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SEC Proposes Custody Rule Modernizations for Investment Advisers and Investment Companies

On October 1, 2026, the Securities and Exchange Commission (SEC) proposed amendments to the custody rules under the Investment Advisers Act of 1940 and the Investment Company Act of 1940. While the primary focus of the amendments is a framework for custody of crypto assets, the proposal also includes several "modernizations" unrelated to crypto assets that address common pain points for investment advisers and investment companies in the "TradFi" space, bringing the rules into line with current industry practices and effectively codifying several staff FAQs. These changes warrant attention even from managers that have no crypto exposure. The SEC's broader reconsideration of the custody rules presents an opportunity for managers to highlight other practical challenges and advocate for changes to address them. Please reach out to us if you would like to discuss submitting a comment letter.

1. Investment Adviser Modernizations

Private Fund Audits

- **Elimination of PCAOB Supervision Requirement**. The proposal would eliminate the custody rule's requirement that accounting firms performing specified audit and examination engagements be registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (PCAOB), while retaining the requirement for an independent public accountant. The SEC explains that the PCAOB inspection is focused on public company audits and does not reach engagements required solely by the Custody Rule. Removal of that eligibility condition could broaden the choice of auditors and the SEC states that it could reduce the costs of audits.
- **Stub Year Audits**. For vehicles formed within the last 90 days of their fiscal year, the proposal would permit an adviser not to obtain an audit for the "stub" period in the first year provided that financial statements, which could be unaudited, are delivered within 90 days after that year-end. The following year's audited statements would have to cover both periods, including the prior unaudited period,

and satisfy the applicable annual delivery deadline. This could reduce the burden of a separate audit, but registrants should note the earlier initial delivery deadline and the reference to formation, rather than first closing or commencement of investment activity.

- **Codifying Fund-of-Funds Guidance**. The rule would expressly provide extended delivery periods for annual audited financial statements. Funds-of-funds would be permitted to deliver their financial statements within 180 days instead of 120. Funds-of-funds-of-funds would be permitted 260 days. Existing staff guidance already provides this relief, but codifying it is nonetheless helpful. The proposal also includes guidance that short delivery delays caused by reasonably unforeseeable circumstances generally would not be considered a violation of the rule, if the adviser reasonably believed delivery would be timely and ensures prompt delivery once those circumstances are resolved. While this is consistent with existing staff guidance, the fact that it is now provided by the SEC itself may give registrants additional comfort.
- **GAAP Audits.** The amendments would generally codify the staff's existing guidance that a vehicle complying with the audit exception must prepare its financial statements in accordance with US GAAP. Vehicles organized outside the United States, as well as those with a general partner or other manager whose principal place of business is outside the United States, would be permitted to prepare their financial statements in accordance with a different standard (e.g., IFRS) provided that the US investors receive a US GAAP reconciliation. Their financial statements would need to contain substantially similar information to US GAAP statements, including a reconciliation of material differences delivered to US investors.[1]

Discretionary Trading Authority

The proposal includes a conditional exception for discretionary trading authority covering both delivery-versus-payment (DVP) and non-DVP transactions. This would address longstanding uncertainty concerning non-DVP transactions, including transactions in loans and private fund interests.

The proposed conditions would limit both trading authority and actual trades to designated accounts in the client's name or transfers recorded in that name by the issuer; prohibit authority to transfer assets to the adviser or its affiliates; and permit transfers to other non-client accounts only with client direction in connection with trading. An adviser would also have to comply separately with the custody rule, or an applicable exception, for other activities or powers that confer custody.[2]

Form ADV Custody Reporting

The proposed Form ADV amendments would require certain advisers to answer "yes" to the custody question even though their custody arrangements have not changed, including advisers whose custody arises solely from fee deductions or through an operationally independent related person. Separate questions would identify reliance on custody-rule exceptions, while distinct instructions would govern reportable amounts and client counts. Advisers should assess whether revised answers would affect any investor-facing disclosures or communications, including due diligence materials.

Other Investment Adviser Matters

- **Standing letters of authorization**. Advisers with custody solely because of a qualifying standing letter of authorization (SLOA) would be excepted from surprise examinations, but not the rule's other requirements. This largely codifies an existing no-action letter.
- **Inadvertent custody**. If an adviser has custody solely due to a custodial agreement where the adviser did not recommend, request or require the custodian, and lacks a copy of the agreement and knowledge or reason to know of the authority, the adviser would be excepted from compliance with the custody rule on that basis. If the adviser knows or has reason to know of the authority, it could continue to rely on the exception if it promptly notifies the client and custodian in writing, repudiates the authority and requests in writing that the authority be removed or superseded by a new agreement consented to by the client and qualified custodian. The SEC recognizes that the adviser may be unable to obtain the requested contractual change.
- **Escrow**. The release also discusses Commission guidance on seller escrow accounts after an asset is sold (e.g., as reserves for a potential indemnification claim). The contemplated guidance would permit commingling client and non-client assets on a limited basis subject to numerous safeguards, including that the escrow is time-limited and part of a fund's audit.
- **Redesignation**. If adopted, the rule would be redesignated as Rule 223-1, rather than Rule 206(4)-2, in recognition of the explicit authority granted to the SEC under the Dodd-Frank Act to regulate safeguarding of client assets.
- **Funds or Securities**. For advisory clients other than registered funds and business development companies (BDCs), the rule would continue to apply to client funds and securities, rather than all assets. The proposal separately addresses crypto self-custody for registered funds and BDCs using a securities-and-similar-investments standard. The SEC's 2023 safeguarding proposal would have

meaningfully expanded the reach of the rule, but it was formally withdrawn in 2025.

