BCLP. Client Intelligent

Insights

SEC PROPOSES SWEEPING EXPANSION OF CUSTODY RULE

Apr 23, 2023

On February 15, 2023, the Securities and Exchange Commission ("SEC"), in a 4-1 vote,[1] proposed significant amendments to Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940, as amended. The proposed rule, designated as new Rule 223-1 (the "Proposed Rule")[2], would amend the Custody Rule and redesignate it as the "Safeguarding Rule." The Proposed Rule, if adopted, would apply to registered investment advisers. Exempt reporting advisers and the accounts of non-U.S. clients of registered offshore advisers would remain excluded.[3]

I. SUMMARY OF KEY CHANGES

The Proposed Rule includes the following key changes to the existing Custody Rule:

- **Expanded Scope of Client Assets.** The current Custody Rule applies to client "funds and securities." The Proposed Rule would expand coverage to include "funds, securities, ***or other positions held in a client's account."*** (emphasis added). The Release makes clear that the new definition would cover crypto assets, financial contracts held for investment positions, collateral posted in connection with a swap contract and physical assets, including artwork, real estate, precious metals or physical commodities.[4]

- **New Conditions for Limited Exception for Privately Offered Securities and Physical Assets.** Like the current Custody Rule, the Proposed Rule would provide an exception to maintaining client assets with a qualified custodian for privately offered securities or physical assets. However, the Proposed Rule would subject the exception to the following new conditions:

    a. 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; and

    b. the adviser reasonably safeguards the assets from loss, theft, misuse, misappropriation or the adviser's financial reversals, including the adviser's insolvency.

- To rely on this exception, the adviser must enter into a written agreement with an independent public accountant and notify that accountant of any purchase, sale or transfer of beneficial ownership of any asset within one business day. The agreement would require the independent public accountant to notify the SEC within one business day of finding any discrepancies. Each privately offered security or physical asset not maintained with a qualified custodian would have to be verified in either a surprise examination or audit.[5]

- **Qualified Custodian Protections.** The Proposed Rule would require advisers with custody of client assets to "maintain" them with a qualified custodian. To meet the "maintain" standard, the qualified custodian must have "possession or control" of client assets', which means that (1) the qualified custodian would be required to "participate in any change in beneficial ownership of [the] assets," (2) the qualified custodian's participation "would effectuate the transaction involved in the change in beneficial ownership," and (3) the qualified custodian's participation would be a "condition precedent to the change in beneficial ownership."[6]

- **Discretionary Trading Authority Included as Custody.** The Proposed Rule would also expand the definition of custody to include discretionary authority. This means that an adviser with discretionary trading authority that trades client assets through an independent custodian must be subject to an annual surprise examination by an independent public accountant to verify client assets. A limited exemption from the surprise examination requirement is available to advisers whose discretionary authority is limited to trading in assets that settle exclusively on a delivery versus payment (DVP) basis and are maintained with a qualified custodian.[7]

  Notably, the Safeguarding Rule, like the Custody Rule, would not require an adviser to report having custody if it has custody solely because it deducts advisory fees or because a related person has custody, but the Release makes clear that such an adviser may have additional disclosure requirements under the revisions that would be made by the Proposed Rule to Form ADV. [8]

- **New Requirement for Private Fund Advisers to Rely on Audit Exception.** For private fund advisers, the audit exception would remain available to satisfy the Safeguarding Rule. However, the Proposed Rule would impose a new requirement that auditors must agree to promptly notify the SEC of an audit report that contains a modified opinion, resignation or dismissal or other termination of the engagement of the accountant.[9]

- **Required Written Agreements with Mandatory Contractual Provisions.** As discussed in Part II below, in a substantial departure from the Custody Rule, the Proposed Rule would require advisers to enter into written agreements with qualified custodians and would require that these agreements contain nine provisions, including a requirement that the qualified custodian

indemnify the client for losses resulting from the custodian's own negligence (i.e., lower than the typical gross negligence standard).[10]

Some practitioners may be bemused by the statement in the Release that the SEC estimates that "each investment adviser and each qualified custodian that enters into an agreement would incur an internal burden of 1 hour each to prepare the written agreement."[11]

- **Segregation of Assets.** The Proposed Rule would require qualified custodians to maintain client assets in clearly identified accounts that are segregated from the adviser's proprietary assets.

