SEC's Proposed Custody Rule Changes And What They Mean

By **Adam Bolter, Alexander Kim and Sydney Sapir** (March 20, 2023)

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On Feb. 15, the U.S. Securities and Exchange Commission voted 4-1 to propose significant amendments to Rule 206(4)-2, also known as the Custody Rule, under the Investment Advisers Act of 1940.[1]

The proposed amendments redesignate the Custody Rule as new Rule 223-1 under the act, known as the Safeguarding Rule.[2] The proposed amendments aim to address and enhance "how investment advisers safeguard client assets ... [in light of] changes in technology, advisory services, and custodial practices."[3]

The Safeguarding Rule represents a potentially fundamental shift in how, and the extent to which, investment advisers select and transact in certain types of client assets. This article examines solely the following key proposed changes and discusses related practical considerations for investment advisers who are registered or otherwise required to register under the Advisers Act and other relevant market participants:

- Expanding the scope of the Custody Rule beyond "funds and securities" to include "other positions held in the client's account";
- Revising and expanding the definition of "custody" to include discretionary authority;
- Including new requirements governing the relationship between advisers and qualified custodians; and
- Modifying the privately offered securities exception to limit the exception's availability to only those situations that are "truly warranted."[4]

Brief Background

The Custody Rule, adopted in 1962, was last amended by the SEC in 2009 following the Bernard Madoff and Allen Stanford frauds.

An adviser who has custody of client funds or securities is required to implement controls designed to protect those client assets from being lost, stolen, misappropriated or subject to the adviser's financial reverses, including insolvency.

An adviser has "custody" within the meaning of the Custody Rule if it or its related person holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them.

In general, the Custody Rule requires that an adviser maintain client funds or securities with a "qualified custodian" and comply with certain other obligations, e.g., engage an independent public accountant to conduct annual surprise examinations to verify assets, or for certain pooled vehicles, satisfy this obligation through delivery of audited financial statements to such vehicles' investors within prescribed time periods.

Expanded Scope Covers All Assets

Under the Custody Rule, an adviser with custody of client "funds or securities" is required to maintain such funds or securities with a qualified custodian. In contrast, the proposed rule would expand the scope of assets that an adviser must maintain with a qualified custodian to include "funds, securities, or other positions held in a client's account."[5]

The expansion would cover all other assets that are neither funds nor securities, such as real estate, commodities, derivatives, crypto-assets — to the extent not already funds or securities — and other emerging asset classes.

In demonstrating the breadth of this coverage, the proposing release specifically identified the following types of assets that would be covered under the Safeguarding Rule:

- Financial contracts held for investment purposes and collateral posted in connection with a swap contract on behalf of the client;
- Physical assets, including artwork, real estate, precious metals and physical commodities, e.g., wheat or lumber; and
- Investments that would be accounted for in the liabilities column of a balance sheet or represented as a financial obligation of the client including negative cash.[6]

Practical Considerations

The proposed rule would create significant and fundamental challenges to the growth of the crypto-asset management sector.

Although the commission clarified that, in its view, most crypto-assets currently fall under the ambit of the Custody Rule because they are likely to be funds or crypto-asset securities, the proposed Safeguarding Rule eliminates any ambiguity and applies to all crypto-assets, including where such assets are neither funds nor securities.[7]

While some prominent crypto-asset custodial service providers have indicated that they currently meet and will continue to meet the definition of a qualified custodian under both the Custody Rule and the proposed rule,[8] both the Custody Rule and the proposed rule exclude some new entrants in the custodial marketplace such as "newly launched state-chartered trust companies that focus on providing crypto asset custody services."[9]

As discussed below, new requirements imposed on the contractual relationship between an adviser and its qualified custodian, as well as requirements on certain persons seeking to serve as qualified custodians, may also create impediments to expanding or maintaining the universe of available qualified custodians, including with regard to custody of crypto-assets.

As such, the proposed rule would likely create additional roadblocks for the existing nascent market for qualified custodians in the crypto-asset space.

The cumulative effect of these proposed changes could have a profound chilling effect on advisers seeking to provide advice to clients on crypto-assets. As SEC Commissioner Mark Uyeda put it, "How could an adviser seeking to comply with this rule possibly invest client funds in crypto assets after reading this release?"[10]

Advisers will also be faced with challenges as they seek to comply with custody requirements regarding more diverse investments such as real property and other physical assets. As the commission noted, qualified custodians may not currently be able to receive and hold such assets.[11]

The proposed rule addresses this issue by including an exception for maintaining physical assets with a qualified custodian provided certain onerous conditions are met such as having an independent public accountant verify any purchase, sale or transfer of beneficial ownership of such assets.[12]

Discretionary Trading Authority

As proposed, the definition of custody would be expanded to encompass arrangements in which the adviser has discretionary authority to trade client assets, i.e., the authority to decide which assets to purchase and sell on behalf of a client — even without the authority on the part of the adviser to obtain possession of those assets.[13]

The expansion of custody to include discretionary authority departs from the commission's historical view when it adopted the Custody Rule in 2003.