Investment Company Modernizations

Broker-Dealer Custody

The most substantial amendment applicable to investment companies would be a rewrite of Rule 17f-1, which governs broker-dealer custody of fund investments. Registered funds and BDCs could use a broker-dealer registered under Exchange Act Section 15(b)(1), rather than only a member of a national securities exchange, provided its custody of the relevant assets is subject to Rule 15c3-3 or another rule the SEC determines provides similar customer protections. The prescriptive safeguarding requirements in Rule 17f-1 would be removed in favor of the broker-dealer regulatory framework in Rule 15c3-3 and similar rules (which, the release notes, did not exist when Rule 17f-1 was enacted). The new eligibility condition could also require changes to existing arrangements: the SEC asks whether funds using broker-dealers whose custody of particular assets is not subject to Rule 15c3-3 would need time to find different custodians.

The changes could have particular value for custody arrangements involving financing: the release contemplates margin liens and rehypothecation within the broker-dealer framework that differ from Rule 17f-1's existing restrictions. For example, Rule 15c3-3's possession-or-control protections distinguish fully paid and excess margin securities from margin securities that may support financing. Funds should examine how proposed contract terms allocate those risks and whether retaining additional protections would be appropriate.

The amendments would also expressly include BDCs in the Investment Company Act custody rules and extend the adviser rule's registered-fund exception to BDC accounts, subject to the separate crypto self-custody provisions. This would formalize the treatment that the SEC describes as current industry practice, rather than introduce an entirely new custody regime for BDCs. Smaller changes would rescind the obsolete $500 free-cash-account rule and correct depository provisions.

Uncertificated Loans and Private-Asset Custody

For BDCs and registered funds investing in privately offered securities, the release asks whether there should be an exception comparable to the exception under the adviser custody rule, noting that no similar provision currently exists under the Investment Company Act. Other requests address affiliated custody, transfer-agent custody of fund shares and cleared-swap collateral.

The release raises a custody issue that remains unresolved by the proposed amendments: how the BDC and registered fund custody rules should address uncertificated loan interests. The SEC acknowledges the difficulties of maintaining these investments with a permitted custodian and describes loan arrangements in which possession of the documents does not itself permit transfer of the loan interest.
The release discusses a 2021 staff no-action letter addressing self-custody of loan interests under Rule 17f-2, the fund self-custody rule. The described safeguards include controls on authorized instructions, monthly reconciliation with administrative-agent records, recording ownership in the fund's name with an unaffiliated administrative agent, and an annual audit with confirmation and reconciliation of loan holdings, supported by the auditor's reliance on controls testing.

The SEC asks whether a specific rule should replace Rule 17f-2's vaulting, access, notation and examination requirements for uncertificated loan interests with alternative safeguards, potentially including an audit verifying the loans combined with an internal control report. The Commission is seeking feedback on this approach, not proposing loan-specific relief in this release.

Crypto Custody in Brief

The proposal would permit conditional adviser self-custody of covered crypto assets when no permitted custodian is available, with a corresponding route for registered management investment companies and BDCs through their advisers and subject to board oversight. It would also permit eligible state trust companies to provide crypto custody, subject to specified safeguards and adviser or fund diligence. These arrangements would carry control, verification, recordkeeping and reporting requirements. An adviser's possession of a non-controlling share of key materials could trigger the proposed self-custody requirements, unless it holds those materials solely in its capacity as a qualified custodian. The proposal would also require a transfer out of self-custody as soon as reasonably practicable when qualified custody becomes available.

Next Steps

The proposal does not currently have any legal effect, and does not change any current regulation or guidance. Comments are due 60 days after publication in the Federal Register. Pending adoption and effectiveness of any amendments, advisers should continue planning for their existing audit and custody obligations. In the meantime, managers can review whether their agreements would permit use of the proposed relief and how revised reporting instructions would affect their Form ADV responses. BDCs and registered funds investing in loans can use the comment process to identify where current custody requirements do not fit their ownership records and settlement arrangements, and which alternative controls would address the relevant risks.

[1] The rule would retain the Form ADV question about whether the auditors' opinion was unmodified (a technical change from "unqualified" to conform to the applicable AICPA auditing standard).

[2] A general partner of a private fund may have numerous other powers that confer custody.

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