STRADLEY RONON

March 27, 2023

Client Alert | Investment Management

SEC Proposes New Rule Addressing Investment Adviser Safeguarding of Client Assets

On Feb. 15, 2023, the Securities and Exchange Commission (SEC or Commission) proposed to replace the existing custody rule (the Current Custody Rule) under the Investment Advisers Act of 1940 (the Advisers Act) with a new one addressing the safeguarding of client assets (Safeguarding Rule). [1] If adopted as proposed, the Safeguarding Rule would fundamentally transform custody arrangements and may result in advisers, particularly smaller advisers, being unable to offer certain asset classes. This alert summarizes the Safeguarding Rule and highlights some key observations and issues for investment advisers to consider.

Key Takeaways

- Would dramatically expand the custody rule.
- Would require substantial additional services from custodians and auditors.
- Would require significant costs to both advisers and custodians, which may be passed on to investors.
- Would have a chilling (or freezing) effect on advisers seeking to provide crypto asset services.

The Safeguarding Rule

The Safeguarding Rule differs from the Current Custody Rules in three main areas: (1) a broader array of client assets and advisory activities are subject to the Safeguarding Rule's protections; (2) the custodial protections for client assets required under the Safeguarding Rule are much more prescriptive; and (3) related recordkeeping and reporting requirements for advisers are updated.

Comments on the Safeguarding Rule are due by May 8, 2023.

[1] Safeguarding Advisory Client Assets, Investment Advisers Act Release No. 6240 (Feb. 15, 2023) (the Release). In proposing the rule, the Commission exercised its authority under section 411 of the Dodd-Frank Wall Street Reform and Consumer Protection Act to propose amending and redesignating Rule 206(4)-2 under the Advisers Act as Rule 223-1. Commissioner Peirce was the sole dissenter citing concerns around timing, workability, crypto assets, the proposed expansion of SEC jurisdiction and the SEC's involvement in overriding private agreements. *See* Statement on Safeguarding Advisory Client Assets Proposal.

I. Expands the Scope of the Current Custody Rule

The Safeguarding Rule would apply to all client "assets," as compared to "funds and securities" under the Current Custody Rule. Under the Safeguarding Rule, assets would include funds, securities or other positions held in a client's account, including crypto assets regardless of securities status and physical assets, such as artwork, real estate and commodities. Such assets could include financial contracts held for investment purposes; collateral posted in connection with a swap contract on behalf of the client; other assets that may not be clearly seen as funds or securities covered by the Current Custody Rule and physical assets – artwork, real estate, precious metals, physical commodities and things considered to be liabilities or financial obligations on a balance sheet, such as negative cash.

The Safeguarding Rule also would expand the definition of custody to cover discretionary trading authority. Discretionary trading authority includes any arrangement under which the adviser is authorized or permitted to withdraw or transfer beneficial ownership of client assets upon the adviser's instruction. An adviser would not be subject to the surprise examination requirement if the sole reason the adviser has custody is that the adviser has discretionary trading authority that is limited to instructing the client's qualified custodian to transact in assets that settle on a delivery versus payment basis. This position is based on the lessened risk associated with delivery versus payment (DVP) transactions, which the SEC Staff previously recognized.[2]

II. Enhances Custodial Protections

As under the Current Custody Rule, investment advisers would be required to maintain client assets with a qualified custodian. Under the Safeguarding Rule, however, banks, savings associations, registered broker-dealers, registered futures commission merchants and certain foreign financial institutions (FFIs)[3] would be able to continue to act as qualified custodians only if they have "possession or control" of client assets and have entered into a written agreement containing certain provisions with the investment adviser.

[2] *See* Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority, Division of Investment Management Guidance Update No. 2017-01 (Feb. 2017).

[3] The Safeguarding Rule would add requirements for FFIs akin to those required by Rule 17f-5 under the Investment Company Act of 1940 for eligible foreign custodians.

- **Possession or control** would be defined 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.
- The Safeguarding Rule would require a **written agreement** between the adviser and the qualified custodian (or between the adviser and client if the adviser is also the qualified custodian). The Release acknowledges that, currently, advisers are rarely parties to the custodial agreement and that this requirement would be a "substantial departure" from current practice. Moreover, the custodial agreement would be required to contain the following provisions:
  - a provision requiring the qualified custodian promptly, upon request, to provide records relating to client assets to the Commission or an independent public accountant for purposes of compliance with the Safeguarding Rule;
  - a provision that the qualified custodian will send account statements,[4] at least quarterly, to the client and the investment adviser, identifying the amount of each client asset in the custodial account at the end of the period as well as all transactions in the account during that period, including advisory fees;[5]
  - a provision prohibiting the qualified custodian from identifying assets on account statements for which the qualified custodian lacks possession or control unless requested by the client;
  - a provision that the qualified custodian, at least annually, will obtain and provide to the investment adviser a written internal control report that includes an opinion of an independent public accountant as to whether controls have been placed in operation as of a specific date, are suitably designed and are operating effectively to meet control objectives relating to custodial services (including the safeguarding of the client assets held by that qualified custodian during the year);[6] and
  - specify the investment adviser's agreed-upon level of authority to effect transactions in the custodial account as well as any applicable terms or limitations.

