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SEC Proposes Significant Changes to Custody Rule for Investment Advisers

Proposed "Safeguarding Rule" Would Expand Scope of Assets and Advisory Activities Covered by the Rule, Introduce Extensive New Requirements for Qualified Custodians, and Update Related Audit, Recordkeeping and Reporting Requirements for Investment Advisers.

SUMMARY

On February 15, 2023, the Securities and Exchange Commission (the "SEC") voted 4-1 to propose to amend and redesignate Rule 206(4)-2 (the current custody rule) as new Rule 223-1 (the proposed safeguarding rule) under the Investment Advisers Act of 1940 (the "Advisers Act").[1] Similar to the current custody rule, the proposed safeguarding rule would require registered investment advisers ("advisers") to safeguard client funds and securities when the adviser holds or has authority to obtain possession of such assets in order to protect against loss, misuse, theft or misappropriation. However, the proposed safeguarding rule introduces a number of significant amendments that the SEC characterizes as designed to enhance investor protections and account for changes in technology, advisory services and custodial practices in the years since the current custody rule was last amended. Among other things, the proposed safeguarding rule would:

- expand the current custody rule to apply to all client "assets" and not only client "funds and securities";
- clarify additional advisory activities covered by the rule (including explicitly covering discretionary trading authority);
- create extensive new requirements for advisers and qualified custodians (including entry into written agreements with prescriptive requirements);
- introduce significant new requirements to the exception for privately offered securities and extend the exception to certain physical assets that would be covered under the rule's expanded scope; and

- expand the availability of the current custody rule's audit provision as a means of satisfying the surprise examination requirement while imposing new requirements on advisers that rely on this exception.

In addition, the SEC is proposing related amendments to advisers' recordkeeping and Form ADV reporting requirements that would require advisers to maintain extensive books and records relating to the proposed safeguarding rule and report additional, granular information about their custody practices and use of qualified custodians.

If adopted as proposed, the safeguarding rule would impose significant new costs and burdens on advisers and custodians.[2] As discussed further below, it would also have significant implications for advisory activities and custody practices relating to crypto or digital assets—which has been a recent focus of the SEC[3] and appears to have been a principal driver of certain aspects of the proposed safeguarding rule—perhaps even before the rule is finalized.

The SEC is seeking comment from the public on the proposal, including responses to nearly 300 specific questions included in the Release. Comments are due 60 days after the date of publication of the proposed amendments in the Federal Register. The proposed compliance transition period following adoption of the rule would be one year for large advisers, or 18 months for advisers with under $1 billion in regulatory assets under management.[4]

BACKGROUND

Rule 206(4)-2 was first adopted in 1962 and last amended by the SEC in 2009 following the revelation of the frauds perpetrated by Bernard Madoff and Allen Stanford. The current custody rule regulates the custody practices of investment advisers registered (and required to register) under the Advisers Act. An adviser that 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, such as insolvency. The current custody rule requires an adviser that has custody, with certain limited exceptions, to maintain client funds or securities with a "qualified custodian" and comply with certain other obligations, including engaging an independent public accountant to conduct an annual surprise examination to verify client assets, which for limited partnerships, limited liability companies and other pooled investment vehicles may be satisfied through delivery of audited financial statements of the investment vehicles.

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") amended the Advisers Act by adding a new Section 223. Section 223 states that an investment adviser registered under the Advisers Act "shall 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."[5] In the Release, the SEC notes that Section 223 extends the

safeguarding requirement to all client assets, not just funds and securities as set forth in the current custody rule.[6]

In addition to the Dodd-Frank directive, the SEC identifies recent market developments as a reason to amend the current custody rule, explaining that "changes in technology, advisory services, and custodial practices create new and different ways for client assets to be placed at risk of loss, theft, misuse, or misappropriation that may not be fully addressed under the current custody rule."[7] This language appears directed at highly-publicized developments relating to the collapse of various crypto-asset companies. To address both recent and future market developments, the proposed safeguarding rule includes a definition of assets of which an adviser has custody that is designed to remain "evergreen."[8]

Commissioner Peirce dissented from the proposal, focusing on, among other things, the potential adverse consequences of the proposal to crypto assets. Commissioner Peirce commented that the proposed safeguarding rule may have the effect of reducing the number of qualified crypto custodians and leaving investors in crypto assets more vulnerable to theft or fraud.[9] Although voting in favor of issuing the proposal, Commissioner Uyeda expressed a number of concerns, including the SEC's failure to address the proposal's potential interaction with the newly proposed rule regarding outsourcing by advisers, and the lack of clarity regarding whether custody is an outsourced function that would be subject to both proposed rules.[10] For more information on the SEC's proposed adviser outsourcing rule, please see our recent firm publication here.[11]

