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Safekeeping of Client Assets

By Genna Garver

The Securities and Exchange Commission (SEC) has been busier than ever with at least 53 proposed rules issued over the past two years and a lofty agenda ahead. Despite significant criticism from the industry and Congress, SEC Chair Gensler has continued to march through the rule-making process, at times simultaneously proposing rules on complex topics with seemingly short, overlapping public comment periods. However, at least one of the SEC's recent proposals has been years in the making—12 years according to Chair Gensler's remarks at the SEC's February 15, 2023 open meeting.[1] The SEC proposed a number of amendments to Rule 206(4)–2 (the custody rule) under the Investment Advisers Act of 1940, as amended (the Advisers Act) and proposed redesignating the custody rule as new rule 223–1 (the safeguarding rule or the proposed rule).[2] The proposals are intended to recognize the evolution in products and services in the industry and to strengthen and clarify existing custody protections. Along with the proposed amendments to the existing custody rule provisions, the SEC proposed amendments to Form ADV and Rule 204-2 (the books and records rule) to improve its oversight and risk-assessment abilities.[3]

Background

In 1962 the SEC adopted the custody rule to safeguard client funds and securities from the financial reverses, including insolvency, of an investment adviser and to prevent client assets from being lost, misused, stolen, or misappropriated.[4] Similar to other Advisers Act rules recently amended or replaced, including Rule 206(4)-1 (previously known as the advertising rule and now known as the marketing rule) and Rule 206(4)-3 (the cash solicitation rule), the custody rule is a relic of a paper-based world gone by. It has been amended over the years to modernize it in light of developments in securities market and offer greater protection for advisory clients. For example, the 2003 amendment expanded the requirement to maintain client funds with a qualified custodian to include client securities in light of the ability to hold most securities in book-entry form.[5]

In 2009 the SEC amended the custody rule again to include custody through related persons following the wake of several enforcement actions involving misappropriation and misuse, the most infamous of which was the fraud perpetrated by Bernie Madoff. [6] Then, in 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)[7] added Advisers Act Section 223 authorizing the SEC to promulgate rules requiring registered advisers to take steps to safeguard client *assets* over which advisers have custody including, without limitation, verification of such assets by an independent public accountant. However, the custody rule has not been amended since before the adoption of Advisers Act Section 223. The proposed

safeguarding rule is the SEC's first attempt to update the rules to require advisers to safeguard all assets over which advisers have custody rather than just funds and securities.

Initial reactions to the proposed rule seemed to suggest the rule if adopted would mostly impact the crypto currency and digital asset industry. However, the proposed rule would bring sweeping changes to long-established investment adviser industry practices across all asset classes and client types. The SEC received over 125 comment letters on the proposed rule to date and entertained meetings with 20 industry participants to discuss the same. If adopted as proposed, the safeguarding rule would have a significant impact not only on the asset management industry, but also the banking industry. Many commenters expressed grave concerns over the proposed rule and called for the SEC to abandon all or portions of the proposal in its current form.[8]

Set forth below is a summary of the material changes proposed by the SEC as well as related industry commentary regarding the same.

Scope of the Proposed Rule

According to the Proposing Release, the Staff is reconsidering the role of a "qualified custodian" and what minimum protections advisory clients should receive in light of the evolution of financial products and services, including the addition of newly launched state-chartered trust companies providing custodial services, the expansion of non-fiduciary custodial accounts, and the development of crypto and other digital assets.[9]

Types of Investments

The proposed rule would expand the types of investments covered by the current custody rule. Significantly, the proposed rule would require advisers to safeguard not only funds and securities as required by the current custody rule, but all types of client assets—funds, securities, or other positions held in an advisory account. The Staff intends this definition of assets to remain evergreen as the industry evolves to ensure all types of assets entrusted to advisers are properly safeguarded.[10]

The proposed rule's definition of assets would include, but not be limited to, the following types of investments:

- All crypto assets, even in the instances in which such assets are neither funds nor securities.[11]
- Financial contracts held for investment purposes.
- Collateral posted in connection with a swap contract on behalf of the client.
- Physical assets, including artwork, real estate, precious metals, or physical commodities (for example, wheat or lumber).
- Investments that would be accounted for in the liabilities column of a balance sheet or represented as a financial obligation of the client including negative cash.[12]

Industry participants have been shocked over the SEC's expanded application of the rule to include all client assets rather than just client funds and securities. It's been almost 12 years since the passage of Dodd-Frank and for nearly as long, Advisers Act Section 223 had not previously garnered much attention, most likely because it was not viewed as a fundamental shift in regulation or practice. Now the industry is pushing back hard claiming the term "client assets" as used in Section 223 is merely a short-hand expression for client funds and securities, which the SEC itself has also used in prior custody rule releases to address the same. [13]

As discussed in the Proposing Release, the SEC believes Congress intended Advisers Act Section 223 to broaden the application of the custody rule to include client assets beyond funds and securities.[14] The SEC's interpretation rests on the fact that Congress changed an early version of the bill—which was limited in scope to client funds and securities—to include "client assets" following the testimony of one Congressional witness who said the existing custody rule's scope left assets

other than funds and securities at greater risk of loss, theft, misappropriation, or being subject to the financial reverses of an adviser.[15] The SEC states in the Proposing Release that the change was made subsequently, but has not provided evidence that the testimony caused the change or that the change was made specifically to broaden the scope. That one witness's testimony may have been more narrowly focused than the SEC suggests, particularly as it relates to privately offered securities owned by private investment funds.[16] It's hard to see this witness's testimony as a call to require advisers to maintain physical artwork of a managed account client with a qualified custodian.

