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SEC Proposes to Redesignate Custody Rule as New Safeguarding Rule Under the Investment Advisers Act

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On February 15, the Securities and Exchange Commission ("SEC") issued a rule release ("Release" or "Proposal") that proposes new Rule 223-1 ("Safeguarding Rule") under the Investment Advisers Act of 1940, as amended ("Advisers Act").[1] The Safeguarding Rule would serve as a redesignation of current Rule 206(4)-2 under the Advisers Act ("Custody Rule") and seeks to enhance protections relating to advisory client assets by, among other things, expanding the scope of the Custody Rule to apply to a broader array of client assets and advisory activities and enhancing the custodial protections that client assets currently receive under the rule.

Background

Originally adopted in 1962 and most recently amended in 2009, the Custody Rule has required investment advisers to safeguard their clients' funds and securities against financial reverses the advisers may experience (e.g., insolvency) as well as against loss, misuse, theft, and misappropriation.

In its current form, the Custody Rule generally requires investment advisers with custody of client funds and securities to establish controls to safeguard those assets, including by keeping the assets with a "qualified custodian" (i.e., a broker-dealer, bank or savings association, futures commission merchant, or certain foreign financial institutions). An adviser is considered to have custody of such assets when it either directly or indirectly holds those assets or has any authority to obtain possession of them, including through its related persons. Importantly, the rule's custodial obligations apply only to funds and securities (not to other assets).

SEC Considerations

In its Release, the SEC stated that recent significant changes in technology, advisory services, and custodial practices have created new and different ways for client assets to experience risk of loss, theft, misuse, or misappropriation that may not be fully addressable under the current Custody Rule. In particular, the SEC noted:

- The economy has experienced an evolution of financial products and services, which has allowed new entrants and services into the custodial marketplace, along with a corresponding reduction in the level of protections offered by custodians.
- A growing number of investor assets do not receive custodial protections, due in part to the Custody Rule's exceptions from the general requirement to maintain assets with a qualified custodian (e.g., the exception for certain "privately offered securities").
- There have been significant developments with respect to crypto assets, which primarily use ledger or blockchain technology to transfer and record ownership of assets. The nature of this technology makes it difficult or impossible to recover lost assets and reverse erroneous or fraudulent transactions.

[1] The Proposal can be found here. An SEC Fact Sheet accompanying the Proposal can be found here.

Proposed Changes to Custody Rule

Relying on authority Congress provided to it under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") to prescribe rules related to investor custody (namely, Section 223 of the Advisers Act), the SEC proposes the following significant changes to the Custody Rule by way of redesignating it as the new Safeguarding Rule.

Expansion of Covered Assets

While the Custody Rule applies only to funds and securities, the new Safeguarding Rule would seek to apply custodial protections "for substantially all types of client assets held in an advisory account." To accomplish this, the rule would define "assets" to include "funds, securities, or *other positions held in a client's account*." The Proposal states the new definition would encompass new investment types as they evolve and multiply, with the SEC taking the position that the entirety of the client's account positions, holdings, and investments should receive the protections of the rule despite how they may be treated for accounting purposes.

New Meaning of Custody

The Safeguarding Rule would expand the circumstances under which an adviser is considered to have custody of client assets and thus an obligation to safeguard those assets. The rule would retain the Custody Rule's definition of "custody," which exists when either (i) the adviser has physical possession of the assets; (ii) an arrangement exists whereby the adviser is authorized or permitted to withdraw the assets maintained with a custodian; or (iii) the adviser is in a capacity that gives it (or its supervised persons) legal ownership of, or access to, the assets. But it would expand the definition to provide that "custody" also exists when there is an arrangement in which the adviser has the discretionary authority to transfer beneficial ownership of the client assets.

Enhanced Custodial Protections

Consistent with the Custody Rule, the Safeguarding Rule would generally require investment advisers with custody of client assets to maintain those assets with a qualified custodian. But the rule would enhance that requirement in various ways.

a. "Possession or Control" of Client Assets

The Safeguarding Rule would state specifically what it means for client assets to be maintained with a qualified custodian. It would specify that the custodian must have "possession or control" of those assets, and that "possession or control" exists when the custodian's participation (i) is required for, (ii) would effectuate the transaction involved in, and (iii) is a condition precedent to any change in beneficial ownership of the assets.

b. Enhanced Adviser-Custodian Relationship

The Safeguarding Rule seeks to ensure qualified custodians provide certain minimum protections to advisory client assets by requiring that (i) the adviser and custodian (or adviser and client, if adviser is serving as custodian) enter into a written agreement with certain enumerated provisions and (ii) the adviser obtain certain reasonable assurances in writing from the custodian.

