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Skadden

Investment Management Alert

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SEC Proposes Expansion of Custody Rule Safeguards for Investment Advisers

On February 15, 2023, the Securities and Exchange Commission (SEC) proposed new rules and amendments (Proposal) to Rule 206(4)-2 (Custody Rule) under the Investment Advisers Act of 1940 (Advisers Act). The Proposal would, if adopted as written:

- Redesignate the current Custody Rule as a new Rule 223-1 (Safeguarding Rule), which would:
  - Expand the types of assets subject to the Safeguarding Rule.
  - Expand the definition of custody to include discretionary trading authority.
  - Impose substantial new custody requirements for investment advisers (Advisers) intended to protect clients.
- Amend Rule 204-2 (Books and Records Rule) to require Advisers to keep additional records for client accounts for which they have custody.
- Amend Form ADV to require Advisers to disclose additional information to the SEC regarding their client custody arrangements.

Proposal

If adopted, key elements and exceptions of the current Custody Rule would be modified or amended as part of the redesignation to the Safeguarding Rule.

Types of client assets. The Proposal expands the types of client assets captured beyond "client funds or securities" and captures any client "assets," including "funds, securities or other positions held in the client's account" over which an Adviser has custody. Thus, the Safeguarding Rule would cover cryptocurrencies and other digital assets, contracts held for investment purposes, collateral posted in connection with a swap contract and physical assets, including real estate, artwork, precious metals and physical commodities, as well as "other positions" that may not be recorded on a balance sheet as an asset (*e.g.*, short positions and written options).[1] The SEC noted that the use of the new term "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 types of assets the client entrusts to the adviser."[2]

[1] Proposal at 27-28.

[2] Proposal at 27.

Definition of custody. The Proposal would explicitly include an Adviser's discretionary authority to trade client assets within the definition of "custody."[3] Under the current Custody Rule, discretionary authority by itself is insufficient to establish that an Adviser has "custody." The Proposal would provide a limited exception from the surprise examination requirement when the sole basis for application is an Adviser's discretionary authority to instruct the client's qualified custodian to transact in assets that settle only on a delivery versus payment basis.[4]

Qualified custodians. The Proposal generally retains the definition of a "qualified custodian" and includes registered broker-dealers, regulated banks and savings associations, registered futures commission merchants and certain foreign financial institutions (FFI). However, the Proposal would impose additional conditions on banks and savings associations as well as foreign financial institutions to qualify as "qualified custodians." Banks and savings associations would be required to hold client assets in an account designed to protect such assets from creditors of the bank or savings association in the event of its insolvency or failure. FFIs would be subject to seven new conditions in order to be considered "qualified custodians," including that an FFI:

- Can have a judgment enforced against it by the Adviser and the SEC.
- Is subject to oversight by a foreign government or financial regulatory authorities.
- Is required to segregate customer assets.
- Is subject to anti-money laundering regulations and requirements similar to those under the Bank Secrecy Act.
- Has the requisite financial strength to provide due care for client assets.
- Is required to implement practices, procedures and internal controls designed to ensure the exercise of due care with respect to the safe-keeping of client assets.
- Is not operated for the purpose of evading the Safeguarding Rule.[5]

Possession or control. Under the Safeguarding Rule, a qualified custodian must maintain "possession or control" of client assets, which means that:

- The qualified custodian is required to participate in any change in beneficial ownership of those assets.
- The qualified custodian is required to effectuate any transaction involving a change in beneficial ownership.
- Qualified custodian involvement is a condition precedent to any change in beneficial ownership.[6]

The "possession or control" requirement is new to the Proposal and represents a change from the current Custody Rule.