Discretionary Authority

The proposed rule generally would retain the current custody rule's three categories that serve as examples of custody: (1) physical possession, (2) certain arrangements when the adviser is authorized or permitted to instruct the client's custodian, and (3) circumstances when the adviser acts in certain capacities. However, the proposed rule would significantly expand the scope of the arrangement category to explicitly include discretionary authority to trade within the definition of custody. According to the Proposing Release, the Staff is proposing this change to "rectify unintended consequences" of its prior interpretive position that authorized trading "delivery versus payment" transactions are excepted by the definition of custody.[17] The Staff specifically called out transactions where an adviser, without the client's or custodian's involvement, could instruct an issuer, transfer agent, or administrator to redeem the client's interest and direct the proceeds to a particular account. Without the client's or custodian's involvement, the adviser could potentially direct those proceeds to an account owned or controlled by the adviser with such misappropriation going undetected for an indeterminate amount of time.

If adopted as proposed, the definition of custody would include discretionary authority and other arrangements under which the adviser is authorized or permitted to withdraw or transfer beneficial ownership of client assets upon the client's instruction. Where an adviser's discretionary authority is limited to transactions that settle only on a delivery versus payment (DVP) basis, the proposed rule would provide a limited exception to the surprise examination requirement of the rule as further discussed below.

Application of the Proposed Rule

The application of the proposed rule would not change from the application of the current custody rule. The proposed rule would apply to investment advisers registered, or required to be registered, with the SEC.[18] In the Proposing Release the SEC Staff confirmed its current position that most of the substantive provisions of the Advisers Act do not apply with respect to the non-US clients (including funds) of a registered offshore adviser. Accordingly, if the proposed safeguarding rule is adopted, it would not apply to non-US clients of an adviser that has its principal office and place of business outside of the United States.[19] Onshore advisers would be subject to the rule with respect to all clients regardless of where they are domiciled or reside.

Proposed Changes to the Definition of Qualified Custodian

Foreign Financial Institutions

While the Staff's position on the application of the rule to offshore advisers would not change, the proposed rule would refine the types of foreign financial institutions (FFIs) that could meet the definition of qualified custodians. Under the current custody rule, an FFI meets the definition of a qualified custodian if it customarily holds financial assets for its customers, provided that the FFI keeps the advisory clients' assets in customer accounts segregated from its proprietary assets.[20] This provision was adopted in 2003 to avoid disruption to existing relationships of foreign advisers and their clients with foreign institutions. According to the 2003 Adopting Release,

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> Where an adviser selects an FFI to hold clients' assets, [the SEC Staff] believe the adviser's fiduciary obligations require it either to have a reasonable basis for believing that the foreign institution will provide a level of safety for client assets similar to that which would be provided by a 'qualified custodian' in the United States or to fully disclose to clients any material risks attendant to maintaining the assets with the foreign custodian.[21]

While this provision did not receive much attention historically, more recently crypto and digital asset advisers have been relying on FFIs to serve as qualified custodians.

Under the proposed rule, an FFI would meet the definition of a qualified custodian if it:

- Is 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;
- Is 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;
- Is required by law to comply with anti-money laundering and related provisions similar to those of the Bank Secrecy Act and regulations thereunder;
- Holds 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;
- Has the requisite financial strength to provide due care for client assets;
- Is 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
- Is not operated for the purpose of evading the provisions of rule 223-1.[22]

Significantly, an adviser would need to make legal determinations for each of the requirements set forth above as to the applicable local law of the FFI's jurisdiction. Every time a client uses an FFI in a new jurisdiction, the adviser would need to undertake legal due diligence to make those determinations. Presumably, the adviser would need to review its prior determinations on a periodic basis. Comments generally agreed this would be an "impossible compliance burden."[23] Even if an adviser could undertake this legal due diligence, the related cost burden and uncertainty as to any one of the determinations would likely deter advisers from servicing assets in those foreign markets. It's also not clear why the SEC believes any FFI would consent to subject itself to the SEC's enforcement jurisdiction, which would mean for many FFIs, appointing an agent for service of process in the United States. The SEC acknowledged in the Proposing Release that these requirements would limit the number of FFIs that could meet the definition of a qualified custodian.[24] Comments though believe the SEC has underestimated this limitation. Many expressed concern that the proposed requirements for FFIs will effectively preclude advisers from investing client assets in foreign markets.[25]

Banks and Savings Associations

The proposed rule would also change the definition of qualified custodian relating to banks and savings associations to address the risk of loss of client assets in the event of the insolvency or failure of the custodian. Under the proposed rule, the definition of qualified custodian would include banks and savings associations only if client assets are maintained in accounts in which client assets are easily identifiable and clearly segregated from the bank's or savings association's assets. While other types of qualified custodians, such as registered broker-dealers and futures commission merchants, are subject to regulation that otherwise require these types of safeguards,

the Staff expressed concern over the inconsistency in treatment of bank and savings association accounts under the various state banking and insolvency laws.[26] Recent bank failures have emphasized this risk of loss with respect to deposit accounts. The bank industry has pushed back hard in comment letters, particularly regarding the requirement to segregate client assets. Please see "Segregation of Client Assets" below for a more detailed discussion on this point.

