropriate measures to safeguard the advisory client's assets;
2. A qualified custodian should indemnify an advisory client when its negligence, recklessness, or willful misconduct results in that client's loss;
3. A qualified custodian should not be relieved of its responsibilities to an advisory client as a result of sub-custodial arrangements;
4. A qualified custodian should clearly identify an advisory client's assets and segregate an advisory client's assets from its proprietary assets;

5. The client's assets should remain free of liens in favor of a qualified custodian unless authorized in writing by the client;
6. A qualified custodian should keep certain records relating to those assets;
7. A qualified custodian should cooperate with an independent public accountant's efforts to assess its safeguarding efforts;
8. Advisory clients should receive periodic custodial account statements directly from the qualified custodian;
9. A qualified custodian's internal controls relating to its custodial practices should be evaluated periodically for effectiveness; and
10. A custodial agreement should reflect an investment adviser's agreed-upon level of authority to effect transactions in the advisory client's account.

[6] The proposed rule would require that the written agreement with the qualified custodian:

1. include a provision requiring the qualified custodian promptly, upon request, to provide records relating to client assets to the Commission or an independent public accountant for purposes of compliance with the rule;
2. 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, including advisory fees;
3. 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);[6] and
4. 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.

[7] In addition to the written agreement requirement, an adviser would have to obtain "reasonable assurances" that a qualified 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.

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).

[8]See rule 206(4)-2(b)(2). The current rule contains an exception for certain uncertificated, privately offered securities, which are not required to be held with a qualified custodian.

[9] 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. 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. The SEC states its belief that "crypto asset securities issued on public, permissionless blockchains would not satisfy the conditions of privately offered securities under the proposed safeguarding rule."

[10] The conditions are:

1. The adviser reasonably determines and documents 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 transfers of beneficial ownership, of such assets;
2. The adviser reasonably safeguards the assets from loss, theft, misuse, misappropriation, or the adviser's financial reverses, including the adviser's insolvency;
3. An independent public accountant, pursuant to a written agreement between the adviser and the accountant,
    1. 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
    2. Notifies the Commission within one business day upon finding any material discrepancies during the course of performing its procedures;
4. 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
5. 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.

[11] 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);
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 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.

Elements of the proposed rule's audit provision are largely unchanged from the audit provision of the custody rule. 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.

[12] The proposed amendments would add new recordkeeping requirements that include:

1. retaining copies of required client notices;
2. creating and retaining records documenting client account identifying information, including copies of all account opening records and whether the adviser has discretionary authority
3. 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;
4. creating and retaining a record that indicates the basis of the adviser's custody of client assets;
5. retaining copies of all account statements; and
6. retaining copies of any standing letters of authorization.

[13] These documents would include: (1) all audited financial statements prepared under the safeguarding rule; (2) a copy of each internal control report received by the investment adviser; 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.

[14] The Commission is proposing to:

1. capture information in Item 9 about an adviser's custody of its "client assets" including a client's funds, securities, and other positions held in a client's account;
2. 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;

3. 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.
4. 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;
5. 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. The SEC is proposing to require advisers to report the following information for all qualified custodians maintaining client assets:
    1. Full legal name of the qualified custodian;
    2. Location of the qualified custodian’s office responsible for the services provided;
    3. Contact information for an individual to receive regulatory inquiries;
    4. Type of entity;
    5. Legal Entity Identifier (if applicable);
    6. Number of clients and approximate amount of client assets (rounded to the nearest $1,000) maintained by the qualified custodian; and
    7. 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.
6. 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. The SEC is 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.