The **written agreement** must provide the following:

- The custodian will promptly, upon request, provide records about client assets to the SEC or an independent public accountant for purposes of compliance with the rule.
- The custodian will (subject to a limited exception) send quarterly account statements with certain enumerated information to both the client and adviser. (This contractual obligation seeks to enhance a provision under the Custody Rule that requires the adviser only to reasonably believe the custodian is sending account statements to the client.)
- The custodian will, at least annually, obtain and provide to the adviser a written "internal control report" that includes an independent public accountant's opinion about certain aspects of the custodian's controls. (This contractual obligation aims to enhance a provision under the Custody Rule that states an internal control report is necessary only when the adviser or its related person acts as the qualified custodian.)
- The agreement must specify the adviser's agreed-upon level of authority to effect transactions in the custodial account and contain terms permitting the adviser and client to reduce that level of authority.

The custodian's **written assurances** must include the following:

- The custodian will exercise due care in discharging its custodial obligations and will implement appropriate measures to safeguard client assets from loss.
- The custodian will indemnify and have insurance in place to protect the advisory client against risk of loss in the event of fault caused by the custodian.

- The custodian acknowledges that the existence of any sub-custodial or similar arrangements will not excuse any of the custodian's obligations to the client.
- The custodian will clearly identify the client assets as such, hold them in a custodial account, and segregate them from the custodian's proprietary assets and liabilities. (This written assurance would supersede the Custody Rule's requirement that custodians maintain assets either in (i) a separate account for each client under that client's name or (ii) accounts that contain only the client assets under the adviser's name.)
- The custodian will not subject client assets to any liens or similar claims in favor of the custodian or its related persons or creditors (except as authorized by the client).

Exception to Custodial Requirement for Privately Offered Securities and Physical Assets

The Custody Rule contains an exception to its general requirement to maintain assets with a qualified custodian for certain "privately offered securities." This exception applies to securities that are (i) acquired from the issuer in a transaction or chain of transactions not involving any public offering; (ii) uncertificated, and whose ownership is recorded only in the issuer's (or its transfer agent's) books in the client's name; and (iii) transferable only with the prior consent of the issuer or holders of the issuer's outstanding securities. Additionally, with respect to securities held for the account of a pooled investment vehicle client, this exception will only apply if the pooled investment vehicle is audited and financial statements are delivered to investors pursuant to the rule's audit provision (subsection (b)(4) of the rule).

Per SEC guidance, this exception also applies to certain instruments evidencing an audited pooled investment vehicle's ownership of certain privately issued securities–namely, nontransferable stock certificates or certificated LLC interests–that were obtained in a private placement ("private stock certificates") provided that (i) the client is a pooled investment vehicle subject to a financial statement audit in accordance with subsection (b)(4) of the Custody Rule; (ii) the private stock certificate can only be used to effect a transfer or to otherwise facilitate a change in beneficial ownership of the security with the prior consent of the issuer or holders of the issuer's outstanding securities; (iii) ownership of the security is recorded in the issuer's (or its transfer agent's) books in the client's name; (iv) the private stock certificate contains a legend restricting transfer; and (v) the private stock certificate is appropriately safeguarded by the adviser and can be replaced upon loss or destruction.

The new Safeguarding Rule would continue to apply an exception to the custodial requirement for certain privately offered securities meeting the above criteria, but would expand the exception to also cover physical assets. With respect to the above criteria for privately offered securities, the Safeguarding Rule would also specify that the securities be capable of only being recorded in the issuer's (or its transfer agent's) nonpublic books in the client's name *as it appears in the records the adviser must keep under Rule 204-2 of the Advisers Act*. The rule would also impose the following additional conditions on the adviser to rely on this exception:

- The adviser must reasonably determine (and document in writing) that ownership cannot be recorded and maintained in a manner in which a qualified custodian can maintain possession, or control transfers of beneficial ownership, of such assets.
- The adviser must reasonably safeguard the assets from loss or the adviser's financial reverses (e.g., insolvency).
- The adviser must enter into a written agreement with an independent public accountant whereby the accountant promptly verifies beneficial ownership transfers of, and immediately notifies the SEC upon finding any material discrepancies regarding, the assets.
- The adviser must immediately notify the accountant of any such beneficial ownership transfers of the assets.
- The existence and ownership of each asset for which the adviser is claiming this exception must be verified pursuant to the rule's annual surprise examination (discussed below) or as part of a financial statement audit.

Client Asset Segregation Requirement for Advisers

The Safeguarding Rule would impose a specific obligation (not currently provided under the Custody Rule) on advisers who have custody of client assets to segregate client assets from the adviser's or its related persons' assets by (i) titling or registering those assets in the client's name (or otherwise holding the assets for the benefit of the client); (ii) not commingling the assets with the adviser's or its related persons' assets; and (iii) not subjecting the assets to any lien or similar claim in favor of the adviser or its related persons or creditors (except as authorized by the client).