Qualified Custodian Protections

According to the Proposing Release, the proposed rule "seeks to create a minimum floor of custodial protection for investors—including those investors that have little or no power to negotiate for those protections—in the event of custodial misconduct."[27] While the current custody rule requires client funds and securities to be merely maintained with a qualified custodian, the proposed rule would require advisers to segregate client assets and qualified custodians to maintain "possession or control" of such client assets. The proposed rule would also set minimum standards for custodial services, including but not limited to the manner in which client assets are held, which are intended to improve safekeeping of client assets today and as the industry evolves.

Segregation of Client Assets

As proposed, client assets must:

- be titled or registered in the client's name or otherwise held for the benefit of that client;
- not be commingled with the adviser's assets or the adviser's related persons' assets; and
- not be subject to any right, charge, security interest, lien, or claim of any kind in favor of the adviser, the adviser's related persons, or the adviser's creditors, except to the extent agreed to or authorized in writing by the client. [28]

The SEC stated in the Proposing Release that this segregation requirement was "designed to prevent the adviser, or its related person, from using client assets for its own purposes or in a manner not authorized by the client or in a manner inconsistent with its fiduciary duty."[29] Custodians, however, are sounding the alarm over significant increased costs, as well as increased operational and settlement risk, and decreased market liquidity.[30] SIFMA went as far as to say the proposed rule would undermine sound bank management of cash deposit accounts and could significantly impact the funding and liquidity management of custody banks. Northern Trust also said that if asset segregation were required, custody banks would have insufficient liquidity to provide intraday and overnight advances and contractual settlement to help clients settle foreign exchange and securities transactions on their contractual settlement dates, which could increase the risk of settlement failures.[31] Northern Trust and others also raised serious concerns over the proposed rule unfairly favoring adviser client depositors over other depositor types.[32]

While the SEC was mindful to incorporate certain of its current no-action positions and related guidance into the proposed rule, the SEC left out of the proposed rule's segregation provision its 2014 IM Guidance on application of the custody rule to various situations involving special purposes vehicles (SPVs) and escrows, as well as its Madison Capital No-Action Letter position on an adviser serving as administrative agent to a loan syndicate.[33]

Possession and Control

The "possession or control" requirement is intended to address risk of loss related to client assets that could otherwise be purchased or sold without involvement from the custodian, as discussed above with respect to discretionary authority. The term "possession or control" as defined in the proposed rule means

> holding assets such that the qualified custodian is required to *participate* in any change

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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.[34]

This requirement is intended to ensure custodians are true gatekeepers in client transactions. According to the Proposing Release, participation would mean the custodian is so involved that it would be "willing to attest to the transaction on an account statement and for which it customarily takes custodial liability."[35]

In its comment letter SIFMA called for exceptions to the "possession and control" requirement raising concern that certain investments, such as repurchase agreements, reverse repurchase agreements, loans, collateralized loan obligations (CLOs), and derivatives (including swaps), would be unavailable to advisory clients as a result of this proposed requirement.[36] European industry groups also expressed concerns over the expanded scope and the "additional complexities and incompatibilities that inevitably would arise in jurisdictions outside the United States, where other laws, regulations and market practices apply."[37]

Written Agreement

Under current industry practice, not all advisers are involved with their client's selection and retention of a custodian.[38] The proposed rule, however, would require a written agreement between the qualified custodian and the adviser (or between the adviser and client if the adviser is also the qualified custodian). The written agreement must provide the following provisions:

- The qualified custodian will promptly, upon request, provide records relating to the adviser's clients' assets held in the account at the qualified custodian to the SEC or to an independent public accountant engaged for purposes of complying with the safeguarding rule.
- The qualified custodian will send account statements, at least quarterly, to the client, or its independent representative, and to the adviser, identifying the amount of each client asset in the account at the end of the period and setting forth all transactions in the account during that period, including investment advisory fees. Such account statements must not identify assets for which the qualified custodian lacks possession or control (that is, assets included for accommodation reporting when the custodian merely reports the holdings or transactions as reported to it by the adviser or a third party), unless requested by the client and the qualified custodian clearly identifies any such assets that appear on the account statement.
- At least annually, the qualified custodian will obtain, and provide to the adviser a written internal control report that includes an 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). If the adviser is the qualified custodian, or if the qualified custodian is a related person, the independent public accountant that prepares the internal control report must verify that client assets are reconciled to a custodian other than the adviser or the adviser's related person and be registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the Public Company Accounting Oversight Board in accordance with its rules.
- Specify the adviser's agreed-upon level of authority to effect transactions in the account as well as any applicable terms or limitations, and permits the adviser and the client to reduce that authority.

