CARLTON FIELDS

SEC Proposes to Remake Advisers Act Custody Rule for a Modern World

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On February 15, 2023, the SEC proposed to significantly overhaul Rule 206(4)-2 under the Investment Advisers Act of 1940 (Advisers Act) — the Custody Rule — once dubbed among the "most critical rules" ever passed under the Advisers Act. In addition to material amendments designed to address perceived gaps in the current protections, the cornerstone anti-fraud rule would be renumbered Rule 223-1 and redesignated the "Safeguarding Client Assets" rule. If adopted as proposed, the new rule will require considerable effort by investment advisers to ensure compliance.

Custody Redefined

The proposed changes would broaden the scope of the rule in two important ways.

Assets. The first is to redefine "custody" to include holding, directly or indirectly, a client's "assets," not merely "funds or securities." This change is intended to apply the provisions of the rule to the entirety of an advisory account's positions, regardless of their nature, including but not limited to, short positions, written options, all crypto assets (whether those assets are deemed "funds" or "securities" or not), and physical assets, such as rare coins, precious metals, artwork, and real estate.

Discretion. The second is to redefine "custody" to include "discretionary authority" over client assets. This represents a reversal of the SEC's previous position that an adviser's authority to instruct a broker-dealer or custodian to effect or settle trades in a client's account does not constitute custody. The prior position was premised on a belief that any risk that a client's assets would be misappropriated by an adviser with discretionary authority was mitigated when the custodian was under instructions to transfer securities (or funds) out of the account only upon a corresponding transfer of securities (or funds) into the account (a delivery versus payment or DVP arrangement). As explained in the proposal, the SEC is now convinced that non-DVP arrangements are no longer so rare as to warrant a continuation of this stance. For example, an adviser could

instruct a privately offered security issuer's transfer agent to sell its client's interest and direct the proceeds to an account in the adviser's name or under its control without the client's knowledge, consent, or participation, and without oversight of a custodian.

Qualified Custodians

The proposed amendments also make important changes relating to qualified custodians. For example, banks and savings associations would be required to hold advisory account assets in an account designed to protect the assets from creditors of the bank or savings association. Two particularly noteworthy proposed changes include: modifying the definition of "qualified custodian" to impose a "robust set of requirements" on foreign financial institutions (FFIs), and; requiring an adviser to maintain client assets only with qualified custodians that have "possession or control" of those assets.

Foreign Financial Institutions. To meet the definition of a qualified custodian under the proposed changes, an FFI must satisfy seven conditions. In particular, the FFI would need to be:

- Incorporated or organized under the laws of a country or jurisdiction other than the United States, provided that the adviser and the SEC are able to enforce judgments, including civil monetary penalties, against the FFI;
- 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;
- Required by law to comply with anti-money laundering and related provisions similar to those of the Bank Secrecy Act and regulations thereunder;
- Holding financial assets for its customers in an account designed to protect such assets from creditors of the FFI in the event of the insolvency or failure of the FFI;
- Having the requisite financial strength to provide due care for client assets;
- 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
- Not operated for the purpose of evading the provisions of the proposed rule.

Presumably, advisers would verify whether an FFI is abiding by these conditions through a combination of reliance on certain "reasonable assurances" also required to be obtained under the proposed amendments and separate requests for additional documentation.

Possession or control. Another key change is that, as proposed, the qualified custodian of an advisory account would be required to have "possession or control" of the account assets, defined as holding the assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets. Under this definition, the qualified custodian's participation would effectuate the transaction resulting in the change of beneficial ownership such that the qualified custodian is willing to attest to the transaction on the account statement and for which it takes custodial liability. Consequently, accommodation reporting, a practice by which the custodian lists assets for which it does not accept custodial liability on a client's account statement as an accommodation, would not be considered sufficient control. Qualified custodians would not be allowed to report assets they do not control. The aim is to preserve the integrity of account statements so that clients can reasonably rely on them.

Because the proposal would require that a qualified custodian have "possession or control" of advisory account assets at all times, an adviser may violate the rule as proposed if it trades crypto assets on a crypto asset trading platform that does not satisfy the definition of a "qualified custodian." This is because certain crypto asset trading platforms require investors to transfer their crypto assets prior to the execution of any trade, meaning the assets would not be in a qualified custodian's possession or control from transfer through settlement.

Custodial Agreement

The proposed rule would also require an adviser to enter into a written agreement with, and receive certain assurances from, the qualified custodian to make sure the qualified custodian provides certain standard custodial protections when maintaining client assets. In particular, the written agreement must:

- Require the qualified custodian to promptly, upon request, provide records relating to clients' assets held in the qualified custodian account to the SEC or to an independent public accountant engaged for purposes of complying with the safeguarding rule;
- Specify the adviser's agreed-upon level of authority to effect transactions in the account, proposing that this contract provision permit the adviser and the client to reduce the specified level of authority;
- Contain a provision requiring the qualified custodian to deliver account statements to clients and to the adviser, as currently advisers must have only a reasonable basis for believing this is done. For pooled investment vehicles, the statements will need to be delivered to each investor; and
- Require the qualified custodian to obtain a written internal control report that includes an opinion of an independent public accountant regarding the adequacy of the qualified custodian's controls, which must be provided to the adviser annually.