OVERVIEW OF THE PROPOSAL

According to the SEC, the proposed safeguarding rule is "designed to recognize the evolution in products and services investment advisers offer to their clients and to strengthen and clarify existing custody protections."[12] The proposed safeguarding rule would broaden the scope of both the types of assets and advisory activities that would be covered by the rule, would create asset segregation requirements for banks or savings associations serving as qualified custodians, and would impose a number of additional conditions for foreign financial institutions to serve as qualified custodians. Further, the proposed safeguarding rule would require advisers to enter into written agreements with and receive certain assurances from qualified custodians in order to ensure that client assets are properly safeguarded. The proposal also includes related amendments to the rule governing books and records required to be maintained by advisers and to Form ADV regarding advisers' reporting obligations in line with the proposed safeguarding rule's requirements.

As noted above, the proposal would have significant implications for advisory activities and custody practices relating to crypto or digital assets—perhaps even before the rule is finalized. First, while the proposed safeguarding rule would apply to all client assets (obviating the need to determine whether a particular digital asset is properly characterized as "funds" or "securities" for purposes of determining the

application of the safeguarding rule), the SEC states its view that "most crypto assets are likely to be funds or crypto asset securities covered by the *current rule*."[13] Second, the SEC states that advisers with custody of crypto asset securities today would be in violation of the current custody rule, given some advisers' self-custody practices as well as the SEC's understanding that significant crypto asset trading volume "occurs on crypto asset trading platforms that often directly settle the trades placed on their platforms," but that such platforms are not qualified custodians.[14] As discussed below, the Release also includes several statements regarding the role of state-chartered trust companies and other state-chartered, limited purpose banking entities as custodians of advisory client assets, including crypto assets.

Scope of Assets and Advisory Activities

The proposed safeguarding rule would broaden the scope of the current custody rule in two significant ways: by expanding the types of client assets covered by the rule and by extending the types of advisory activities that constitute "custody" for purposes of the rule.

The current custody rule obligates an adviser to comply with certain requirements when the adviser has "custody" of client "funds or securities."[15] In alignment with the language employed in Section 223 of the Advisers Act added by Dodd-Frank, the proposed safeguarding rule would require an adviser to safeguard client "assets" of which it has custody, with "assets" broadly defined as "funds, securities, or other positions held in the client's account."[16] The SEC believes the inclusion of "other positions" in the new definition of "assets" will allow the proposed safeguarding rule both to remain applicable even as new types of investments evolve and to serve as a catchall for (i) assets that may not necessarily be recorded on a balance sheet for accounting purposes, such as short positions and written options; (ii) assets that may not clearly be "funds" or "securities", such as certain crypto assets, financial contracts held for investment purposes, and collateral posted in connection with swap contracts on behalf of a client; and (iii) physical assets, such as artwork, real estate, precious metals, and physical commodities.[17]

The proposed safeguarding rule generally maintains the framework of the current custody rule's definition of "custody", including that the rule would continue to apply when an adviser's related person has the ability to obtain client assets in connection with advisory services, while expanding the definition of "custody" in two ways. First, the rule explicitly includes "discretionary authority" as a covered "arrangement." Second, the rule includes authorization "to withdraw or transfer beneficial ownership of client assets."[18] Below is a comparison of the proposed definition of "custody" against the definition in the current custody rule:

> *Custody* means holding, directly or indirectly, client ~~funds or securities~~ **assets**, or having any authority to obtain possession of them. You have custody if a related person holds, directly or indirectly, client ~~funds or securities~~ **assets**, or has any authority to obtain possession of them, in connection with advisory services you provide to clients. Custody includes:
>
> i. Possession of client ~~funds or securities~~ **assets** (but not of checks drawn by clients and made payable to third parties) unless you receive them inadvertently and you return them to the sender promptly but in any case within three business days of receiving them;

ii. Any arrangement (including, **but not limited** to a general power of attorney **or discretionary authority**) under which you are authorized or permitted to withdraw ~~client funds or securities maintained with a custodian~~ **or transfer beneficial ownership of client assets** upon your instruction ~~to the custodian~~; and

iii. Any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives you or your supervised person legal ownership of or access to client ~~funds or securities~~ **assets**.[19]

Although the SEC previously stated its belief that an adviser's authority to issue instructions to effect or settle trades presents reduced risks of misappropriation due to the nature of the transactions as one-for-one exchanges,[20] the SEC now believes that discretionary trading authority presents the types of risks the proposed safeguarding rule is designed to address (for example, because the adviser "could use its discretionary trading authority over a client's assets to instruct [a transfer agent or administrator] to sell its client's interest and to direct the cash proceeds of the sale to an account that the adviser owns and controls").[21] However, the proposed safeguarding rule also includes an exception to the surprise examination requirement "when the sole basis for the application of the rule is an adviser's discretionary authority that is limited to instructing the client's qualified custodian to transact in assets that settle only on a delivery versus payment basis."[22]