Advisers also must have a reasonable belief that these requirements have been implemented. In the Proposing Release the Staff acknowledged that an agreement between the custodian and the adviser would be a substantial departure from current industry practice, but stated they believe such departure is still necessary to help protect client assets from the harms the custody rule is designed to address.[39] While the Proposing Release does not provide examples of how an adviser could satisfy and evidence full compliance with this requirement, the SEC stated that if a qualified custodian fails to properly provide the adviser with the required quarterly account statement or the required annual internal control report discussed below, the adviser could not reasonably believe that the qualified custodian is complying with the contractual obligations of the written agreement.[40] The SEC also stated an adviser could use its records of client account statement copies it receives from the qualified custodian to form the basis of its reasonable belief that the qualified custodian has implemented the proposed contractual requirement to deliver account statements.[41]

Many commenters raised issues with respect to the written agreement requirement for advisers participating in managed account programs.[42] Primary advisers to these programs often reallocate client assets to different advisers depending on performance and strategy. The proposal would effectively require each new adviser added to a client's portfolio to enter into a new agreement with the client's custodian and obtain assurances from each custodian at the outset of the relationship, which could cause serious disruption in service.

Commenters generally expressed significant concern that the requirement to specify the agreed-upon level of the adviser's authority means custodians would be responsible for monitoring that authority to ensure advisers are not engaging in unauthorized transactions in their client accounts.[43] One commenter went as far as to say, "ensuring that instructions received from advisers conform to their authority is outside the role of a global custody bank, would be operationally impractical, and could create a moral hazard."[44]

Reasonable Assurances

If adopted as proposed, advisers would be required to obtain reasonable assurances in writing from the qualified custodian that the custodian will comply with the following 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.
- 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.

Advisers would be required to maintain an ongoing reasonable belief that the custodian is complying with these requirements. Furthermore, the SEC stated that to form its reasonable belief, advisers should "seek to become sufficiently familiar with safeguarding practices to identify concerns or

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red flags in order to, among other things, form an opinion as to whether the assurance that they receive from the qualified custodian that the qualified custodian is acting with due care is reasonable."[45]

Those advisers who are serving as qualified custodians would be required to include in their written agreement with the client a provision requiring the adviser to comply with those requirements.

Commenters generally expressed concern that the SEC is exceeding its authority by attempting to indirectly regulate custodians.[46] The New York Department of Financial Services and others expressly stated that Congress has not authorized the SEC to regulate custodians directly, some of which are extensively regulated under federal and state law.[47] The Proposing Release also lacks any explanation as to why it is necessary for advisers, rather than regulators, to ensure institutions that meet the definition of a qualified custodian are doing their job to adequately safeguard client assets.[48]

There is also concern, based on current industry practice, that custodians will not agree to indemnify clients for losses and or maintain insurance for risk of loss of the client's assets caused by the qualified custodian's negligence.[49]

Exceptions

Certain Assets Unable to Be Maintained with a Qualified Custodian

When the custody rule's exception for certain privately offered securities was adopted in 2003, most securities were certificated and the Staff intended the exception to be used on rare occasions.[50] Now that most securities are uncertificated and custodian practices have developed to safeguard privately offered securities, the Staff is proposing to narrow the definition of privately offered securities to ensure the exception is available only in circumstances that truly warrant it—where 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. The proposed rule also would expand the definition to include certain physical assets in light of the expanded scope of the proposed rule to include maintenance requirements for all client assets, rather than just funds and securities.

Accordingly, to rely on the exception under the proposed rule, an adviser must document its reasonable determination that ownership cannot be recorded and maintained (book-entry, digital, or otherwise) in a manner in which a custodian is able to maintain possession or control of the particular asset. The Proposing Release explains that this determination would involve an analysis of the asset and the available custodial market and the SEC does not expect advisers to identify and evaluate every conceivable qualified custodian.[51] The examples provided in the Proposing Release leave open many questions as to exactly how advisers will make this determination and whether they will be second-guessed in hindsight by the Division of Examinations.[52] Perhaps the examples were meant to depict the very narrow circumstances under which the SEC believes the exception should remain available—unharvested wheat is one of the few examples provided.

The proposed rule also would require advisers to notify their independent public accountant within one business day of any purchase, sale, or other transfer of beneficial ownership of the assets. Then, the account would be required to verify such transfer promptly after receiving such notice, and to provide notification to the SEC within one business day upon finding any material discrepancy. The accountant would be required to perform the verification during the annual independent verification conducted pursuant to proposed rule 223-1(a)(4) or as part of a financial statement audit performed pursuant to proposed rule 223-1(b)(4) of this section.

Commenters, including public accounting firms, requested clarity on the standards under which these verification engagements should be performed as there are prescribed requirements under the proposed rule and there is no concept of "verification"

under audit, attestation, or consulting standards.[53] In sharing its view of individual transaction verification procedures, KPMG LLP stated,

> . . . each individual transaction verification would likely be its own examination engagement with its own reporting requirements. As such, the required procedures for each individual examination engagement would include, for example, performing planning and risk assessment procedures, obtaining sufficient appropriate evidence to support the opinion in the examination report, evaluating the reliability of information produced by the entity, evaluating the use of specialists, supervising the work of other practitioners, and issuing a separate written report that complies with the attestation standards.[54]

Ernest & Young cautioned that verification procedures would be costly and would not add meaningful additional protections.[55] SIFMA Commenters also expressed significant concern over the proposed rapid timeline for verifications.[56] As noted in the PWC Letter, a single transaction could impact dozens of entities and accounts and multiple clients of one investment adviser. SIFMA also called for the rejection of the individual transaction verification stating, "it is unclear what additional protection, if any, the significant burden of independent verification for every purchase, sale, or other transfer of beneficial ownership will offer to clients."[57]