- **New Conditions for Foreign Financial Institutions (FFIs).** As with the Custody Rule, FFIs would be eligible to continue to serve as qualified custodians under the Safeguarding Rule, subject to several significant new conditions, including oversight by governmental regulatory authorities, the ability to segregate custodied assets, submission to U.S. jurisdiction, and compliance with anti-money laundering regulations.[12]

- **Significant Hurdles for Crypto Assets.** As discussed in Part III below, the Proposed Rule would likely restrain advisers' ability to trade provide advisory services with regard to crypto assets. Chairman Gensler's public statement about the Proposed Rule includes strident remarks about crypto assets and crypto industry participants and emphasizes Chairman Gensler's view that the existing Custody Rule already covers most crypto assets:

  > "Make no mistake: Today's rule, the [existing Custody Rule], covers a significant amount of crypto assets. As the release states, 'most crypto assets are likely to be funds or crypto asset securities covered by the current rule.' Further, though some crypto trading and lending platforms may claim to custody investors' crypto, that does not mean they are qualified custodians. Rather than properly segregating investors' crypto, these platforms have commingled those assets with their own crypto or other investors' crypto. When these platforms go bankrupt—something we've seen time and again recently—investors' assets often have become property of the failed company, leaving investors in line at the bankruptcy court."
  >
  > "Make no mistake: ***Based upon how crypto platforms generally operate, investment advisers cannot rely on them as qualified custodians."***
  >
  > "[T]oday's proposal, in covering all asset classes, would cover all crypto assets—including those that currently are covered as funds and securities and those that are not funds or securities . . . ."[13](emphasis added).

- Commissioner Uyeda, who supported the Proposed Rule, takes a bleaker view for crypto assets: "[the Proposed Rule's] approach to custody appears to mask a policy decision to block

access to crypto as an asset class."[14]

II. SPECIFIC CONTRACTUAL REQUIREMENTS FOR CUSTODIAL AGREEMENTS

As stated above, in a substantial departure from the existing Custodial Rule, the Proposed Rule would require a written contract between a qualified custodian and an investment adviser with regard to client assets.

The written contract must include specific enumerated provisions that require the qualified custodian to:

- Promptly, upon request, provide records to the SEC or to an independent auditor conducting an annual audit;
- Send an account statement to the client or its representative identifying each client asset held in the account and summarizing all transactions;
- At least annually, provide the adviser with a written internal control report that includes the opinion of an independent public accountant regarding the effectiveness of the qualified custodian's internal controls; and
- Specify the adviser's agreed-on authority to effect transactions in the custody account and any relevant limitations.

Additionally, the Proposed Rule would require written contracts to include the following provisions:

- **Standard of Care.** The qualified custodian will exercise due care in accordance with reasonable standards in discharging its custodial duties and will implement appropriate measures to safeguard client assets. As applied to crypto assets, the Release elaborates that "the exercise of due care may require, in many cases, that crypto assets be stored in a cold wallet, but depending on the facts and circumstances, such as when a client seeks to buy and sell crypto assets very frequently, due care may mean the use of hot wallets in combination with robust policies and procedures."[15]
- **Indemnification and Insurance.** The qualified custodian will indemnify the client in the event of the qualified custodian's negligence, recklessness or willful misconduct and have insurance to protect the client (i.e., a lower standard than the typical gross negligence standard).
- **Sub-custodial Arrangements.** In respect of a qualified custodian's use of sub-custodial arrangements, the written contract must specify that that 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.

- **Segregation of Client Assets.** The qualified custodian will hold client assets in a custodial account, segregated from the qualified custodian's proprietary assets and liabilities.
- **No Security Interest or Lien.** 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 as agreed to by the client.