Qualified Custodian Provisions

The proposed safeguarding rule would make significant changes that impact the conditions under which specified institutions can serve as qualified custodians of client assets. Consistent with the current custody rule, the definition of "qualified custodian" under the proposed safeguarding rule would include federal or state-chartered banks,[23] savings associations,[24] registered broker-dealers, registered futures commission merchants ("FCMs"), and certain foreign financial institutions ("FFIs"), but the proposed safeguarding rule would add requirements for qualified custodians that are banks, savings associations and FFIs.[25]

Specifically, under the proposed safeguarding rule, in order to serve as a qualified custodian, a bank or a savings association would be required to hold client assets "in an account designed to protect such assets from creditors of the bank or savings association in the event of the insolvency or failure of the bank or savings association."[26] The SEC believes that requiring the bank or savings association to utilize such an account (i.e., "an account in which client assets are easily identifiable and clearly segregated from the bank's assets") would make the requirements for banks and savings associations similar to those for broker-dealers and FCMs.[27] The SEC appears to be referring to a "special deposit," a type of deposit product that has been characterized under various state laws as akin to a trust, bailment or agency, but whose status under state law is often unclear.[28] The SEC states that assets in a segregated account "are more likely to be returned to clients upon the insolvency of the qualified custodian because they may pass outside of a bank's insolvency, may be recoverable if wrongly transferred or converted, and are not treated as general assets of the bank."[29] The SEC also states, without explanation, that the protections afforded by requiring

segregated accounts under the proposed safeguarding rule "would be limited to the clients of those qualified custodians that would not be subject to the resolution processes deployed by the [Federal Deposit Insurance Corporation ("FDIC")] or by the [Office of the Comptroller of the Currency ("OCC")] or have not developed and deployed comprehensive custodial service agreements governing their relationships with their custodial customers."[30] However, the basis for — or even the meaning of — this statement is unclear.[31]

Additionally, the Release refers to a "growing number of state-chartered trust companies and other state-chartered, limited purpose banking entities now offering custodial services for crypto assets"[32] and notes that, in light of the increasing number of such entities, 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 [it] believe[s] a qualified custodian should provide under the rule."[33] To that end, the Release cites the SEC's 2020 statement requesting input on "whether there are qualities that would be important for safeguarding crypto assets that might not be important for safeguarding other types of assets."[34]

The proposed safeguarding rule also creates seven new conditions, which are partly drawn from the qualifications for a foreign financial entity to act as an "Eligible Foreign Custodian" under Investment Company Act Rule 17f-5, in order for an FFI to serve as a qualified custodian for client assets. The SEC states that market developments, including recent events in crypto asset markets, have highlighted the need for enhanced custody safeguards of client assets held outside the United States.[35] Under the proposed safeguarding rule, an FFI must:

- 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;
- be 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;
- be required by law to comply with anti-money laundering and related provisions similar to those of the Bank Secrecy Act and regulations thereunder;
- hold 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;
- have the requisite financial strength to provide due care for client assets;
- be 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 be operated for the purpose of evading the provisions of the proposed safeguarding rule.[36]

In a departure from the current custody rule, the proposed safeguarding rule would require that in order to qualify as a "qualified custodian," an institution must "have 'possession or control' of client assets pursuant to a written agreement between the qualified custodian and the adviser."[37] "Possession or control" would be defined to mean "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."[38] The SEC views "participation" by a qualified custodian as the type of engagement that would enable the custodian to attest to the underlying transaction on an account statement, and the SEC explicitly notes that it does not view "accommodation reporting" as "participation."[39] In the Release, the SEC specifically discusses the applicability of the new "possession or control" requirement to crypto assets, noting as an example that a qualified custodian would be considered to have possession or control of a crypto asset if the custodian generates and maintains the private wallet keys in a way that an adviser could not change the crypto asset's beneficial ownership without the custodian's involvement in the process.[40]

Written Agreements and Reasonable Assurances

The proposed safeguarding rule would amend the current custody rule by requiring advisers to enter into written agreements with and receive certain written assurances from the qualified custodian selected to maintain client assets. In situations in which the qualified custodian is the adviser itself, the proposed safeguarding rule would require the adviser to enter a written agreement with the client. The SEC acknowledges in the Release that requiring written agreements between advisers and custodians "would be a substantial departure from current industry practice," wherein advisory clients typically enter into agreements with custodians directly.[41]