Audit Exception

The availability of the current custody rule's audit exception to the provisions requiring notice to clients, account statements, and an independent verification would be expanded to all types of entities that undergo a financial statement audit at least annually and upon liquidation. Commenters were generally supportive of this change.[58]

Standing Letters of Authorization

The proposed rule seeks to address circumstances under which advisers are deemed to have custody under the rule because their clients' custodial agreements give them a broad authority that they neither want nor use.[59] Accordingly, the proposed rule would exempt advisers from the independent verification requirement in proposed rule 223-1(a)(4) if they have custody of client assets solely because of a standing letter of authorization (SLOA).[60] SLOA includes those arrangements 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. The client's authorization must include 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 the adviser cannot have the ability or authority to designate or change any information about the third-party recipient (including name, address, and account number). The Staff believes there is little risk to clients under these circumstances because the adviser's role in effecting any change in beneficial ownership is circumscribed and ministerial.[61] Importantly, SLOA for this purpose would not include arrangements where the client's qualified custodian is the adviser's related person.

The exception essentially codifies the Staff's current no-action position for advisers who exercise limited authority pursuant to a SLOA without undergoing an annual surprise examination, if the SLOA arrangement meets certain specified conditions.[62]

Discretionary Authority

The proposed rule provides a similar exception to the independent verification requirement in proposed rule 223-1(a)(4) when the adviser's sole reason for having custody is because it has discretionary authority with respect to those assets. The exception applies only for client assets that are

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maintained with a qualified custodian in accordance with the rule and for accounts where the adviser's discretionary authority is limited to instructing its client's qualified custodian to transact in assets that settle exclusively on a delivery versus payment basis. Notably, the North American Securities Administrators Association expressed concern in its comment letter that this exception would be imprudent and contradictory to the proposal's aim of risk reduction and create an opportunity for advisers to engage in misconduct.[63]

Amendments to the Investment Adviser Recordkeeping Rule

The proposed amendments to Rule 204-2's books and records requirements aim to make available to SEC examiners a complete custodial record of client accounts. According to the Proposing Release, the SEC's Staff has experienced challenges with the completeness and accuracy of advisory client account records.[64] To address these challenges, the proposed amendments would require advisers to keep more detailed and a broader scope of records currently required under the rule and keep new records for each client account of which it has custody as follows:

- Client Communications
  - Copies of required client notifications required under the proposed safeguarding rule and any responses thereto.
- Client Accounts
  - Client account identifying information, including account inception date, client type (as reported in Item 5.D. of Form ADV) and copies of all account opening records, whether the adviser has discretionary authority and authority to deduct advisory fees and information regarding termination.
  - Custodian identifying information, including a record that identifies and matches, for each client, the account name and account number, or any other identifying information, from any person or entity, including any qualified custodian, that maintains client assets to the corresponding advisory account record for each client as required under Account Activity below; copies of required qualified custodian written agreements, copies of all records received from the qualified custodian relating to client assets, a record of the basis for the required reasonable assurances that the adviser obtains from the qualified custodian, and if applicable, a copy of the adviser's written reasonable determination that ownership of certain specified client assets 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.
  - A record that indicates the basis of the adviser's custody of client assets, including whether a related person has custody.
  - Copies of all account statements delivered by the qualified custodian to the client and to the adviser; copies of any account statement delivered by the adviser to the client, including copies of any account statement delivered by the adviser to the client containing required notifications under; and, for pooled investment vehicle clients, records reflecting the delivery of account statements, notices, or financial statements (as applicable) to all investors in such client.
- Account Activity (transaction and position information)
  - (as a modification of the currently required journal and ledger records for custody accounts) Records reflecting all trade and transaction activity in client accounts, that includes the date and price or amount of all

purchases, sales, receipts, deliveries (including one-way delivery of assets, and free receipt and delivery of securities and certificate numbers, as applicable), deposits, transfers, withdrawals, cash flows, corporate action activity, maturities, expirations, expenses, income posted to the account, and all other debits and credits to or from the account.

- — (as a modification of the currently required copies of confirmations of all transactions effected by or for the client in the client account) Trade confirmations that show the date and price of each trade as well as any instruction received by the adviser concerning transacting in the assets.
- — A record not just for each security, but for each asset, in which each client has a position, which record shall show the name of such client having any interest in such asset, the amount or interest of such client, and the location of such asset.

- ■ Independent Public Accountant Engagements
  - — All audited financial statements prepared under the safeguarding rule.
  - — A copy of each internal control report obtained by a qualified custodian and received by the adviser pursuant to the safeguarding rule.
  - — A copy of any written agreement between the independent public accountant and the adviser or the client, as applicable, required under the proposed safeguarding rule.
- ■ Standing Letters of Authorization
  - — Copies of, and records relating to, any standing letter of authorization issued by a client to the adviser. Although not expressly required by the proposed amendments, the Proposing Release states these records should include the name and either the address or the account number of each recipient to whom a transfer of client assets may be directed, along with any instructions the adviser has provided to the client's qualified custodian to transfer client's assets to that recipient.[65]

Amendments to Form ADV

The SEC also proposed amendments to Form ADV's Instructions, Glossary and Item 9 of Part 1A to align reporting obligations with the proposal.[66] The proposed changes are intended to improve the structure of Form ADV Item 9.4.