III. SPECIFIC CHALLENGES FOR CRYPTO ASSETS

As noted by Commissioner Uyeda, the "[Release] takes great pains to paint a "no-win" scenario for crypto assets."[16]The Proposed Rule creates several significant hurdles to investment advisers seeking to advise clients with respect to crypto assets. First, because of the technological features of crypto assets, especially the common use of multi-signature verification, the Release acknowledges that it may be difficult for a qualified custodian to demonstrate exclusive possession or control of crypto assets due to their specific characteristics *(e.g.,* being transferable by anyone in possession of a private key).[17]In other words, the underlying technology supporting crypto assets may prevent them from being assets that a qualified custodian could be authorized to hold.

Second, the Release also indicates that an adviser might not be able to trade client assets on any crypto asset exchange that is not itself a qualified custodian. The Release, for example, acknowledges that many crypto trading platforms require investors to pre-fund trades, a process in which investors transfer their crypto assets, including crypto asset securities, or fiat currency to such an exchange prior to the execution of any trade. Because most of these platforms are not qualified custodians, the Release acknowledges that an adviser trading client assets on such platforms would not be in compliance with the Proposed Rule.[18]

Fundamentally, the Release questions crypto service providers' use of state-chartered trust companies to establish themselves as qualified custodians, and would appear to speculate that the "[SEC] must be mindful of the extent to which many of these new entrants to the custodial marketplace offer, and are regulated to provide, the types of protections we believe a qualified custodian should provide under the [Proposed Rule]."[19] The Release poses a number of questions for comment on the matter. Commissioner Uyeda commented in his public statement that the questions may suggest that the SEC views "state regulated banking entities [as] less trustworthy than federally chartered ones."[20]

IV. RECORDKEEPING AND FORM ADV REVISIONS

The Proposed Rule includes amendments to Rule 204-2, the books and records rule, which would require advisers to maintain more detailed records of trade and transaction activity. It also amends Form ADV and the instructions thereto "to help advisers identify when they may have custody of client assets, to provide the Commission with information related to advisers' practices to

safeguard client assets, and to provide the Commission with additional data to improve our ability to identify compliance risks."[21]

V. COMMENT PERIOD AND COMPLIANCE DATES

The SEC is allowing for a 60 day comment period after publication of the Proposed Rule in the Federal Registration. Once a final rule is adopted, the Release states that the compliance date would be one year following the final rule's effective date, which would be 60 days after the date of publication of the final rules in the Federal Register for advisers with more than $1 billion in regulatory assets under management ("RAUM"). For advisers with up to $1 billion in RAUM, the Release contemplates the compliance date would be 18 months following the final rule's effective date, which would be 60 days after the date of publication of the final rule in the Federal Register.[22]

VI. CONCLUSION

The breadth and scope of the Safeguarding Rule, as proposed, would impose significant costs and burdens on investment advisers, qualified custodians and service providers. We encourage clients and market participants to submit comments on aspects of the Proposed Rule applicable to them.

REFERENCES

[1] Commissioner Hester Peirce was the sole dissenting commissioner. Commissioner Mark Uyeda supported the Proposed Rule but expressed significant concerns about it in his public statement. *See, e.g.,* Hester Peirce, Statement on Safeguarding Advisory Client Assets Proposal (Feb. 15, 2023), available here ["Peirce Statement"); Mark T. Uyeda, Statement on Proposed Rule Regarding the Safeguarding of Advisory Client Assets (Feb. 15, 2023), available here ("Uyeda Statement").

[2] *See* Safeguarding Advisory Client Assets, Release No. IA-6240 (Feb. 15, 2023) (the "Release"), available here. The text of proposed new Rule 223-1 appears on pp. 411-425 of the Release.

[3] *See* Release at fn. 3.

[4] *See* Release at 28.

[5] *See* Release at 133-134.

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

[7] *See* Release at 33-34.

[8] *See* Release at 229.

[9] *See* Release at 181.