Such written agreements would be required to include the following provisions:

- an obligation of the qualified custodian to promptly, upon request, provide records relating to client assets it holds to the SEC or an independent public accountant engaged for purposes of complying with the proposed safeguarding rule;
- an obligation of the qualified custodian to send account statements, at least quarterly, to the client and the adviser, identifying each client asset in the account and summarizing all transactions during the statement period;
- an obligation of the qualified custodian to obtain and provide to the adviser, at least annually, a written internal control report that includes the 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); and
- specifications regarding the adviser's agreed-upon level of authority to effect transactions in the client's account and any relevant limitations.[42]

The first two provisions above incorporate and expand existing requirements and the latter two provisions would introduce new requirements to the framework of the current custody rule. Specifically, the obligation to agree in writing that the custodian will deliver quarterly account statements would change the existing requirement that an adviser have a reasonable basis for believing this is being done.[43] The provision regarding the adviser's level of authority to effect transactions is intended to permit the adviser and the

client to reduce the specified level of authority, in light of the SEC's understanding that many custodial agreements between the custodian and the client grant the adviser authority that is broader than what the adviser and client agreed to in the advisory agreement.[44] In addition, the obligation to obtain and provide an internal control report expands the existing internal control requirement to *all* qualified custodians, rather than only to the adviser or its related person acting as a qualified custodian.[45]

Furthermore, advisers would need to obtain "reasonable assurances"[46] in writing from a qualified custodian that it will comply with the following five requirements:

- 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 type of loss;
- 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 of the client's assets maintained with the qualified custodian in the event of the qualified custodian's own negligence, recklessness, or willful misconduct;
- 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;
- the qualified custodian will clearly identify the client's assets as such, hold them in a custodial account, and will segregate all client assets from the qualified custodian's proprietary assets and liabilities; and
- 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.[47]

In addition, under the proposed safeguarding rule, advisers would be required to "maintain an ongoing reasonable belief" that the custodian is complying with these requirements.[48]

The proposed safeguarding rule adopts a simple negligence standard for determining a custodian's liability to clients for the custodian's conduct. This standard aligns with provisions of other recent SEC rulemakings that propose this standard,[49] which have been sharply criticized by many advisers, investors and service providers. As was the case with those other proposals, requiring a custodian to provide indemnification (and maintain insurance) for simple negligence may represent a substantial departure from current market practice and result in significant increased costs to advisers, including potentially reducing the number of firms willing to serve as a qualified custodian, which costs may ultimately be passed on to clients. The Release justifies this consequence on the basis that for custodians that currently provide indemnification only for gross negligence, the simple negligence standard "would likely operate as a substantial expansion in the protections provided by qualified custodians to advisory clients."[50]

Exceptions for Privately Offered Securities and Physical Assets

The proposed safeguarding rule would expand the scope of the current exception for privately offered securities but introduce five new requirements for an adviser in order for it to rely upon the exception. An

adviser would not be required to comply with the safeguarding requirements of the proposed safeguarding rule with respect to client assets that are privately offered securities or physical assets if:

- 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, (i) 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 (ii) notifies the SEC 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 of each transaction; and
- The existence and ownership of each of the client's privately offered securities or physical assets that is not maintained with a qualified custodian are verified during the annual surprise examination or as part of a financial statement audit.[51]

The stringent requirements above reflect the SEC's view that "[i]deally, a robust market for custodial services would develop for [all] physical assets and privately offered securities" and would likely result in an exceedingly narrow exception.[52] The first condition would require extensive ongoing analysis and documentation by the adviser that a qualified custodian is not able to provide custody services for the asset, with substantial risk of second-guessing by SEC examination and enforcement staff.[53] The requirement to have an independent public accountant verify each transaction involving an asset exempt from the proposed safeguarding rule would also impose meaningful new obligations on advisers and their accounting firms, although the SEC appears to take the view that these obligations could be assumed relatively efficiently.[54]

The proposed safeguarding rule generally retains the current custody rule's definition of "privately offered securities" but amends the second prong of the definition to provide that such securities must be securities that are uncertificated and ownership *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*.[55] This change appears to be designed to exclude from the definition crypto asset securities, which are issued on public, permissionless blockchains and evidenced through public keys or wallet addresses.[56] With regard to physical assets, the SEC has declined to provide a definition of the term or include specific types of assets for which the exception would be available, instead taking the view that "a principles-based facts and circumstances approach that requires an adviser to look to the characteristics and nature of a particular physical asset is more appropriate."[57]