Digital assets. The Proposal would require Advisers with custody of a client's cryptoassets "to ensure those assets are maintained with a qualified custodian that has possession or control of the assets at all times." One way for an Adviser to demonstrate that a qualified custodian has "possession or control" of a client's cryptoassets is if the qualified custodian "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."[7] The Proposal notes the SEC's understanding that cryptoasset trading often occurs on trading platforms that settle the trades directly and require investors to pre-fund (*e.g.*, investors will transfer their cryptoassets to a trading platform prior to the execution of any trade). To the extent these trading platforms are not qualified custodians, Advisers would be in violation of this requirement given the lack of involvement by a qualified custodian.[8]

Written agreement requirements. Under the Proposal, Advisers would be required to enter into a written agreement with, and obtain certain reasonable assurances from, qualified custodians, to ensure clients receive certain standard custodial protections during the period for which an Adviser has custody over a client's assets. The list of required provisions in any written agreement include, among others, a requirement that:

- Qualified custodians will promptly provide records regarding a client's assets to the SEC or an independent public account upon request.
- Qualified custodians will send account statements, at least quarterly, to the client or its independent representative, and to the Adviser, identifying the amount of assets in the account and setting forth all transactions in the account.
- Qualified custodians obtain and provide to the Adviser, at least annually, a written internal control report from an independent public accountant regarding the adequacy of the qualified custodian's controls, with certain additional requirements if the Adviser or a related person is acting as custodian.
- Specifies the agreed-upon level of authority for the Adviser to effect transactions.[9]

[3] Proposed Rule 223-1(d)(3).

[4] Proposed Rule 223-1(b)(8).

[5] Proposed Rule 223-1(d)(10)(iv).

[6] Proposed Rule 223-1(d)(8).

[7] Proposal at 67.

[8] The SEC also notes that Advisers would be "in violation of the current custody rule because custody of the [cryptoasset] would not be maintained by a qualified custodian from the time the [cryptoasset] was moved to the trading platform through the settlement of the trade." Proposal at 68.

[9] Proposed Rule 223-1(a)(1)(i).

The requirement that a written agreement include that qualified custodians will provide records to the SEC or an independent public account upon request, and the requirement to specify an Adviser's level of authority, are not required under the current Custody Rule.[10]

In addition to the foregoing, an Adviser must obtain reasonable assurances in writing from the qualified custodian (or, if an Adviser is also the qualified custodian, the written agreement with the client must provide) that the qualified custodian will comply with, and an Adviser must maintain an ongoing reasonable belief that the qualified custodian is complying with, the following requirements:

- The qualified custodian will exercise due care in accordance with reasonable commercial standards in discharging its duty as custodian and will implement appropriate measures to safeguard client assets from theft, misuse, misappropriation or other similar type of loss.
- The qualified custodian will indemnify the client (and will have insurance arrangements in place that will adequately protect the client) against losses resulting from their negligence, recklessness or willful misconduct.
- The existence of any subcustodial, securities depository or other similar arrangements with regard to the client's assets will not excuse any of the qualified custodian's obligations to the client.
- The qualified custodian will clearly identify the client's assets as such, hold them in a custodial account and segregate all client assets from the qualified custodian's proprietary assets and liabilities.
- The qualified custodian will 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.[11]

The SEC acknowledged that these requirements are a substantial departure from current practice. For example, the indemnification standard included in the Proposal would subject custodians to a simple negligence standard rather than a gross negligence standard.[12]

Exception for privately offered securities. The Proposal would expand the Custody Rule's existing exception from maintaining certain privately offered securities with a qualified custodian to include "physical assets, including artwork, real estate, precious metals, or physical commodities." However, the Safeguarding Rule would limit the "availability of the exception to circumstances that truly warrant it," and in order for an Adviser to rely on the exception, it must, among other restrictions:

- Reasonably determine that ownership cannot be recorded and maintained in a manner in which a qualified custodian can maintain possession, or control transfers of beneficial ownership, of such assets.
- Reasonably safeguard the assets from loss, theft, misuse, misappropriation or becoming subject to an Adviser's financial issues, including insolvency.
- Have an independent public account, pursuant to a written agreement between the Adviser and the accountant, verify any purchase, sale or other transfer of beneficial ownership of such asset and notify the SEC within one business day of finding any material discrepancies.
- Notify the independent public accountant of any purchase, sale or other transfer of beneficial ownership of assets within one business day.
- Have the existence and ownership of the client's privately offered securities and physical assets that are not maintained with a qualified custodian verified during the annual surprise examination or as part of a financial statement audit.[13]

The Proposal also notes the SEC's belief that digital assets "issued on public, permissionless blockchains would not satisfy the definition of privately offered securities" under the Safeguarding Rule; accordingly, such digital assets must be maintained with a qualified custodian.[14] These modifications are a significant departure from the Custody Rule, which allows Advisers to rely on the exception without the restrictions described above, if it complies with the Custody Rule's "audit provision."