In the 2003 adopting release, the commission took the position that an adviser's authority to issue instructions to a custodian to effect or settle trades — authorized trading — at least with regard to transactions that settle on a delivery versus payment, or DVP, basis, would not constitute custody.[14]

In contrast, the Safeguarding Rule would expand the definition of custody to include discretionary trading authority. The commission stated that this change would "rectify any unintended consequences of our prior interpretive position."[15]

Although the authorized trading exception from custody would no longer exist under the Safeguarding Rule, the concept would live on, albeit in a narrow exception to the "surprise examination," i.e., independent verification, requirement.[16]

Under the Safeguarding Rule, an adviser would not be required to comply with the surprise examination requirement with regard to client assets that are maintained with a qualified custodian, provided the sole basis[17] for application of the rule is an adviser's discretionary authority that is limited to instructing the client's custodian to transact in assets that settle only on a DVP basis.

Practical Considerations

By virtue of having discretionary authority, many advisers who previously did not have custody under the current Custody Rule would be required to comply with the Safeguarding Rule.

Although the Safeguarding Rule provides limited relief from the surprise examination requirement for transactions that settle on a DVP basis, other significant obligations, including qualified custodian requirements, would still apply.

As proposed, an adviser who uses a variety of instruments that do not settle on a DVP basis, including, for example, certain derivatives (like options, futures and swaps), bank loans and foreign securities, would be subject to the full panoply of requirements and associated costs under the Safeguarding Rule.[18]

The SEC is seeking input regarding discretionary trading authority and the proposed limited exception. The requests for comment suggest the commission might consider further conditions, for example, limiting the exception to situations in which the qualified custodian has systems in place to ensure the adviser is unable to initiate non-DVP settled transactions.

The commission may also consider requiring that the adviser implement policies and procedures regarding its discretionary authority, and if so, requiring an internal control report or other external testing or auditing of such policies and procedures.

Defining Qualified Custodian and Regulating the Adviser-Qualified Custodian Relationship

The Safeguarding Rule, like the Custody Rule, deems a variety of financial institutions to be suitable to serve as so-called qualified custodians.

This includes, for example, state and federally chartered banks and trust companies, registered broker-dealers, futures commission merchants and certain foreign financial institutions, or FFIs.

Although the entities that may currently serve as qualified custodians have not changed, the Safeguarding Rule does impose a number of new conditions that an FFI must satisfy to serve as a qualified custodian.[19]

Practical Considerations

With respect to crypto-assets, the pool of available qualified custodians is likely to contract as fewer FFIs may qualify to serve as qualified custodians under the Proposed Rule, including non-U.S. crypto trading platforms.

The proposed rule imposes a stricter set of standards on FFIs that seek to address recent entity failures in the crypto-asset space and further align FFIs with the regulatory regime applicable to their U.S. entity counterparts.

For example, the proposed rule would require that FFIs comply with laws and regulations similar to the anti-money laundering provisions of the Bank Secrecy Act and hold customer assets in accounts designed to protect such assets from the entity's creditors in cases of insolvency.

Although the Safeguarding Rule did not modify the ability of state-chartered trust companies to serve as qualified custodians, the SEC has raised questions regarding the quality of regulatory oversight imposed on these companies and questioned whether such companies provide the types of protections that a qualified custodian should provide under the Safeguarding Rule.[20]

The Safeguarding Rule also seeks to clarify the Custody Rule's requirement that a qualified custodian "maintain" the client's assets. As proposed, "a qualified custodian does not 'maintain' a client asset for purposes of the rule if it does not have 'possession or control' of that asset."[21]

Under the proposed rule, "possession or control" would be defined to mean holding assets such that: (1) the qualified custodian is required to participate in any change in beneficial ownership of those assets; (2) the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership; and (3) the qualified custodian's involvement is a condition precedent to the change in beneficial ownership.[22]

According to the proposing release, under existing relevant regulatory regimes, a qualified custodian is considered to have "possession or control" when assets are in their exclusive or physical possession or control — a standard that the commission acknowledges likely presents challenges, e.g., when seeking to prove exclusive control of a crypto-asset.[23]

The proposed rule generally requires that the qualified custodian be involved in any change in beneficial ownership involving client assets. This is a very difficult standard to satisfy for certain assets.

For example, in the context of private securities that must be held with a qualified custodian because they do not meet the "privately offered securities" exception, discussed below, it is difficult to fathom how qualified custodians would be involved in the transfer of the private securities in compliance with the proposed rule given that such securities are typically transferred in privately negotiated sales between a buyer and seller without any involvement of qualified custodians.