Crypto Byte

With respect to crypto assets, the Release acknowledges that satisfying the possession or control standard may be difficult to prove. Further, the Release states that most crypto assets trade on platforms that are not qualified custodians, and such practice would result in an adviser with custody of a crypto asset being in violation of the Current Custody Rule because "custody of the crypto asset security 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." This current practice also would constitute a violation of the Safeguarding Rule.

[4] This provision would not be required if the client is an entity whose investors will receive audited financial statements as part of the financial statement audit process pursuant to the audit provision of the Safeguarding Rule.
[5] The Safeguarding Rule also would require that the adviser have a reasonable belief, after due inquiry, that the qualified custodian is sending quarterly statements to its clients in compliance with this provision.
[6] The Safeguarding Rule also would retain the current requirement that if the qualified custodian is a related person or the adviser, the independent public accountant verify that the client assets are reconciled to a custodian other than the adviser or the related person and that such accountant is registered with and subject to inspection by the Public Accounting Oversight Board.

If the Safeguarding Rule is adopted as proposed, the written agreement requirement will impose substantial burdens on both advisers and custodians, dictating the commercial arrangements between the two and presumably driving up costs for both.

Additionally, under the Safeguarding Rule, an adviser would be required to obtain **written reasonable assurances** from the qualified custodian of certain minimum investor protection elements for advisory clients and maintain an ongoing reasonable belief that the custodian is complying with such client protections. These reasonable assurances would include the following:

Due Care	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 types of loss.
Indemnification	The qualified custodian will indemnify the client (and will have insurance arrangements in place that will adequately protect the client) against the risk of loss in the event of the qualified custodian's own negligence, recklessness or willful misconduct.
Other Arrangements	The existence of any sub-custodial, 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.
Segregate Assets	The qualified custodian will clearly identify the client's assets as such, hold them in a custodial account and segregate them from the qualified custodian's proprietary assets and liabilities.
Subject to Right, Charge, Security Interest, Lien or Claim	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.

The Release acknowledges that these requirements, particularly the requirement that a custodian's liability be based on simple negligence, "may create practical difficulties (*e.g.*, higher costs of compliance, or market contraction for custodial services)." Indeed, these requirements would likely lead to higher costs for custody services (which costs may be passed to clients) and, for some advisers, a limited choice of services. As a practical matter, the Safeguarding Rule does not address what an adviser is expected to do if its qualified custodian has errors with regard to one or more of these representations; the Safeguarding Rule does not specify at what point an adviser will no longer be able to reasonably believe that the custodian is complying nor does it address what an adviser should do under these circumstances, particularly if the market for custodial services is limited.

III. Modifies the Privately Offered Securities Exception and Expands It to Physical Assets

The Release acknowledges the lack of a custodial market for privately offered securities[7] and the need for an expanded exception to the Safeguarding Rule with respect to such assets and would expand the exception to include physical assets. Under the Safeguarding Rule, privately offered securities and physical assets would be excepted from the requirement that they be maintained with a qualified custodian, provided the following conditions are met:

- The adviser reasonably determines and documents 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 transfers of beneficial ownership of such assets.
- The adviser reasonably safeguards the assets from loss, theft, misuse, misappropriation or the adviser's financial reverses, including the adviser's insolvency.
- An independent public accountant, pursuant to a written agreement between the adviser and the accountant:
  - verifies any purchase, sale or other transfer of beneficial ownership of such assets promptly upon receiving notice from the adviser of any purchase, sale or other transfer of beneficial ownership of such assets; and
  - notifies the Commission within one business day upon finding any material discrepancies during the course of performing its procedures.
- The adviser notifies the independent public accountant engaged to perform the verification of any purchase, sale or other transfer of beneficial ownership of such assets within one business day.
- The existence and ownership of each of the client's privately offered securities or physical assets that are not maintained with a qualified custodian are verified during the annual surprise examination or as part of a financial statement audit.

Crypto Byte

Crypto assets do not appear to fall into either the privately offered securities definition or the definition of physical assets. As a result, crypto assets would be subject to all of the Safeguarding Rule's provisions.

