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SEC proposes enhanced safeguarding rule for registered advisers, including new crypto asset guidance

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The SEC's proposed amendment would expand the current custody rule under the Advisers Act to cover a broader array of client assets and advisory activities and impose new custodial protections for client assets.

Introduction

On February 15, 2023, the SEC proposed a sweeping new rule (Proposed Rule) which would replace current Rule 206(4)-2 (Custody Rule) under the Investment Advisers Act of 1940 (Advisers Act or Act). The Custody Rule was originally adopted in 1962 and was most recently amended in 2009. It regulates the custody practices of investment advisers registered (or required to register) under the Advisers Act. The Custody Rule is intended to protect advisory clients from the misuse or misappropriation of their funds and securities over which the adviser has "custody." The Proposed Rule would broaden the scope of the current Custody Rule by, among other things, expanding the type assets that are subject to the rule (including explicitly covering crypto assets, whether or not securities), increasing the compliance burden for advisers, and imposing additional requirements for custodians to qualify as qualified custodians. The Proposed Rule would also significantly enhance the role of qualified custodians used by advisers.

The Proposed Rule is "designed to recognize the evolution in products and services investment advisers offer to their clients and to strengthen and clarify existing custody protections, while also proposing complementary refinements to how advisers report custody information on Form ADV and the books and records they are required to keep that are designed to improve [the SEC's] oversight and risk-assessment abilities."[1] According to the Proposal, its core purpose is to enhance the safeguarding of client assets from loss, misuse, theft, or misappropriation by, and from the insolvency or financial reverses of, an adviser. The Proposed Rule would apply to registered advisers that have custody of a client's assets and any related person of the adviser that has custody in connection with the advisory services that the adviser provides to the client. Like the Custody Rule, the Proposed Rule would not apply to exempt reporting advisers.

Principal elements of the Proposed Rule

According to the Proposal, the Proposed Rule was designed to strengthen and clarify custodial protections for advisory client assets by implementing, among other things, the following key elements:

Expanding the scope of the rule to a broader range of client assets and advisory activities.

The current Custody Rule applies to client "funds and securities" over which an adviser has custody. In an effort to enhance the current rule, the Proposed Rule would expand the definition of "assets" subject to the rule to include "funds, securities, *or other positions held in the client's account.*"[2] The SEC indicated that this addition would also include other types of investments such as crypto assets, financial contracts and physical assets (e.g., artwork, real estate, precious

metals and physical commodities). The SEC noted in the Proposing Release that in expanding the scope of the rule, it hopes to capture various investment types that develop in the future, irrespective of their status as funds or securities. The Proposed Rule would also expand the circumstances under which an advisor is considered to have custody of a client's assets to include discretionary authority to trade the client's assets. The SEC noted that the expanded scope of the Proposed Rule is intended to address the risk of loss raised by evolving discretionary trading practices, which today do not always involve a "one-for-one exchange of assets under a custodian's oversight."[3]

Requiring qualified custodians to have "possession or control" of client assets.

In a change from the current rule, the Proposed Rule would require that an adviser keep client assets with a qualified custodian that has possession or control of those assets. The Proposed Rule defines "possession or control" as "holding assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets, 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."[4] According to the Proposal, this change is designed to ensure account statement integrity and reliability, which the SEC views as critical to the safeguarding of client assets.[5] Namely, the SEC believes that this requirement will prevent advisers from requesting that custodians provide accommodation reporting, i.e., listing assets on a client's account statement on an accommodation basis only, without attesting to the holdings or transactions in such assets, and without taking steps to appropriately safeguard such assets.

Requiring advisers to enter into written agreements with, and obtain reasonable assurances from, qualified custodians regarding certain minimum custodial protections.

As described in the Proposal, the Proposed Rule is not intended to prescribe specific safeguarding procedures or the manner in which client assets must be held, but rather, is designed to serve as guardrails to promote certain minimum safeguarding protections for advisory client assets. For example, advisers would be required to enter into a written agreement with its qualified custodians, including provisions requiring qualified custodians to:

- provide client asset documentation to the SEC or an independent public accountant upon request;
- provide, at least quarterly, account statements to the adviser and the client; and
- obtain and share, at least annually, a written internal control report that includes an opinion from an independent public accountant.

The written agreement between the adviser and its qualified custodian would also be required to specify the adviser's agreed-upon level of authority to effect transactions in the client's account as well as any applicable terms or limitations of that authority. In the Proposal, the SEC acknowledged that a written agreement between an adviser and its custodian would be a "substantial departure from current industry practice,"[6] but emphasized its belief that such requirement would be necessary to ensure that standard custodial protections would be available to all clients.