Crypto-asset platforms — which themselves often are not FFIs — typically require that accounts be prefunded with the platform before execution of a trade and maintain control over accounts before assets can be used for trading.[24] Such procedures would not appear to comply with the possession or control standard because client assets would not be held with a qualified custodian at all times.

Finally, the Safeguarding Rule would require advisers to enter into written agreements with and obtain certain assurances in writing from the qualified custodian. The commission stated that such requirements are designed to serve as guardrails, rather than specific safeguarding procedures, helping to ensure that the qualified custodian provides certain standard custodial protections when maintaining client assets.[25]

These contractual terms, which the adviser must "reasonably believe" have been implemented, would address recordkeeping, account statements, internal control reports and the adviser's agreed-upon level of authority to effect transactions in the account.[26]

In addition, an adviser would be required to obtain "reasonable assurances" from the qualified custodian in writing that the custodian will comply with and maintain an "ongoing reasonable belief" that the custodian is complying with: requirements regarding its standard of care; indemnification and insurance; responsibility for subcustodians and other service providers; asset ownership and segregation of client assets; and prohibition on unauthorized liens on client assets.[27]

If the proposed rule is adopted, nearly 15,000 currently registered advisers will be required to repaper their existing custodial agreements, which is a monumental undertaking.

Moreover, advisers, depending on their size and relative bargaining position, may find it more or less difficult to negotiate these changes with market participants who remain willing and are eligible to serve as qualified custodians.

Privately Offered Securities Exception

The proposed rule would narrow the availability of the privately offered securities exception to maintaining assets with a qualified custodian.

In the commission's view, the modifications are "designed to limit availability of the exception to circumstances that truly warrant it because we believe the bulk of advisory client assets are able to be maintained by qualified custodians and should be safeguarded in the manner contemplated under the safeguarding rule."[28]

In order to rely on the privately offered securities exception, the adviser must: (1) reasonably determine and document its view that ownership cannot be recorded and maintained by a qualified custodian; (2) reasonably safeguard the assets, including from insolvency; (3) engage an independent public accountant to promptly verify transactions in which there is a change in beneficial ownership of such assets and provide certain notifications of any material discrepancies to the commission; and (4) ensure that the existence and ownership of all 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, as applicable.[29]

Practical Considerations

The proposed rule's conditions applicable to the privately offered securities exception are significant and are likely to raise a number of practical considerations and questions. For example, how does an adviser prove a negative and document its reasonable determination that no qualified custodian exists who could record and maintain such an asset?

Advisers will also need to consider the work that must be performed by an accountant in verifying transactions in which there is a change in beneficial ownership of such an asset, taking into account the short timelines on which transactions may need to be effected. These challenges may result in a changing landscape for advisers and the extent to which advisers invest in such privately offered securities.

In what appears to be another wrinkle in a burgeoning crypto-asset universe, the SEC made clear its view that crypto-asset securities issued on public, permission-less blockchains would not meet the conditions of privately offered securities under the proposed rule.[30]

Final Thoughts

If adopted substantially as proposed, the Safeguarding Rule would have significant implications for advisers, qualified custodians and other market participants. The proposed amendments would result in many more advisers — with many more types of assets —

deemed to have custody and thus required to comply with the Safeguarding Rule.

Furthermore, the breadth of the Safeguarding Rule, combined with the prescriptive regulatory posture regarding the adviser-qualified custodian relationship, would present a seismic shift in the current regulatory landscape for advisers and their custodial obligations.

And, while certainly not a spoiler alert, one can see a common thread across the key changes discussed above — namely, that the challenges presented in complying with the Safeguarding Rule are particularly acute as it relates to investments in crypto-assets. The proposing release provides for a 60-day comment period following the publication of the release in the Federal Register.[31]

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[1] See Katten's Passle post on this topic.

[2] Safeguarding Advisory Client Assets, Investment Advisers Act Rel. No. 6240 (Feb. 15, 2023) (the "Proposing Release"). The SEC is, in part, proposing the Safeguarding Rule under Section 223 of the Advisers Act, added as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Dodd-Frank Act, Pub. L. 111-203, 124 Stat. 1376 (2010). Section 223 states, in part, that an Adviser must "take such steps to safeguard client assets over which such adviser has custody, including, without limitation, verification of such assets by an independent public accountant, as the Commission may, by rule, prescribe." 15 U.S.C. 80b-18b.

[3] Proposing Release at 1, 12.

[4] Id. at 24.

[5] Id. at 20.

[6] Id. at 28.

[7] Id.

[8] Jesse Hamilton, "Coinbase, Anchorage Digital Say They'd Be OK under SEC Custody Proposal, but Risks May Lurk for Others," CoinDesk (Feb. 15, 2023), https://www.coindesk.com/policy/2023/02/15/coinbase-anchorage-say-theyll-be-ok-under-sec-custody-proposal-but-risks-may-lurk-for-others/.