The Safeguarding Rule exception to the custody requirements for privately offered securities and physical assets would be much more prescriptive and would limit an adviser's use of the exception. First, replacing the Current Custody Rule's objective test for what constitutes a privately offered security with a subjective test that requires the adviser to "reasonably determine" that ownership cannot be recorded and maintained in a sufficient manner by a qualified custodian is problematic and would be quite burdensome on compliance personnel. Moreover, these determinations would be subject to second-guessing by the SEC, and it is noteworthy that the Release highlights that, despite reliance on Dodd-Frank authority, section 206(4) of the Advisers Act still is available for custody rule violations and does not require the SEC to demonstrate scienter. Moreover, the provisions requiring notice to accountants and accountant notice to the SEC are burdensome and impractical for many private securities and physical assets (*e.g.*, for private securities in which an

[7] The Safeguarding Rule would retain the current definition of privately offered securities but would also require that the securities 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 records required to be kept by the adviser.

adviser transacts frequently, it would be impractical for the accountant to verify promptly each transaction) and would result in costly accounting and auditing services. In addition, the SEC recognizes that the requirement to verify the existence and ownership of "each" security or asset is a change from current practice for most surprise examinations and annual audits that rely on a representative sample of assets.

IV. Changes to Requirements for Advisers who Custody Client Assets

In circumstances in which the adviser has custody of client assets, the Safeguarding Rule would require that the client assets (a) be titled or registered in the client's name or otherwise held for the benefit of that client (*i.e.*, if an adviser purchases privately offered securities that are held on the books of the issuer or the issuer's transfer agent, the adviser should ensure that the issuer or transfer agent properly records and registers the adviser's client as owner); (b) not be commingled with the adviser's assets or its related persons' assets; and (c) not be 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.

As under the Current Custody Rule, the Safeguarding Rule would require an investment adviser to notify its client in writing promptly upon the opening of an account with a qualified custodian on its behalf, and such notice must contain certain elements as required by the Safeguarding Rule.

In addition to the current requirements regarding surprise examinations of investment advisers with custody of client assets, the Safeguarding Rule requires the adviser to have a reasonable belief that the written agreement between the independent public accountant and the adviser has been implemented *(e.g.,* that the accountant performed the examination and its Form ADV-E responsibilities as required by the agreement). The Safeguarding Rule also would provide exceptions to the surprise examination requirement when the adviser's sole reason for having custody is because it has discretionary authority or because the adviser is acting according to a standing letter of authorization, each subject to certain conditions.

Under both the Current Custody Rule and the Safeguarding Rule, an adviser that obtains an audit at least annually and upon an entity's liquidation consistent with the rule would be deemed to have complied with the surprise examination requirement and would eliminate the need for an adviser to comply with the client notice requirement. The Safeguarding Rule largely maintains the audit provisions under the Current Custody Rule but makes the following changes:

- Expanded availability from "pooled investment vehicle" clients to "entities" (which would include pension plans, retirement plans, 529 plans and ABLE plans).
- A requirement for the 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.
- A requirement for there to be a written agreement between the adviser or the entity and the auditor requiring the auditor to notify the Commission upon the auditor's termination or issuance of a modified opinion.

- Extending the delivery deadline to 180 days in the case of a fund of funds or 260 days in the case of a fund of funds of funds of the entity's fiscal year-end.[8]

The SEC also proposed complementary changes to the Advisers Act books and record rule and Form ADV to align reporting obligations with the Safeguarding Rule and to improve the accuracy of custody-related data available to the SEC, its Staff, and the public. Finally, the Staff of the SEC is reviewing certain of its prior guidance related to custody to determine if any prior guidance should be withdrawn in the event the Safeguarding Rule is adopted.

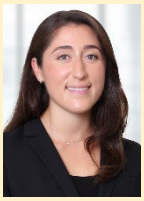
For more information contact:

Sara P. Crovitz
Partner
202.507.6414
scrovitz@stradley.com

Susan Gault-Brown
Chair, Fintech, Co-Chair,
Derivatives & Commodities
202.507.5171
sgault-brown@stradley.com

Jennifer Hillman
Associate
215.564.8623
jhillman@stradley.com

Peter M. Hong
Co-Chair, Derivatives &
Commodities
202.419.8429
phong@stradley.com



Allie Maccarone
Associate
215.564.8545
amaccarone@stradley.com

Lawrence P. Stadulis
Co-Chair, Fiduciary
Governance
202.419.8407
lstadulis@stradley.com

[8] These extended deadlines may encourage advisers to utilize a fund of fund of one rather than a separately managed account.