

SUPPORTING STATEMENT
For the Paperwork Reduction Act Information Collection Submission for
Rule 206(4)-2 Redesignated as Rule 223-1

A. JUSTIFICATION

1. Necessity for the Information Collection

Section 206(4) of the Investment Advisers Act of 1940 (“Advisers Act”) [15 U.S.C. 80b-6(4)] prohibits any investment adviser from engaging in any act, practice or course of business which is fraudulent, deceptive or manipulative and gives the Commission the power, by rules and regulations, to define and prescribe means reasonably designed to prevent such acts, practices and courses of business. In 2010 Congress added Section 223 of the Advisers Act [15 U.S.C. 80b-23] which further gives the Commission the power to prescribe by rule the steps a registered investment adviser must take to safeguard client assets over which it has custody, including, without limitation, verification of such assets by an independent public accountant.

Rule 206(4)-2 (the “custody rule” or the “current rule”) currently regulates the custodial practices of advisers.¹ In the light of developments and the additional authority that Congress has given the Commission under the Dodd-Frank Act to prescribe investment adviser custody rules, on February 15, 2023, the Commission proposed to redesignate 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.² The proposed rule contains several “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995 [44 U.S.C. 3510 to 3520]. The current title for the collection of information is “Rule

¹ 17 CFR 275.206(4)-2.

206(4)-2 under the Investment Advisers Act of 1940 -- Custody of Funds or Securities of Clients by Investment Advisers.” The proposed revised title for the collection of information is “Rule 223-1 under the Investment Advisers Act of 1940 – Safeguarding client assets.” The collection of information is currently approved under OMB control number 3235-0241. 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.³ 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.⁴

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 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.

² We are also renumbering portions of the custody rule that we are not amending.

³ 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.

⁴ 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).

The proposed rule would define “assets” as “funds, securities, or other positions held in a client’s account.”⁵ 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.⁶ 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.

Proposed rule 223-1, which will effectively amend and 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.⁷ 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,

⁵ Proposed rule 223-1(d)(1).

⁶ See Section 223, *supra* footnote **Error! Bookmark not defined.**

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 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.

2. Purpose and Use of the Information Collection

The Commission currently uses the information required by rule 206(4)-2 and would continue to use the information required by redesignated and amended rule 223-1 in connection with its investment adviser enforcement, regulatory, and examination programs. Advisory clients use and would continue to use the information required by rule 223-1 to confirm proper handling of their advisory accounts. Without the information collected under the rule, the Commission would be less efficient and effective in its programs and advisory clients would not have information they need to monitor the adviser’s handling of their accounts.

3. Consideration Given to Information Technology

The collection of information requirements under rule 206(4)-2 as amended and redesignated under proposed rule 223-1 take the form of (1) annual surprise examinations

conducted by independent public accountants, (2) delivery of audited financial statements to any advisory client whose financial statements are able to be audited, (3) delivery of notices to clients about new custodial accounts, (4) internal control reports by independent public accountants registered with, and subject to regular inspection by, the PCAOB, (5) written agreements with qualified custodians regarding the control of clients' assets, (6) written agreements with independent public accountants in relation to an adviser's reliance on the exception to maintain client assets with a qualified custodian for privately offered securities or physical assets, (7) notifications to an adviser's independent public accountant of any purchase, sale, or other beneficial ownership of such assets. The Commission currently permits advisers to provide to clients the information required by rule 206(4)-2 electronically and proposed rule 223-1 makes no change to this standard.⁸ Accountants also electronically file with the Commission their reports with their surprise examination findings. Finally, the Commission does not prescribe a particular format or delivery method for internal control reports, and similarly it does not prohibit the use of information technology for these purposes.

4. Duplication

The requirements of proposed rule 223-1 are not duplicated elsewhere for those investment advisers that must comply with the rule.

5. Effect on Small Entities

The requirements of proposed rule 223-1 apply equally to all investment advisers that are

⁸ See *Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information; Additional Examples Under the Securities Act of 1933, Securities Exchange Act of 1934, and Investment Company Act of 1940*, Investment Advisers Act Release 1562, (May 9, 1996).

registered with the Commission and have custody of funds or securities of their clients, including those advisers that are small entities. It would defeat the purpose of the rule to exempt small entities from these requirements.