Segregation of client assets. The Proposal would require Advisers to segregate a client's assets over which they have custody from their and their related persons' assets by ensuring that a client's assets are:

- Titled or registered in, or otherwise held for the benefit of, the client.
- Not commingled with an Adviser and its related persons' assets.
- Not subject to any right, charge, security interest, lien or claim of any kind in favor of the Adviser, its related persons or its creditors, except to the extent agreed to or authorized in writing by the client.[15]

[10] Proposal at 22.

[11] Proposed Rule 223-1(a)(1)(ii).

[12] Proposal at 89.

[13] Proposed Rule 223-1(b)(ii).

[14] Proposal at 135.

[15] Proposed Rule 223-1(a)(3).

Although similar to the requirement that Advisers obtain reasonable assurances from qualified custodians, the SEC notes that this requirement is important and complementary as it will ensure isolation of and more readily identify a client's assets (*e.g.*, for privately offered securities, issuers will properly record the client as the owner). The exception allowing clients to agree in writing to subject their assets to a claim will permit, for example, arrangements to deduct unpaid fees or to obtain a security interest in client assets for margin lending.[16]

Amendments to the surprise examination requirement. Under the current Custody Rule, subject to certain exceptions, Advisers who have custody over a client's assets must enter into a written agreement with an independent public accountant to undergo an annual surprise examination. The Proposal supplements this requirement by also requiring that Advisers have a reasonable belief 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)."[17] The Proposal also amends the notice requirement so that notices regarding a finding of any material discrepancy are sent electronically to the newly designated Division of Examinations, not the director of the Office of Compliance Inspections and Examinations.[18]

Exceptions from the surprise examination requirement. The Proposal would retain the Custody Rule's exception from the surprise examination requirement for limited partnerships and pooled investment vehicles subject to annual audit, but it would expand the exception further, making it available to all entities whose financial statements are able to be audited in accordance with the Safeguarding Rule. While the audit provision under the Safeguarding Rule is similar to that under the Custody Rule, for non-U.S. Advisers who do not prepare their financial statements in accordance with U.S. generally accepted accounting principles (GAAP) to rely on the exception, their financial statements must:

- Contain information that is substantially similar to financial statements prepared in accordance with U.S. GAAP.
- Reconcile all material differences with U.S. GAAP.
- Ensure the reconciliation, including supplementary U.S. GAAP disclosures, is distributed to U.S. investors as part of the audited financial statements.[19]

Additionally, the Safeguarding Rule would require a written agreement between Advisers and auditors to, among other things, notify the SEC in the event of a modified opinion or the resignation, dismissal or other termination of the engagement of the accountant. The Proposal would also expand the availability of such exceptions to circumstances where an Adviser has custody solely because it has discretionary authority or because an Adviser is acting according to a standing letter of authorization.[20]

Form ADV amendments. The Proposal would amend Form ADV to align an Adviser's reporting obligations with the Proposal's new requirements and "improve the accuracy of custody-related data available to the SEC, its staff, and the public."[21]

Record-keeping rule amendments. The Proposal would also amend Rule 204-2 under the Advisers Act and require Advisers to keep additional and more detailed records of trade and transaction activity, and position information for client accounts over which an Adviser has custody.

Transition and Comment Period

The comment period for the Proposal will remain open until 60 days after its publication in the Federal Register. If adopted, the Safeguarding Rule would require compliance within one year for Advisers with more than $1 billion in regulatory assets under management and 18 months for Advisers with less than $1 billion in such assets.[22]

[16] Proposal at 95.

[17] Proposal at 177.

[18] Proposed Rule 223-1(a)(4).

[19] Proposed Rule 223-1(b)(4).

[20] Proposed Rule 223-1(b)(7).

[21] Proposal at 25.

[22] Proposal at 240.