In addition to the written agreement, the Proposed Rule would also require advisers to obtain reasonable assurances in writing from qualified custodians (and maintain an ongoing reasonable belief) that the custodian will:

- 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;
- indemnify the client (and have insurance arrangements in place) against losses caused by the qualified custodian's negligence, recklessness, or willful misconduct;
- not be excused from its obligations to the client as a result of any sub-custodial or other similar arrangements;
- clearly identify and segregate client assets from the custodian's 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, except to the extent agreed to or authorized in writing by the client.

Expanding the exception for privately offered securities and certain physical assets, provided additional safeguarding requirements are met.

The Proposed Rule would include an exception for advisory client assets that are unable to be maintained by qualified custodians, namely certain privately offered securities and certain physical assets. The Proposed Rule retains the elements from the Custody Rule's definition of "privately offered securities" and adds an additional requirement that the privately offered securities must 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 adviser's records. Rather than providing a specific definition, the SEC indicated that "what constitutes a 'physical asset' is often self-evident."[7] In order for either of these two classes of assets to fall under the exception, the adviser would need to reasonably determine (and document 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 of such assets."[8] The SEC noted in the Proposed Rule that it anticipates this reasonable determination would be a result of an adviser's analysis of the asset and the availability of custodial services for such asset in the market.

In order to rely on the exception, the adviser would also be required to reasonably safeguard the assets, enter into a written agreement with an independent public accountant to perform verification of purchases, sales or other transfers of the assets (under which the independent public accountant would be required to notify the SEC within one business day upon finding any material discrepancies), and notify such independent public accountant of a purchase, sale or other transfer of such assets within one business day. In addition, the Proposed Rule would require that the existence and ownership of the assets be verified during an annual independent verification or as part of a financial statement audit by an independent public accountant

The SEC noted that the Proposed Rule instituted these modifications to the Custody Rule in an effort to limit the availability of the exception because the SEC believes that "the bulk of advisory client assets are able to be maintained by qualified custodians and should be safeguarded in the manner contemplated by the [Proposed Rule]."[9]

Requiring segregation of client assets held in custody.

The Proposed Rule would require an adviser with custody of client assets to segregate such assets by:

- titling or registering the assets in the client's name or otherwise holding the assets for the client's benefit;
- not commingling the assets with the adviser's or any of its related persons' assets; and
- 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.

The SEC noted that this requirement is designed to complement the Proposed Rule's requirement for an adviser to obtain reasonable assurance that a qualified custodian is similarly segregating client assets, and is needed because some client assets are not maintained with a qualified custodian.[10]

Although the Proposed Rule would require client assets to be segregated from those of the adviser and its related persons, the SEC highlighted that the Proposed Rule would not prohibit commingling client assets with other clients' assets, which it noted is commonly done in a manner in which a client's assets are reasonably identifiable. The SEC also highlighted that the prohibition against liens on client assets in favor of the adviser, its related persons or creditors is not intended to prohibit arrangements authorized by the client in writing, such as authorization to subject client assets to securities lending or margin lending arrangements, or to deduct fees from client assets for services provided by the adviser or its related persons. According to the Proposal, the intent behind this new requirement is to help ensure that client assets are more readily identifiable as client property and able to be returned to the client in the event an adviser experiences financial hardship.

Modifying the surprise exam requirement and its exceptions.

The Proposed Rule amends the surprise exam requirement of the Custody Rule, which currently requires independent verification of client assets over which an adviser has custody at least annually by surprise examination pursuant to a written agreement between the adviser and an independent public accountant. In a change to the current rule, the SEC highlighted the Proposed Rule's new requirement for the adviser to have a reasonable belief that the independent public accountant is capable of, and intends to comply with, its obligations under such agreement with respect to the surprise exam requirement. The SEC emphasized that entering into the agreement alone would not satisfy the Proposed Rule,

without such reasonable belief.

Although the SEC believes that verification by independent public accounts is critical for safeguarding client assets, the SEC also noted that Proposed Rule is intended to better balance the costs of obtaining such surprise examinations with the need for investor protection in certain contexts. For example, the Proposed Rule would provide exceptions to the surprise examination requirement when an adviser has custody of client assets (maintained with a qualified custodian) solely because it has discretionary authority over such assets that is limited to transactions settling on a delivery-versus-payment basis. The Proposed Rule would also provide an exception to the surprise examination requirement when an adviser has custody of client assets solely because of a standing letter of authorization, defined 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" provided that:

- the qualified custodian is not a related person of the adviser;
- the client's authorization includes the client's signature, the third-party recipient's name and either its address or account number at a custodian to which the transfer should be directed; and
- the adviser has no ability or authority to designate or change any information about the third-party recipient, including name, address and account number.[11]

The Proposed Rule would also modify the Custody Rule's annual audit exception by expanding its availability to "any other entity" (i.e., not just pooled investment vehicles).[12] In a change from the Custody Rule, the Proposed Rule would also require:

- 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
- a written agreement between the adviser or the entity and the auditor requiring the auditor to notify the SEC upon the auditor's termination or issuance of a modified opinion.