6. Consequences of Not Conducting Collection

If the information required by rule 223-1 is either not collected or is collected less frequently, both the Commission's ability to protect investors and the ability of clients to monitor the handling of their accounts would be reduced.

7. Inconsistencies with Guidelines in 5 CFR 1320.5(d)(2)

Investment advisers registered with the Commission may be required to maintain and preserve certain information required under rule 223-1 for more than three years. The long-term retention of these records is necessary for the Commission's inspection program to ascertain compliance with the Investment Advisers Act and its rules.

8. Consultation Outside the Agency

The Commission and the staff of the Division of Investment Management participate in an ongoing dialogue with representatives of the investment adviser industry through public conferences, meetings and informal exchanges. These various forums provide the Commission and the staff with a means of ascertaining and acting upon paperwork burdens confronting the industry. In addition, the Commission has requested public comment on the proposed amendments and redesignation of the custody rule, including the collection of information requirements resulting from the proposed amendments. Before adopting these amendments, the Commission will receive and evaluate public comments on the proposed amendments and their associated collection of information requirements.

9. Payment or Gift

Not applicable.

10. Confidentiality

Not applicable.

11. Sensitive Questions

Not applicable.

12. Burden of Information Collection

The following estimates of average burden hours and costs are made solely for purposes of the Paperwork Reduction Act of 1995⁹ and are not derived from a comprehensive or even representative survey or study of the cost of Commission rules and forms.

The respondents to this collection of information under the proposed rule are investment advisers registered or required to be registered with the Commission that have custody of client assets. 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.¹⁰

All such advisers will be subject to the proposed rule. As of September 2022, there were 15,160 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

⁹ 44 U.S.C. 3501 *et seq.*

¹⁰ 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).

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.¹¹

We have made certain estimates of the burdens associated with the proposed amendments solely for the purpose of this PRA analysis. 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 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.

¹¹ 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).

**Table 1: Summary of Burden Hours, and Burden
Hour Costs Estimates for Each Proposed Rule 223-1 Information Collection
Hour Costs**

| 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* * This is not broken up into initial and ongoing burden because the annual burden is estimated to be the same each year. | 36,844 (4 per adviser obtaining a surprise examination or audit) | 18,422 (.5 hour per response) | |
| 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) | |

| Rule 223-1 Description of New Requirements | No. of Responses | Internal Burden Hours | External Burden Costs |
|---|---|------------------------------------|------------------------------|
| 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* *This would be a one-time burden to include account numbers in the notices. | 13,944 advisers (1 per adviser) | 13,944 hours (1 hour per adviser) | |
| 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 |

13. Cost to Respondents

Cost burden is the cost of goods and services purchased to meet the requirements of proposed rule 223-1, such as for the services of outside counsel and independent auditors. The cost burden does not include the hour burden discussed in Item 12 above. Estimates are based on the Commission's experience.

As summarized in Table 1 above, we estimate the annual external cost associated with the proposed amendments and redesignation to be \$378,598,500.

14. Cost to the Federal Government

There are no additional costs to the federal government.

15. Changes in Burden

As noted above, the approved annual burden for rule 206(4)-2 is 288,202 hours. We now estimate that the total information collection hours is 398,152 hours. The primary cause of the increase is the result of (a) an increase in the estimated number of investors in pooled investment vehicles whose advisers do not provide advisory services exclusively to pooled investment vehicles and (b) an increase in the estimated average number of clients of advisers that have custody of client assets.¹² The currently approved annual burden under rule 206(4)-2 includes an aggregate cost estimate of \$174,367,000. We now estimate that the annual cost burden under the rule would increase to \$378,598,500, which is attributable to an increase in the number of medium sized advisers that will be subject to the surprise examination requirement with respect to 5% of their clients as well as inflation adjustments.

¹² See *supra* notes **Error! Bookmark not defined.** and **Error! Bookmark not defined.**

16. Information Collection Planned for Statistical Purposes

Not applicable.

17. Approval to Omit OMB Expiration Date

Not applicable.

18. Exception to Certification Statement for Paperwork Reduction Act

Submission

Not applicable.

B. COLLECTION OF INFORMATION EMPLOYING STATISTICAL METHODS

Not applicable.