Minimum Custodial Protections

In addition to required contractual provisions, the proposal recognizes certain fundamental protections that should be provided to a custodial customer when the adviser has custody. A qualified custodian should:

- Exercise due care and implement appropriate measures to safeguard the advisory client's assets;
- Indemnify an advisory client when its negligence, recklessness, or willful misconduct results in that client's loss;
- Not be relieved of its responsibilities to an advisory client as a result of sub-custodial arrangements;
- Clearly identify an advisory client's assets and segregate an advisory client's assets from its proprietary assets;
- Keep client's assets free of liens in favor of a qualified custodian unless authorized in writing by the client;
- Keep certain records relating to those assets; and
- Cooperate with an independent public accountant's efforts to assess its safeguarding efforts.

In addition, they should provide:

- Advisory clients with periodic custodial account statements directly from the qualified custodian;
- Internal controls relating to its custodial practices should be evaluated periodically for effectiveness; and
- A custodial agreement that should reflect an investment adviser's agreed-upon level of authority to effect transactions in the advisory client's account.

An adviser would be required to obtain reasonable assurances in writing from the qualified custodian that the custodian will comply with these requirements and must maintain an ongoing reasonable belief that the custodian is complying with these requirements. Note, in other contexts under the Advisers Act, to form a reasonable belief an adviser must take affirmative steps, though what steps the adviser should take to form such reasonable belief is left ambiguous in the proposal.

Assets That Cannot Be Maintained With a Qualified Custodian

Of course, one consequence of broadening the definition of "custody" to include holding a client's "assets," including physical assets, is that there will be certain account holdings that cannot be practically maintained with a qualified custodian. Under such circumstances, the proposed changes would include an exception from the requirement that such assets be held with a qualified custodian if:

- The adviser reasonably determines and documents in writing that ownership cannot be recorded and maintained in a manner in which a qualified custodian can maintain possession or control;
- The adviser reasonably safeguards the assets from loss, misappropriation, etc.;
- 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 SEC within one business day upon finding any material discrepancies during the course of performing its procedures.
- The adviser notifies the accountant engaged to perform the verification of any purchase, sale, or other transfer of beneficial ownership of such assets within one business day; and
- The existence and ownership of each privately offered security or physical asset not maintained with a qualified custodian is verified during the annual surprise examination or as part of a financial statement audit.

The proposed changes will apply to physical assets as well "privately offered securities," as defined, that cannot be maintained with a qualified custodian, and it is intended to enhance transparency, deter misconduct, and increase the likelihood that loss or misappropriation of these assets would be detected sooner. Significantly, the SEC noted its belief that transactions and ownership in crypto asset securities issued on public, permission-less blockchains would *not* meet the definition of a "privately offered security." As such, an adviser could not rely on this exception with respect to crypto asset securities that are not maintained with a qualified custodian. As proposed, "privately offered securities" would be redefined (slightly) to include, in part: securities that are uncertificated; the ownership of which can only be 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 the adviser is required to keep under Rule 204-2; and are transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer. Indeed, it is difficult to think of a crypto asset security that would meet this definition.

Adviser Obligations

Investment advisers with custody of client assets would be required to segregate those assets by: (1) titling or registering the assets in the client's name or otherwise holding the assets for the client's benefit; (2) not commingling the assets with the adviser's or any of its related persons' assets; and (3) 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.

While maintaining a client's assets separate from those of the adviser is, of course, an important control for safeguarding those assets from misuse or misappropriation, as noted in the proposal, the "…segregation provision is critical in light of the fact that some client assets are not maintained with a qualified custodian."

Exceptions From the Surprise Examination

The proposal also includes new exceptions from the requirement that an adviser undergo an unannounced examination by an independent public accountant to verify assets over which the adviser is deemed to have custody. These include advisers deemed to have custody solely because of a standing letter of authorization, and those with custody solely due to discretionary authority when the account assets are maintained with a qualified custodian and the adviser's discretionary authority is limited to transactions in assets that settle exclusively on a DVP basis.

Form ADV and Recordkeeping Rule

The proposal includes modifications to Form ADV, among other reasons, to better align reporting obligations with the proposed changes and to provide the SEC with critical information regarding heightened compliance risks at a firm. It also would amend Advisers Act Rule 204-2 to require that certain additional records be maintained including, among others, the basis for the adviser having custody of client assets in an account, records of required client notifications and independent public accountant engagements under the proposed rule, as well as books and records related to specific types of client account information, custodian information, transaction and position information, and standing letters of authorization.

Conclusion

If adopted as proposed, and depending on each adviser's practice, the new "Safeguarding Client Assets" Rule will likely require allocation of considerable resources to ensure compliance, including, among other steps:

- Analysis of FFIs, banks and savings associations, and other custodians currently used to custody client advisory accounts to ensure that they will meet the new, expanded definition of "qualified custodian";
- Drafting and adopting tailored policies, procedures, processes and disclosures;
- Training of relevant staff regarding the new policies, procedures, and processes;
- Entering into new agreements with custodians who meet the requirements of the final rule, and;
- Seeking additional written assurances of qualified custodians, as required.

The effective date of the rule would be 60 days following publication of the final rule in the Federal Register. The proposal includes a phased transition based on a firm's total regulatory assets under management (RAUM) with a compliance date of one year following the effective date for advisers with more than $1 billion in RAUM, or 18 months following the effective date for advisers with up to $1 billion in RAUM.

The comment period for the proposal is 60 days after date of publication in the Federal Register. As of the date of this article, the proposal has not been published in the Federal Register.

Authored By

Mederic A. Daigneault

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