Segregation of Client Assets Held by the Adviser as Custodian

The proposed safeguarding rule would require that advisers with custody of client assets segregate those assets from the assets of the adviser and its related persons. Specifically, the proposed safeguarding rule would require, for client assets of which the adviser has custody, that such assets: (i) be titled or registered in the client's name or otherwise held for the benefit of that client; (ii) not be commingled with the adviser's or its related persons' assets; and (iii) 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.[58]

Surprise Examination Requirement

The proposed safeguarding rule would introduce certain amendments to the existing surprise examination requirement applicable to advisers that have custody of client assets. In addition to the prompt verification requirement applicable to exempt assets described above, the proposed safeguarding rule would require *each* privately offered security or physical asset not maintained with a qualified custodian to be verified as part of the surprise examination or audit (or, if applicable, in the audited financial statements). The SEC notes that this would likely represent a change from current practice for most surprise examinations and audits, which typically rely on a representative sample of assets under custody selected by the accountant.[59] In addition, the proposed safeguarding rule would require that the annual surprise examination be performed pursuant to a written agreement between the adviser and the independent accountant *that the adviser reasonably believes has been implemented*.[60] The change would require advisers to hold a reasonable belief that the accountant is capable of and intends to comply with such agreement, including, for example, ensuring that the accountant has access to the SEC Form ADV-E filing system.[61]

The proposed safeguarding rule would also make certain amendments to the exceptions to the surprise examination requirement. As described above, the proposed safeguarding rule adds an exception to the surprise examination requirement that applies when an adviser has custody of client assets solely because it has discretionary authority limited to instructing the qualified custodian to transact in assets that settle exclusively on a delivery versus payment basis, as well as when the adviser has discretionary authority solely because of a standing letter of authorization.[62]

Further, the proposed safeguarding rule would expand the scope of the availability of financial statement audits to satisfy the surprise examination requirement to "entities" generally (beyond the previous limitation to limited partnerships, limited liability companies, and other pooled investment vehicles).[63] The SEC states that such a change would eliminate uncertainty about which entities can use the audit provision, citing to pension plans, retirement plans, college saving plans (529 plans), and Achieving a Better Life Experience savings accounts (ABLE plans or 529A accounts), and would provide enhanced investor protection compared to surprise examinations and may reduce costs for entities that already undergo audits that are

similar in scope.[64] With respect to single-purpose vehicles established to hold investments of a pooled investment vehicle ("SPV"), an adviser would have the choice of whether to treat the SPV as a separate client or treat the SPV's assets as the pooled investment vehicle's assets of which it has custody indirectly, as long as the SPV's assets would be considered within the scope of the financial statement audit of the pooled investment vehicle client(s). However, if the SPV has third party investors, the adviser would be required to treat the SPV's assets as a separate client for purposes of the safeguarding rule.[65]

Recordkeeping Requirements and Form ADV Amendments

The proposed safeguarding rule would also make related amendments to advisers' recordkeeping and Form ADV reporting requirements. The proposed amendments to rule 204-2 (the books and records rule) would require an investment adviser that has custody of client assets to make and keep true, accurate, and current records of required client notifications and independent public accountant engagements under proposed rule 223-1, 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.[66]

The proposed Form ADV amendments would, among other things, amend Item 9 of Part 1A (and corresponding sections of Schedule D) to require new information corresponding to proposed rule 223-1 and to increase the quality of reported information.[67] Among other new reporting requirements, advisers would be required to report detailed information regarding client assets and the number of clients falling into each category of custody (i.e., direct or indirect), and to provide certain identifying and other information about the qualified custodians maintaining client assets.[68]

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ENDNOTES

[1] Safeguarding Advisory Client Assets, SEC Release No. IA-6240; File No. S7-04-23 (Feb. 15, 2023) ("Release"), *available at* https://www.sec.gov/rules/proposed/2023/ia-6240.pdf.

[2] In its economic analysis of the proposed safeguarding rule, the SEC points to, among other things, the following aspects of the proposed safeguarding rule that would create additional costs for advisers and other affected parties (including qualified custodians and independent public accountants) if the rule is adopted as proposed: (i) the expanded scope of the rule's applicability (covering all client assets, rather than client funds and securities); (ii) new requirements applicable to arrangements with qualified custodians (including both requirements that will increase the custodian's costs, such as new requirements applicable to banks, savings associations and foreign financial institutions, and requirements that will increase the adviser's costs, such as the requirement to enter into written agreements and obtain reasonable assurances); (iii) expanded requirements applicable to the exception for privately offered securities and physical assets; and (iv) new recordkeeping requirements, including amendments to require a more detailed and broader scope of records of trade and transaction activity and position information for each client account. *See generally id.* at 271-330.

