

# Regulatory Alert

Regulatory Insights for Financial Services

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## SEC Proposes Amendments to the Custody Rule

### KPMG Regulatory Insights:

- *The issuance explicitly states that the protections apply to “all assets, including crypto assets”—thus the SEC continues to look to apply existing regulations and authorities to the digital asset market.*
- *The SEC proposal reiterates its Congressionally granted authority (under the Dodd Frank Act) to “safeguard client assets over which the adviser has custody.”*
- *In issuing, the SEC chair denotes the proposal will “help ensure that advisers don’t inappropriately use, lose, or abuse investor’s assets”. “Use”, “lose” or “abuse” are important words aligned to key principles of customer/investor protection, fiduciary duty, best interest, and data privacy.*

The Securities and Exchange Commission (SEC) [proposed](#) to amend Rule 206(4)-2 under the Advisers Act (currently known as the Custody Rule) and redesignate it as the Safeguarding Rule (new rule 223-1 under the Advisers Act). Amendments to the current rule are intended to strengthen investor protections related to advisory client assets and to “expand the scope of the current Custody Rule beyond client funds and securities to include any client assets for which an adviser has custody.” Key provisions are outlined below.

The SEC 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 [Advisers] Act’s antifraud provisions.”

### Proposed Safeguarding Rule

**Expanded Scope.** Under the proposed rule, the SEC would expand the definition of “assets” to include “funds, securities, or other positions held in a client’s account.” The new definition would encompass the entirety of a client account’s positions, holdings, and investments including short positions and written options; all crypto assets, including those that do not meet the definition of a fund or security; financial contracts held for investment purposes, collateral posted in connection

with a swap contract on behalf of the client, or other assets that may not be clearly funds or securities covered by the Custody Rule; physical assets (e.g., artwork, real estate, precious metals, and physical commodities such as wheat and lumber); and certain assets that might be accounted for as liabilities or financial obligations.

**Custody.** “Custody” would be defined to mean “holding, directly or indirectly, client assets, or having any authority to obtain possession of them.” Such authority would include “discretionary authority” as defined in the rule. With limited exception, investment advisers would continue to be required to maintain client assets for which they have custody with a “qualified custodian” (defined to include banks, savings associations, registered broker-dealers, registered futures commission merchants, and certain foreign financial institutions (FFIs) that meet specific conditions and requirements). Further, the qualified custodian would be required to have “possession or control” of the clients’ assets.

**Enhanced Protections.** The proposed Safeguarding Rule would also provide for additional enhanced protections including:

- Requiring an adviser to enter into a written agreement with and to receive certain assurances from the qualified custodian (in writing) to ensure the qualified custodian

provides certain standard custodial protections when maintaining client assets. These protections would include:

- An internal control report (at least annually) that includes an opinion of an independent public accountant relating to the effectiveness of internal controls relating to custodial services.
  - Specification of the agreed-upon level of authority to effect transactions in the client's account.
  - "Reasonable assurances" regarding due care, indemnification, limitation of liability for sub-custodial services, segregation of client assets, and attachment of liens to client assets.
- Expanding the "privately offered securities" exception (where advisers are not required to custody assets with a qualified custodian) to include certain physical assets and modifying the exception to require advisers to have a "reasonable belief" that the assets cannot be maintained by a qualified custodian and to meet other requirements for safeguarding the assets.
- Retaining the requirement for an independent public accountant to verify client assets through a surprise examination while adding certain provisions intended to facilitate compliance as well as a requirement that the

adviser must "reasonably believe" that a written agreement between the adviser and the accountant has been implemented.

**Additional Amendments.** Provisions under the proposed rule would also amend:

- The Investment Advisor Recordkeeping Rule to require more detailed records than currently required for trades, transaction activity, and position information for each client account for which the adviser has custody. In addition, the proposal would add new recordkeeping requirements related to client communications, client accounts, account activity, independent public accountant engagements, and letters of authorization.
- Form ADV to align reporting obligations for investment advisers to the requirements proposed within the Safeguarding Rule.

**Comment Period.** The SEC requests comment on the proposed changes and listed questions to be submitted no later than 60 days after the date of publication in the Federal Register.

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