Updating complementary recordkeeping requirements and reporting on Form ADV with respect to custody of client assets.

To enhance the SEC's oversight of the safeguarding practices of advisers and their compliance with the rule, the SEC also proposed to amend the current Advisers Act recordkeeping rule by requiring advisers to keep certain enumerated records in line with the requirements of the Proposed Rule. The SEC also proposed to amend Form ADV to align advisers' reporting of custody-related data with the requirements of the Proposed Rule.

Key takeaways

If adopted, the Proposed Rule would enhance the role of custodians and increase compliance burdens for advisers, while requiring changes to current industry practices for custodial services. In the Proposal, the SEC also highlighted issues under the current Custody Rule that may have immediate implications for advisers advising clients with respect to crypto assets.

Some key takeaways of the Proposal include the following:

The SEC clarified its views regarding the treatment of crypto assets under both the existing Custody Rule and the Proposed Rule, raising implications for advisers managing crypto assets.

The Proposed Rule's expansion to include "other positions held in a client's account" would capture all crypto assets, even if such crypto assets were not "funds or securities" under the current Custody Rule. In the Proposal, the SEC expressed its general concerns with the distributed ledger or blockchain technology that is used to record ownership and transfers of crypto assets, and noted that the use of cryptographic key pairings in such technology can make it difficult or impossible for advisory clients to reverse erroneous or fraudulent transactions, or recover lost assets, in the event that such keys are lost, forgotten or misappropriated. According to the Proposal, the proposed updates to the rule were in part intended to address the safeguarding risks raised by such technology for advisers and their clients.

Notably, the Proposal also highlighted the SEC's views on certain issues regarding the application of the current Custody Rule to crypto assets. Regarding the scope of the current rule, the SEC stated its view that "most crypto assets are likely to be funds or crypto asset securities covered by the current rule," a view that many market participants have not shared.[13] The SEC also highlighted existing issues under the current rule raised by crypto trading platforms that require investors to pre-fund or transfer their crypto securities to the platform prior to execution of a trade, and do not themselves qualify as qualified custodians. The SEC stated that in its view, such practice would generally result in a violation of the Custody Rule because custody of such crypto securities "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."[14] The SEC indicated that such crypto trading platforms raise compliance issues under the current Custody Rule, and would continue to implicate these issues under the Proposed Rule. The SEC's position could raise challenges for advisers that seek to trade on platforms that require pre-funding, but are not themselves qualified custodians. Structures to comply with the rule, such as interposing a qualified custodian between the adviser and the platform, are being considered.

Regarding the Proposed Rule's requirement that a qualified custodian maintain "possession or control" of an advisory client's assets, the SEC acknowledged that it may be challenging to demonstrate exclusive possession or control of crypto assets because there may be multiple physical or electronic copies of the private keys needed to transfer such assets. To address these challenges, the SEC clarified that "possession or control" under the Proposed Rule differs from the possession or control requirement for broker-dealers under Exchange Act Rule 15c3-3, which the SEC has interpreted to require exclusive possession or control of crypto assets.[15] The SEC highlighted that the proposed definition of "possession or control" for purposes of the Proposed Rule would depend on whether the qualified custodian is required to participate in a change in beneficial ownership of an asset, and that demonstrating exclusive possession or control was one way, but not the only way, to satisfy such definition.[16]

In order to qualify as qualified custodians under the proposed safeguarding rule, banks and savings associations would be required to segregate client assets in bankruptcy-remote accounts, which would be consistent with current requirements for broker-dealers, futures commission merchants and foreign financial institutions.

The proposed changes to the definition of "qualified custodian" would require a bank or savings association to hold client assets (including cash) in segregated accounts designed to protect such assets from creditors of the bank or savings association. According to the Proposal, the SEC intended to provide a uniform and consistent standard to safeguard client assets in the event of the insolvency or failure of a bank or savings association acting as a qualified custodian. It is unclear whether the SEC intends this requirement to prevent the custody of client assets in ordinary deposit accounts within the custodial arrangements.