On a positive note, the proposed changes would give Item 9 of Part 1A a much-needed makeover. The first question, proposed Item 9.A.(1), would simply identify whether or not the adviser has custody. Advisers will respond in the affirmative regardless of the basis for which they have custody, whether they have custody directly, including solely because of their ability to automatically deduct advisory fees from client accounts, or indirectly because their related persons have custody. This change should hopefully alleviate industry confusion created by the current format of Items 9.A. and 9.B.

The second question, proposed Item 9.A.(2), however, will require disclosure of the amount of client assets of which the adviser has custody and the number of clients attributable to those assets broken down by categories of the adviser's basis for custody (that is, ability to deduct advisory fees, having discretionary authority, having physical custody, having a standing letter of authorization, etc.). While some advisers maintain similar custody charts to help compliance identify whether the adviser has custody, this proposed item could significantly increase the compliance burden for those who do not already maintain this information on a client basis.

The proposed new item 9 also would require disclosure of any exceptions relied on as well as information regarding the accountant performing the annual audit in accordance with that exception. In addition to the identification of each qualified custodian, new Item 9 would require the approximate dollar amount and related number of clients for assets not maintained by a qualified custodian. The proposal would

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change the "Report Not Yet Received" response to the question regarding whether the internal control report prepared by the independent public accountant contains an unqualified opinion. The response would be updated to "Report Not Yet Received for Most Recent Fiscal Year End," which would eliminate any remaining confusion as to which report the question relates.

Importantly, as with the current Form ADV, advisers will need to file other-than-annual updates if certain information reported in Item 9 becomes inaccurate. The current Form ADV requires other-than-annual updates to inaccurate information provided in response to Item 9, *except*:

- Item 9.A.(2) (the approximate amount of *client* funds and securities and total number of *clients* for which you have *custody);*
- Item 9.B.(2) (the approximate amount of *client* funds and securities and total number of *clients* for which your *related persons* have *custody*);
- Item 9.E. (the commencement date of your surprise examination during your last fiscal year); and
- Item 9.F. (the number of persons acting as qualified custodians for your clients).

While the exceptions to the other-than-annual update requirements under the proposed Form ADV are similar, the updated Form ADV would require more information and therefore increase the compliance burden with other-than-annual updates. If adopted as proposed, advisers would need to file an other-than-annual amendment if any information provided in response to the following sections in Item 9 becomes *inaccurate* in any way:

- Item 9.A.(1) (whether the adviser has custody of client assets either directly or because a related person has custody of client assets in connection with advisory services that the adviser provides to the client)
- Item 9.B. (whether the adviser is relying on certain exceptions to the proposed rule and if so, which one(s))
- Item 9.C. (whether client assets are maintained with a qualified custodian and related identifying information, including whether the adviser or a related person serves as a qualified custodian under the proposed rule)
- Item 9.D.(1) (whether client assets are not maintained by a qualified custodian)
- Item 9.E. (whether the adviser is required to obtain a surprise examination by an independent public accountant under the proposed rule)

Advisers would need to update responses to the following remaining sections of Item 9 only as part of their annual updating amendments:

- Item 9.A.(2) (the chart detailing the approximate amount of *client* funds and securities and total number of *clients* for which you or your *related persons* have *custody, broken out by category of the adviser's basis for custody)*; and
- Item 9.D.(2) (the approximate amount of client assets not maintained by a qualified custodian) unless the adviser's response to Item 9.D.(1) (whether client assets are not maintained by a qualified custodian) has changed.

Transition Period and Compliance Date

The proposed effective date for the proposed rule and related Form ADV amendments would be sixty (60) days after the date of publication of the final rules in the Federal Register. Likely a welcome change to past practice,[67] the proposal includes two different compliance dates based on the amount of regulatory assets under management (RAUM). For advisers with more than $1 billion in RAUM the transition to compliance period would end one year following the effective date. For advisers with up to

$1 billion in RAUM, the transition to compliance period would end 18 months following the effective date.

A number of commenters suggested an extended compliance period, with a few commenters suggesting at least a three-year compliance period or as much as a three and a half-year compliance period for small advisers.[68] A number of commenters just requested more time to consider the proposal in light of the volume of proposed and recently adopted rules issued by the SEC.[69]

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NOTES

1 *See* Chair Gensler's February 15, 2023 open meeting remarks regarding work by Melissa Roverts Harke, Assistant Director, SEC, at *https://youtu.be/_vC91WIzmGg*.

2 *Safeguarding Advisory Client Assets*, Release No. IA-6240 (Feb. 15, 2023) [88 FR 14672 (Mar. 9, 2023)] (Proposing Release).

3 Proposing Release, *supra* n.2 at 14676.

4 *See Custody or Possession of Funds or Securities of Clients*, Investment Advisers Act Release No. 123 (Feb. 27, 1962) [44 FR 2149 (Mar. 6, 1962)] (1962 Adopting Release).

5 Another example of how times have changed over the years during which the custody rule has been in effect is the length of SEC rule releases. The proposing release for the 2003 amendment, which was adopted just over 20 years, was only 14 pages long. *See Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2044 (Jul. 18, 2002) [67 FR 48579 (Jul. 25, 2002)] (2002 Proposing Release).