[10] *See* Release at 77. Commissioner Peirce, in dissenting, cautioned that requiring prescriptive written agreements may prove unworkable and that the SEC may not have jurisdiction to require such contracts. "Getting custodians to enter into written agreements and provide the required reasonable assurances may be difficult for advisers and costly for clients. Small advisers may have a particularly difficult time complying with these requirements." *See* Peirce Statement, *supra* note 1.

[11] *See* Release at 354.

[12] The new requirements are similar to those currently applicable to "Eligible Foreign Custodians" as defined in rule 17f-5 under the Investment Company Act of 1940, as amended. Under the Proposed Rule, for an FFI to qualify as a qualified custodian, "it would need to be: [i] incorporated or organized under the laws of a country or jurisdiction other than the United States, provided that the adviser and the Commission are able to enforce judgments, including civil monetary penalties, against the FFI; [ii] regulated by a foreign country's government, an agency of a foreign country's government, or a foreign financial regulatory authority as a banking institution, trust company, or other financial institution that customarily holds financial assets for its customers; [iii] required by law to comply with anti-money laundering and related provisions similar to those of the Bank Secrecy Act [31 U.S.C. 5311, et seq.] and regulations thereunder; [iv] holding financial assets for its customers in an account designed to protect such assets from creditors of the foreign financial institution in the event of the insolvency or failure of the foreign financial institution; [v] having the requisite financial strength to provide due care for client assets; [vi] required by law to implement practices, procedures, and internal controls designed to ensure the exercise of due care with respect to the safekeeping of client assets; and [vii] not operated for the purpose of evading the provisions of the proposed rule." *See* Release at 47-48. Based on the experience of investment advisers for investment companies registered under such Act, confirming compliance with these conditions would be an onerous undertaking.

[13] Chair Gary Gensler, Statement on Proposed Rules Regarding Investment Adviser Custody (Feb. 15, 2023), available here.

[14] *See* Uyeda Statement *supra* note 1.

[15] *See* Release at 85—86.

[16] *See* Uyeda Statement *supra* note 1.

[17] While the Release could be clearer on the topic of multi-signature processes, it would appear that a qualified custodian could have "possession or control" of a crypto asset if it holds one of the critical keys necessary to effect a transaction in client assets on the basis that the custodian of one of the keys is "required to participate in a change in beneficial ownership ...." *See* Release at 66-67. For a description of multi-signature processes, *see* Multisignature Wallets Can Keep Your Coins Safer (If You Use Them Right), Coindesk (Nov. 10, 2020), available here.

[18] *See* Release at 68.

[19] *See* Release at 75-76.

[20] *See* Uyeda Statement *supra* note 1. As an aside, we would note that in contrast to the SEC the New York State Department of Financial Services already has provided specific guidance to the crypto asset sector regarding custody. *See* Guidance on Custodial Structures for Customer Protection in the Event of Insolvency, New York State Department of Financial Services (Jan. 23, 2023), available here.

[21] *See* Release at 227.

[22] Commissioner Peirce, acknowledged in her public statement the difficulties imposed by the short comment period and compliance period and cited such difficulties as one of the reasons for dissenting: "…[This] rule has broad implications for investors, investment advisers, and custodians. To get it right, we need the thoughtful input of commenters. Comments are due sixty days after publication in the Federal Register, which does not allow the public enough time to analyze all aspects of this proposal, particularly in light of the already loaded rulemaking docket. Moreover, the proposed implementation period—at one year for large advisers and eighteen months for smaller advisers—is too short. This rule will require a lot of work, and a year seems too short to accomplish all of it. I appreciate the extended time for smaller advisers, but even eighteen months seems like an aggressive timeline for the changes contemplated here." *See* Peirce Statement *supra* note 1.

RELATED PRACTICE AREAS

- Corporate
- Private Investment Funds
- Crypto and Digital Assets
- Private Equity

MEET THE TEAM

Robert M. Crea

San Francisco

robert.crea@bclplaw.com
+1 415 675 3413

Lauren A. Ford

Charlotte

lauren.ford@bclplaw.com
+1 704 749 8930

Carol R. Schepp

New York

carol.schepp@bclplaw.com
+1 212 541 2004