Under the Proposed Rule, advisers would be required to obtain reasonable assurances from qualified custodians that they will provide certain custodial protections to their clients, including indemnification and standards of care that may differ from the current market practice for custodians.

For example, the proposed indemnification requirement would require reasonable assurance that a qualified custodian will indemnify clients for loss due to the qualified custodian's "negligence, recklessness, or willful misconduct."[17] In the Proposal, the SEC acknowledged that contractual liability standards for custodians vary widely, and that the proposed requirement may result in some custodians having to change their liability standard from gross negligence to simple negligence.[18] In the SEC's view, such a change would be justified because it would provide important investor protection benefits. However, it is unclear whether custodians would be willing or able to modify the terms of their custody agreements with advisory clients to satisfy this requirement, and whether such modification would result in higher custody fees being charged to such clients. The SEC did not address the common practice of custodians capping their liability regardless of the liability standard to which they agree.

The enhanced qualification standards for foreign financial institutions under the Proposed Rule may limit the availability of foreign institutions willing to act as qualified custodians, and may be difficult

for advisers to assess.

For example, the Proposed Rule would require advisers to determine that foreign financial institutions acting as qualified custodians are, among other things, required by law to comply with anti-money laundering laws similar to the Bank Secrecy Act and regulations thereunder. The SEC noted that foreign financial institutions would satisfy this standard if they are subject to the laws of a member or observer jurisdiction of the Financial Action Task Force (FATF), and not listed on any sanctions list established by OFAC. For foreign financial institutions that are not located in an FATF jurisdiction, it may be difficult for advisers to assess whether applicable anti-money laundering laws are similar enough to regulations under the Bank Secrecy Act for such institution to qualify as a qualified custodian under the Proposed Rule. Under the Proposed Rule, advisers would also need to determine, among other things, that the adviser and the SEC could enforce judgements, including civil money penalties, against a foreign financial institution. The SEC noted that this requirement could be satisfied if the foreign financial institution has offices in the U.S. or appoints an agent for service of process in the U.S. It is unclear whether most foreign institutions would be willing to comply with these requirements in order to act as a qualified custodian, and the availability of qualified custodians for advisers investing in foreign investments may be limited.

In order to rely on the Proposed Rule's modified exception for privately offered securities, advisers would be required to make reasonable determinations regarding the availability of custodial services that may present challenges.

As discussed above, the Proposed Rule would impose additional requirements for an adviser to be able to rely on the exception for privately offered securities and physical assets. Among other things the adviser would be required to reasonably determine (and document 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 of such assets."[19] The SEC clarified that such reasonable determination would not require "the identification of every conceivable qualified custodian and an evaluation of its custodial services."[20] However, it is unclear how frequently such determination would need to be made and updated, and how extensively an adviser would need to conduct its diligence on the custodial marketplace for its determination to be considered reasonable. In addition, the SEC acknowledged that it is "increasingly possible for qualified custodians to provide custody services for privately offered securities, and that such "determination may be more difficult to support as the custodial industry continues to evolve."[21] For certain privately offered securities, such as limited partnership interests in private funds, it may be possible, although not standard practice, for a qualified custodian to be recorded as the nominee record holder and maintain possession or control over such asset in that manner. The SEC did not comment on whether advisers would need to take into account such unusual practices in assessing the availability of custodial services.

Comments are due on or before May 8, 2023. The SEC proposes to require registered advisers to comply with the Proposed Rule starting eighteen months from the rule's effective date.

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1 Safeguarding Advisory Client Assets, SEC Release No. IA-6240 (Feb. 15, 2023) (Proposal) at 19.

2 Proposed Rule 223-1(d)(1). Emphasis added.

3 Proposal, at 13.

4 Proposed Rule 223-1(d)(8).

5 Proposal, at 15.

6 Id., at 77.

7 Id., at 136.

8 Id.

[9] Id., at 24.

[10] Id., at 166.

[11] Id., at 211.

[12] The Custody Rule provides an annual audit exception from the surprise examination requirement with respect to a client account that is a limited partnership (or limited liability company or other pooled investment vehicle) subject to an annual audit by an accountant that is registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (PCAOB), provided certain requirements are met. Advisers Act Rule 206(4)-2(b)(4).

[13] Proposal at 18.

[14] Id., at 68.

[15] See, e.g., SEC Division of Trading and Markets & FINRA Office of General Counsel, Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities (July 8, 2019), https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities.

[16] Proposal, at 67.

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

[18] Proposal, at 87 and 89.

[19] Id.

[20] Id., at 137.

[21] Id., at 138.