6 *See Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2968 (Dec. 30, 2009) [75 FR 1455 (Jan. 11, 2010)] (2009 Adopting Release).

7 Public Law 111–203, 124 Stat. 1376 (2010).

8 *See* Comment Letter from Steven Wager, Chair, Americas Focus Committee, The Association of Global Custodians (Mary 8, 2023) (AGC Letter), Comment Letter from Rebekah Goshorn Jurata, General Counsel, American Investment Council (May 8, 2023) (AIC Letter), Comment Letter from Teresa Heitsenrether, Executive Vice President, Global Head of JPM Security Services and Troy Rohrbaugh, Executive Vice President, JPM Head of Global Markets (May 3, 2023) (JPM Letter), Comment Letter from Kristen Malinconico, Director, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce (May 8, 2023) (U.S. Chamber of Commerce Letter), Comment Letter from John L. Thornton, Co-Chair, Committee on Capital Markets Regulation, Hal S. Scott, President, Committee on Capital Markets Regulation, and R. Glenn Hubbard, Co-Chair, Committee on Capital Markets Regulation (May 8, 2023) (CCMR Letter), Comment Letter from David C. Phelan, Executive Vice President and General Counsel, State Street Corporation (May 11, 2023), Comment Letter from Jennifer W. Han, Executive Vice President, Chief Counsel & Head of Global Regulatory Affairs, Managed Funds Association (May 8, 2023) (MFA Letter).

9 Proposing Release, *supra* n.2 at 14675-14676.

10 Proposing Release, *supra* n.2 at 14678-14679.

11 In the Proposing Release the Staff expressly stated that crypto assets that are funds or securities are subject to the current custody rule, which applies to all "funds and securities" over which an adviser has custody. Whether a crypto asset is a security turns on whether the asset is an investment contract under the test set forth by the Supreme Court in SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946). *See* Proposing Release, *supra* n.2 at ns.29 and 58.

12 Proposing Release, *supra* n.2 at 14679.

13 *See* SIFMA Letter, *infra* n.46 (noting the SEC used the phrase "client assets" as a convenient shorthand form for "funds or securities" in a 2010 Form ADV amendment adopting release), Comment Letter from Andrew Vollmer, Senior Affiliated Scholar, Mercatus

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Center at George Mason University (April 7, 2023) (Vollmer Letter) (the term client assets is a short-form expression for the types of client assets normally handled by an investment adviser as defined by the Advisers Act: securities or the funds related to them), U.S. Chamber of Commerce Letter (it is reasonable to consider that Congress' use of the term "client assets" should be read to only refer to those assets under the scope of the SEC's regulatory authority, specifically, securities and cash related to buying and selling securities.).

14 Proposing Release, *supra* n.2 at 14674.

15 *See* Proposing Release *supra* n.2 at n. 14 and accompanying text (discussing the statement of James S. Chanos, Chairman, Coalition of Priv. Inv. Companies). Note, as highlighted in the Vollmer Letter, *supra* n.13, the Proposing Release cites the wrong Congressional hearing for Mr. Chanos's testimony. For the full of Mr. Chanos's testimony, *see* Regulating Hedge Funds and Other Private Investment Pools, Hearing Before the Subcomm. on Sec., Ins., and Inv. of the Sen. Comm. on Banking, Housing, & Urb. Aff., 111th Cong. 50–51 (2009) (statement of James S. Chanos, Chairman, Coalition of Priv. Inv. Companies)), which can be found at *CHRG-111shrg54883.pdf* (*govinfo.gov*), starting at 44 (Chanos Statement). For more on the legislative history, *see* the Vollmer Letter, *supra* n.13.

16 *See* Chanos Statement at n.19 and accompanying text:

> In addition, the SEC's custody rules under the Advisers Act are insufficient to protect private investment fund assets from theft or prevent other forms of fraud. Although the SEC recently proposed amendments to these rules, even as proposed to be amended, the rules do not fully protect the assets of private investment funds. For example, the rules exclude from custody requirements certain types of instruments that are commonly owned by private investment funds, an exclusion that would deprive investors in those funds of the protection that a custodian provides. Access control requirements under the rules are rudimentary at best, particularly for assets other than publicly traded securities. . . These instruments are privately issued uncertificated securities, bank deposits, real estate assets, swaps, and interests in other private investment funds, as well as shares of mutual funds, which, under current law, can simply be titled in the name of the private investment fund care of the manager, and the evidence of ownership held in a file drawer at the manager of the private investment fund. The issuers of those assets are permitted to accept instructions from the manager to transfer cash or other value to the manager. This gaping hole in current Advisers Act custody requirements can allow SEC-registered advisers easily to abscond with money or other assets and falsify documentation of ownership of certain categories of assets, and makes it difficult for auditors, investors and counterparties to verify the financial condition of advisory accounts and private investment funds. Requiring independence between the function of managing a private investment fund and controlling its assets, by requiring that all assets be titled in the name of a custodian bank or broker-dealer for the benefit of the private fund and requiring all cash flows to move through the independent custodian, would be an important control. Similarly, requiring an independent check on the records of ownership of the interests in the private investment fund, as well as imposing standards for the qualification of private investment fund auditors—neither of which currently is required by the Advisers Act— would also greatly reduce opportunities for mischief.