Change to Surprise Examination Requirement

The Custody Rule generally requires advisers with custody of client assets to arrange by written agreement for an independent public accountant to verify the assets by way of an annual surprise examination and follow certain enumerated procedures in doing so.

The rule states an adviser will be deemed to have complied with this requirement with respect to pooled investment vehicle client assets if those assets are subject to annual audit (in accordance with certain enumerated procedures) and the client distributes its audited financial statements to its investors (pursuant to specific enumerated requirements). The Safeguarding Rule would expand this provision to apply to the assets of *any advisory client entity* capable of being audited in accordance with the rule (and not just pooled investment vehicle clients).

The Safeguarding Rule would also add two exceptions to the surprise examination requirement. The first exception would apply to certain assets (meeting certain enumerated criteria) if the adviser's sole basis for having custody is discretionary authority with respect to the assets. The second exception would apply to certain assets of which the adviser has custody solely because of a standing letter of authorization (also meeting certain enumerated criteria).

Updated Recordkeeping and Reporting Requirements

The Proposal also seeks to update recordkeeping requirements under Rule 204-2 of the Advisers Act by requiring advisers to keep records of certain items under the new Safeguarding Rule, and of certain enumerated records specific to client accounts, custodians, transactions, and positions. Moreover, the Proposal seeks to amend Form ADV to align the adviser's reporting obligations with the changes sought to be imposed by the new rule.

Our Thoughts

The new Safeguarding Rule would greatly expand the types of assets requiring custodial protection. By redefining "assets" to include "other positions held in a client's account," the SEC would for the first time subject assets other than funds or securities to maintenance by qualified custodians. Such "other positions" would undoubtedly encompass all crypto assets, regardless of their status as securities, as well as holdings that may not necessarily be recorded on a balance sheet as assets for accounting purposes, such as short positions and written options. It would also include certain financial contracts, collateral posted in connection with swap agreements, and even investments that would appear as liabilities on a balance sheet, such as negative cash.

As a result, advisers would need to arrange for the custodial protection of many assets not currently subject to the rule. But as the SEC recognized in the Release, the custodial markets for many assets, including privately offered securities and crypto assets, are not fully developed. This will put enormous pressure on institutions serving as qualified custodians to expand their business infrastructures to safeguard these new types of assets in accordance with the rule's many requirements. Doing so will likely impose enormous costs on custodians, take a substantial amount of time, and involve trial and error.

The Safeguarding Rule's redesigned exception to the custody requirement for certain privately offered securities and physical assets will make it more difficult for assets to qualify for the exception. Moreover, the exception's new requirement that the adviser determine ownership cannot be recorded and maintained in a sufficient manner by a custodian is likely to prove problematic. While the current exception's criteria are objective and advisers have grown comfortable with how to comply with them, this new subjective requirement, which essentially requires advisers to justify their use of the exception, will cause uncertainty in compliance and could lead to the SEC alleging compliance failures if it disagrees with the adviser's determination.

The Safeguarding Rule's requirements that qualified custodians must enter into certain contractual obligations with, and provide written assurances to, the client's adviser would substantially increase custodians' potential liability for custody-related failures. As the SEC recognizes, many of the protections the rule seeks to impose are not universally provided to all custodial customers; also, under existing market practices, advisers are rarely parties to the custodial agreement (which is generally just between the advisory client and custodian). The new requirements will likely cause custodians to increase the price of custodial services to remain profitable or even refuse business with certain advisory clients (e.g., those with less bargaining power) altogether. As a result, arranging for custody of client assets may become a much more complicated endeavor.

The Safeguarding Rule's many new obligations could also invite increased enforcement activity.

Importantly, the SEC indicated in the Release that it intends to maintain its ability to pursue advisers for safeguarding failures pursuant to the Advisers Act's antifraud provisions despite the rule's redesignation under Section 223. Enforcement actions brought under the antifraud provisions could result in especially severe penalties and, as the SEC emphasized in the Release, do not necessarily require proof of scienter.

Next Steps

The comment period for the proposed Safeguarding Rule is open until 60 days after the date of publication in the Federal Register. Lowenstein Sandler will monitor the status of the proposed rule and provide additional updates and analysis in future Client Alerts so that advisers can determine whether changes are required to their existing compliance policies and procedures. Please contact one of the listed authors of this Client Alert or your regular Lowenstein Sandler contact if you have any questions regarding the proposed Safeguarding Rule.

Contacts

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