[3] For example, on March 31, 2022, the SEC staff released Staff Accounting Bulletin No. 121 ("SAB 121"), which provides interpretative guidance for entities to consider when they have obligations to safeguard crypto assets for their platform users. SAB 121 expresses the views of the staff regarding the accounting for obligations to safeguard crypto assets an entity holds for platform users and describes unique technological, legal and regulatory risks that companies encounter when satisfying their safeguarding obligations. *See* Staff Accounting Bulletin No. 121, 87 Fed. Reg. 21,015 (April 11, 2022).

[4] Release at 240.

[5] *Id.* at 11; 15 U.S.C. § 80b-23.

[6] Release at 11-12.

[7] *Id.*

[8] *See, e.g., id.* at 27.

[9] Commissioner Hester M. Peirce, Statement on Safeguarding Advisory Client Assets Proposal (Feb. 15, 2023), available at https://www.sec.gov/news/statement/peirce-statement-custody-021523 (citing Release at 274) ("We run the risk… of 'caus[ing] investors to remove their assets from an entity that has developed innovative safeguarding procedures for those assets, possibly putting those assets at a greater risk of loss.'" (citing Release at 274)). Commissioner Peirce also observed that, to the extent the SEC is using the Release to assert the current applicability of the custody rule to most crypto assets, this could have the effect of immediately discouraging investment advisers from advising their clients with respect to crypto assets. Commissioner Uyeda expressed similar concerns about the overall approach to crypto custody, which he believes "appears to mask a policy decision to block access to crypto as an asset class." Commissioner Mark T. Uyeda, Statement on Proposed Rule Regarding the Safeguarding of Advisory Client Assets (Feb. 15, 2023), ("Uyeda Statement") available at https://www.sec.gov/news/statement/uyeda-statement-custody-021523.

[10] Uyeda Statement; *See* Outsourcing by Investment Advisers, 87 Fed. Reg. 68,816 (Proposed Oct. 26, 2022) (to be codified at 17 C.F.R. Pts. 275 and 279). *See also* Release at footnote 91 ("We remind advisers that as additional financial institutions become available to custody assets, advisers must continue to exercise their fiduciary duties to clients in connection with selection and monitoring of the qualified custodian.").

ENDNOTES (CONTINUED)

[11] Sullivan & Cromwell LLP, SEC Proposes New Requirements for Outsourcing by Investment Advisers (Nov. 4, 2022), ("Adviser Outsourcing Memo") available at https://www.sullcrom.com/files/upload/sc-publication-sec-proposes-new-requirements-for-outsourcing-by-investment-advisers.pdf.

[12] Release at 19.

[13] *Id.* at 18 (emphasis added).

[14] *Id.* at 67-68.

[15] 17 C.F.R. § 275.206(4)-2(a).

[16] Proposed safeguarding rule 223-1(d)(1).

[17] Release at 27-28. The Release does not explain how advisers would be able to satisfy the proposed safeguarding rule's requirements with respect to bilateral contracts that are off-balance sheet positions for an advisory client or give rise to a liability or receivable on the client's balance sheet. The SEC seeks comment on, among other things, whether particular types of assets held in client advisory accounts should be exempt from the proposed safeguarding rule, including because of the existence of other safeguards that apply to such assets that would satisfy the proposed safeguarding rule's policy goals. *Id.* at 29-30.

[18] Proposed safeguarding rule 223-1(d)(3)(ii).

[19] *Id.* at 223-1(d)(3); 17 C.F.R. § 275.206(4)-2(d)(2).

[20] *See* Custody of Funds or Securities of Clients by Investment Advisers, 68 Fed. Reg. 56,691 (Oct. 1, 2003), at n.10.

[21] Release at 33.

[22] *Id.* at 33-34; *see also* proposed safeguarding rule 223-1(b)(8).

[23] The Advisers Act defines "bank" as "(A) a banking institution organized under the laws of the United States or a Federal savings association, as defined in section 2(5) of the Home Owners' Loan Act, (B) a member bank of the Federal Reserve System, (C) any other banking institution, savings association, as defined in section 2(4) of the Home Owners' Loan Act, or trust company, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by State or Federal authority having supervision over banks or savings associations, and which is not operated for the purpose of evading the provisions of this title, and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph." 15 U.S.C. § 80b–2(a)(2).

[24] The Federal Deposit Insurance Act defines "savings association" as "(A) any Federal savings association; (B) any State savings association; and (C) any corporation (other than a bank) that the Board of Directors and the Comptroller of the Currency jointly determine to be operating in substantially the same manner as a savings association." 12 U.S.C. § 1813(b)(1).

[25] *See* proposed safeguarding rule 223-1(d)(10). Under the current custody rule, FCMs are qualified custodians only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon. The Release does not address the application of the proposed safeguarding rule to securities held by an FCM in relation to cleared swaps, including those swaps that are required to be cleared through FCMs under applicable law.