[9] Proposing Release at 75-76. The definition of a qualified custodian under both the Custody Rule and the Proposed Rule, among other things, includes a bank or a savings association that has deposits insured by the Federal Deposit Insurance Corporation ("FDIC"). 17 C.F.R. § 275.206(4)-2(d)(6)(i). However, some states, including New York and Wyoming, allow their state-chartered trust companies to provide custodial

services without FDIC insurance. Such companies would, as a result, not meet the qualified custodian standard. See, e.g., New York Department of Financial Services,"OrganizationofaTrustCompanyfortheLimitedPurposeofExercisingFiduciaryPowers,"https://www.dfs.ny.gov/apps_and_licensing/banks_and_trusts/procedure_certificate_merit_trust_comp (last visited Mar. 10, 2023).

[10] Mark Uyeda, SEC Commissioner, Statement on Proposed Rule Regarding the Safeguarding of Advisory Clients (Feb. 15, 2023) (noting "This approach to custody appears to mask a policy decision to block access to crypto as an asset class. It deviates from the Commission's long-standing position of neutrality on the merits of investments. Nevertheless, I prefer having a discussion about crypto assets in the context of notice and comment rulemaking as opposed to enforcement actions.").

[11] Proposing Release at 128.

[12] See Proposed Rule 223-1(b)(2).

[13] See Proposed Rule 223-1(d)(3)(ii) (stating that custody includes "[a]ny arrangement (including, but not limited to a general power of attorney or discretionary authority) under which you are authorized or permitted to withdraw or transfer beneficial ownership of client assets upon your instruction...").

[14] Custody of Funds or Securities of Clients by Investment Advisers, Advisers Act Rel. No. 2176 (Sept. 25, 2003) (the "2003 Adopting Release") ("An adviser with power of attorney to sign checks on a client's behalf, to withdraw funds or securities from a client's account, or to dispose of client funds or securities for any purpose other than authorized trading has access to the client's assets."). See 2003 Adopting Release, at n.10 (stating "An adviser's authority to issue instructions to a broker-dealer or a custodian to effect or to settle trades does not constitute 'custody.' Clients' custodians are generally under instructions to transfer funds (or securities) out of a client's account only upon corresponding transfer of securities (or funds) into the account. This 'delivery versus payment' arrangement minimizes the risk that an adviser could withdraw or misappropriate the funds or securities in its client's custodial account.").

[15] See Proposing Release at n.37.

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

[17] The Safeguarding Rule states that reliance on certain exceptions is not mutually exclusive. See Proposed Rule 223-1(b)(9).

[18] The authorized trading exception under the current Custody Rule has never been clearly articulated to apply (or not to apply) to non-DVP settled transactions. See, e.g., Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority, SEC Division of Investment Management, Guidance Update, No. 2017-01 (Feb. 2017) (suggesting that one way to resolve concerns regarding inadvertent custody that may arise due to conflicting authorities in custodial agreements would be to draft a letter addressed to the custodian that limits the adviser's authority to DVP settled transactions). See also Letter from Paul G. Cellupica, then-Deputy Director and Chief Counsel, Division of Investment Management to Karen Barr, President & Chief Executive Officer, Investment Adviser Association, Engaging on Non-DVP Custodial Practices and Digital Assets (Mar. 12, 2019) (requesting, among other things, public engagement on custodial trading practices that are not processed or settled on a DVP basis). However, under the Safeguarding Rule,

authorized trading over non-DVP settled transactions would clearly constitute "custody" and be subject to all the requirements of the Proposed Rule.

[19] See Proposed Rule 223-1(d)(10)(iv)(A-G). For example, to qualify, the FFI must "be regulated by its home country 'as a banking institution, trust company, or other financial institution that customarily holds financial assets for its customers'" and "hold its customers' assets in accounts designed to protect such assets from the entity's creditors in case of insolvency or the entity's failure."

[20] See Proposing Release at 75-76.

[21] Id. at 21.

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

[23] See Proposing Release at 66.

[24] Id. at 67-68.

[25] Id. at 77.

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

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

[28] See Proposing Release at 24.

[29] See Proposed Rule 223-1(b)(2)((i)-(v)). The Proposed Rule would also require that the Adviser notify the independent public accountant engaged to perform the verification of such transactions within one business day. See proposed rule 223-1(b)(2)(iv).

[30] See Proposing Release at 135.

[31] On March 3, 2023, a consortium of 12 financial services trade associations requested a 60-day extension of the comment period (citing, among other things, "broad based, complex, and technical, proposing changes that will drastically and permanently alter the custody business model and the prevailing market for custody services.").