[26] Proposed safeguarding rule 223-1(d)(10)(i).

[27] Release at 44-45.

ENDNOTES (CONTINUED)

[28] The Uniform Law Commission has established a Drafting Committee on Special Deposits to prepare a uniform law or model state legislation on special deposits, noting that the law on special deposits "has not developed much since the 1930s." *See* https://www.uniformlaws.org/committees/community-home?communitykey=03b97b65-e517-440f-ad0b-f981cd4f72e5. A recent commentator noted that "Special deposits are an obscure legal specialty, in desuetude since the Great Depression. The doctrine, which has a questionable foundation, is largely unintelligible today." Joseph H. Sommer, *Special Deposits*, 76 Bus. Law. 841, 842 (Summer 2021).

[29] Release at 45. In a question posed in the Release, the SEC asks if "commenters agree with [the SEC's] view that [the enhanced protection of segregated deposit accounts] is especially important in light of the broad range of regulatory regimes and insolvency processes to which a growing number of state-chartered trust companies and other state-chartered, limited purpose banking entities entering the custodial market may be subject". *Id.* at 53-54. The SEC also asks if "the rule [should] require [segregated accounts] for a subset of [banks and savings associations] that are not federally insured or OCC member banks…[or for] state banks that are not members of the Federal Reserve System." *Id.* at 54-55.

[30] *Id.* at 279.

[31] Even in an FDIC receivership, at least one relatively recent court has found that "[i]f a bank fails, special deposits do not become part of the receivership estate, and therefore special depositors are entitled to be paid in full before other creditors of the bank." *Merrill Lynch Mortg. Cap., Inc. v. F.D.I.C.*, 293 F. Supp. 2d 98, 103 (D.D.C. 2003). The FDIC must defer to state law as to whether a deposit is or is not a special deposit. *Id.*

[32] Release at 273.

[33] *Id.* at 75-76.

[34] *Id.* at 78. *See* SEC, Staff Statement on WY Division of Banking's "NAL on Custody of Digital Assets and Qualified Custodian Status" (Nov. 9, 2020), available at https://www.sec.gov/news/public-statement/statement-im-finhub-wyoming-nal-custody-digital-assets.

[35] Release at 47.

[36] Proposed safeguarding rule 223-1(a)(10)(iv).

[37] Release at 41-42.

[38] Proposed safeguarding rule 223-1(a)(8).

[39] Release at 62. "Accommodation reporting" is described by the SEC as a practice "in which the custodian lists assets for which it does not accept custodial liability on a client's account statement as being on an accommodation basis only; the custodian does not attest to the holdings of or transactions in those investments or take steps to ensure that the investments are safeguarded appropriately." *Id.* at 15.

[40] *Id.* at 66-68.

[41] *Id.* at 77; *See id.* at 74 ("We understand that under existing market practices, advisers are rarely parties to the custodial agreement, which is generally between an advisory client and a qualified custodian, resulting in an adviser having limited visibility into the custodial arrangements of its clients.").

[42] Proposed safeguarding rule 223-1(a)(1)(i).

[43] *See* 17 C.F.R. § 275.206(4)-2(a)(3).

[44] Release at 105.

ENDNOTES (CONTINUED)

[45] *See* 17 C.F.R. § 275 206(4)-2(a)(6). The Release notes that the SEC is not requiring the provision of a specific type of internal control report as long as the required objectives are addressed, but the SEC provides guidance in the Release regarding the types of reports that would be deemed to be sufficient for purposes of the rule. A report on the description of controls placed in operation and tests of operation effectiveness, commonly referred to as a "SOC 1 Type 2 Report," would be sufficient to satisfy the requirements of the internal control report, provided that the report covers whether the controls have been placed in operation as of a specific date, are suitably designed, and are operating effectively in order to meet control objectives as required by the rule. A report that simply provides a report of procedures or controls a qualified custodian has put in place as of a point in time, commonly referred to as a "SOC 1 Type 1 Report," would not satisfy the requirements of the internal control report because it does not test operation effectiveness of the controls. In addition, a report issued in connection with an examination of internal control conducted in accordance with AT-C Section 315: Compliance Attestation ("AT-C Section 315") or AT-C Section 320: Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control over Financial Reporting ("AT-C Section 320") under the standards of the American Institute of Certified Public Accountants would also be sufficient, provided that the report covers whether the controls have been placed in operation as of a specific date, are suitably designed, and are operating effectively in order to meet control objectives as required by the rule. Similarly, a report based on an examination in accordance with PCAOB AT-1 of a broker-dealer's compliance report prepared pursuant to rule 17a-5 of the Exchange Act would be sufficient to satisfy the internal control requirement. Release at 103 n.195.

[46] In the Release, the SEC cites to Exchange Act Section 13(b)(7), which defines "reasonable assurance" and "reasonable detail" as "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs" and to its own guidance regarding management's report on internal control over financial reporting, which discusses the meaning of "reasonable assurance". Release at 83 n.149.

[47] Proposed safeguarding rule 223-1(a)(1)(ii).

[48] *Id.*

[49] *See* Outsourcing by Investment Advisers, 87 Fed. Reg. 68,816 (Proposed Oct. 26, 2022) (to be codified at 17 C.F.R. Pts. 275 and 279); Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 87 Fed. Reg. 16,886 (Proposed Feb. 9, 2022) (to be codified at 17 C.F.R. Pt. 275). For more information on these recent rulemakings, please see our firm publications on the SEC's proposed adviser outsourcing rule and the SEC's proposed rule changes for private fund advisers. Adviser Outsourcing Memo, *supra* note 11; Sullivan & Cromwell LLP, SEC Proposes Significant Rule Changes for Private Fund Advisers (Feb. 16, 2022), available at https://www.sullcrom.com/files/upload/sc-publication-sec-proposes-significant-rule-changes-for-private-fund-advisers.pdf.

[50] Release at 287.

[51] Proposed safeguarding rule 223-1(b)(2).

[52] Release at 133.

[53] *Id.* at 136-39 ("In order to be eligible for the exception, the rule would require an adviser to determine, and document 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 of such assets. Such a determination necessarily depends on the facts and circumstances in issue. Moreover, these determinations would necessarily evolve over time as assets and the custodial industry change, allowing the proposed rule to remain evergreen.")

[54] The SEC states its view that the notice from the adviser to the accountant "would not be challenging for any adviser to provide to the independent public accountant, especially considering the limited nature of the requirement relative to the more involved aspects of many of the closings related to privately offered securities or physical assets such as the preparation or review of closing memos,

confirmation of receipt of funds, execution of signature pages, and many other more time-consuming tasks related to closings for these types of assets." *Id.* at 144-45. The SEC goes on to note, "[b]ased on our experience with the audit provision in the current rule, we understand that independent public accountants are familiar with a wide variety of transaction verification and tracing transaction activity as this is a normal audit procedure." *Id.* at 145.

55 Proposed safeguarding rule at 223-1(d)(9)(ii) (emphasis added).

56 Release at 135.

57 *Id.* at 136. However, in the Release, the SEC does provide examples: "[R]eal estate and physical commodities such as, corn, oil, and lumber are physical assets, while assets like cash, stocks, bonds, options, futures and funds are not, even if they provide exposure to physical assets. Physical evidence of ownership of non-physical assets that can be used to transfer beneficial ownership, like stock certificates, private keys, and bearer or registered instruments do not, themselves, qualify as physical assets and would not qualify for the exception from the qualified custodian requirement. Similarly, certain physical evidence of physical assets such as a warehouse receipt for certain commodities would not qualify for the exception if they can be used to transfer beneficial ownership even though the commodities documented by the warehouse receipt may qualify for the exception. Or in the real estate context, a deed or similar indicia of ownership that could be used to transfer beneficial ownership of a property would not qualify for the exception, but the physical buildings or land would qualify." *Id.*

58 Proposed safeguarding rule 223-1(a)(3).

59 Release at 147. According to the SEC, this change is intended to address the SEC's concern that a loss of such assets could go undetected for a long period of time if not included in the sample covered by the surprise examination or audit. *Id.*

60 Proposed safeguarding rule 223-1(a)(4) (emphasis added).

61 Release at 177-78.

62 Proposed safeguarding rule 223-1(b)(7)-(b)(8). "Standing letter of authorization" means "an arrangement among [the adviser], the client, and the client's qualified custodian in which [the adviser is] authorized, in writing, to direct the qualified custodian to transfer assets to a third-party recipient on a specified schedule or from time to time, provided: (i) The client's qualified custodian is not [the adviser's] related person; (ii) The client's authorization includes the client's signature, the third-party recipient's name, and either its address or account number at a custodian to which the transfer should be directed; and (iii) [The adviser has] no ability or authority to designate or change any information about the third-party recipient, including name, address, and account number." Proposed safeguarding rule 223-1(d)(12).

63 Release at 185-87; Proposed safeguarding rule 223-1(b)(4).

64 Release at 185-87.

65 Release at 199-201. The requirement to treat SPV assets as a separate client would codify existing staff guidance with respect to SPVs.

66 *Id.* at 217.

67 *Id.* at 228.

68 *Id.* at 231-32.

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