17 *See* Proposing Release, *supra* n.2 at 14677, *citing Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2176 (Sept. 25, 2003) [68 FR 56692 (Oct. 1, 2003)]

(2003 Adopting Release) at n. 10 and accompanying text (clients' custodians are generally under instructions to transfer funds or securities out of a client's account only upon a corresponding transfer of securities or funds into the account).

18 The 1962 version of the custody rule applied to all investment advisers, whether registered or exempt, until the rule's 1997 amendment. Currently, state registered investment advisers are generally subject to custody rules adopted by state securities regulators based on the model custody rule of the North American Securities Administrators or language similar to either the NASAA model custody rule or the SEC custody rule.

19 Proposing Release, *supra* n.2 at n.3.

20 Custody rule 206(4)-2(d)(6)(iv).

21 2003 Adopting Release, *supra* n.17 at n. 22.

22 Proposed rule 223-1(d)(10)(iv).

23 *See* CCMR Letter, *supra* n.8.

24 Proposing Release, *supra* n.2 at 14684.

25 *See* U.S. Chamber of Commerce Letter.

26 Proposing Release, *supra* n.2 at 14683.

27 Proposing Release, *supra* n.2 at 14694.

28 Proposed rule 223-1(a)(3).

29 Proposing Release, *supra* n.2 at 14678.

30 *See* SIFMA Letter, *infra* n.46, AGC Letter, *supra* n.8, Comment Letter from Peter B. Cherecwich, President, Asset Servicing, Northern Trust Corporation (May 8, 2023) (Northern Trust Letter).

31 *See* Northern Trust Letter, *supra* n.30.

32 *See* Northern Trust Letter, *supra* n.30, AGC Letter, *supra* n.8 (cash segregation would undermine one of the objectives of the federal deposit insurance regime by affording the claims of some stakeholders (that is, investment adviser clients) priority over the claims of general depositors and the Federal Deposit Insurance Corporation (FDIC) as receiver.), JPM Letter, *supra* n.8, Comment Letter from Roman Regelman, CEO of Securities Services and Digital, BNY Mellon (May 8, 2023).

33 *See* Private Funds and Application of the Custody Rule to Special Purpose Vehicles and Escrows, Division of Investment Management Guidance Update No. 2014–07 (June 2014), Madison Capital Funding LLC, SEC Staff No-Action Letter (Dec. 20, 2018) (Madison No-Action Letter). Note, the Proposing Release requested comment on both positions. However, few industry comments on point were made despite industry practice of reliance on this guidance. *See* Comment Letter from Apratim (Robby) Sen, Associate General Counsel, Apogem Capital LLC (May 8, 2023) (requesting the SEC preserve the relief given in the Madison No-Action Letter as part of the adoption of any final rule by codifying an exception directly into the rule text or alternatively, by incorporating an exception in interpretive guidance in the adopting release to Rule 223-1).

34 Proposed rule 223-1(d)(8).

35 Proposing Release, *supra* n.2 at 14687.

36 *See* SIFMA Letter, *infra* n.46.

37 *See* Comment Letter from Pete Tomlinson, Head of Post Trade, Association for Financial Markets in Europe; John Siena, Chair, Association of Global Custodians—European Focus Committee; and Wim Mijs, Chief Executive Officer, European Banking Federation (May 8, 2023).

38 *See* Comment Letter from Lisa Crossley, NSCP Executive Director and CEO, National Society of Compliance Professionals (May 11, 2023) (NSCP Letter).

39 Proposing Release, *supra* n.2 at 14691.

40 Proposing Release, *supra* n.2 at 14693.

41 Proposing Release, *supra* n.2 at 14749.

42 *See* Comment Letter from Craig Pfeiffer, President and CEO, Money Management Institute (May 8, 2023) (MMI Letter) (if the proposal requires an adviser to enter into written agreements and receive written assurances from each qualified custodian, that will effectively shut down these programs).

43 *See* AGC Letter, *supra* n.8, JPM Letter, *supra* n.8. *See also* Proposing Release, *supra* n.2 at 14750 (Staff believes custodians have been reluctant to modify or customize advisers' level of authority because doing so would increase qualified custodians' need to monitor customer accounts, and to accept liability,

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for unauthorized transactions by an adviser and its personnel; the proposed rule could create operational costs for qualified custodians including the costs of adapting existing systems and processes to modify or customize the level of authority of investment advisers with respect to customer accounts), ICI Letter, *infra* n.49 (the requirement can be read to inappropriately put the qualified custodian in the place of monitoring the adviser's trading activities to ensure consistency with the investment management agreement between the adviser and its client).

[44] *See* AGC Letter, *supra* n.8.

[45] Proposing Release, *supra* n.2 at 14693

[46] *See* AIC Letter, *supra* n.8 (the SEC cannot regulate these qualified custodians indirectly by requiring commercial terms be included in the agreement, which would not otherwise exist but for the SEC's own proposed regulatory requirement.), Comment Letter from Kevin M. Carroll, Deputy General Counsel, SIFMA (May 8, 2023) (SIFMA Letter) (the proposal exceeds the SEC's regulatory authority by imposing private contractual terms and other obligations on third-party qualified custodians over whom the SEC does not have jurisdiction), Vollmer Letter, *supra* n.13 (the proposed rule is an attempt to regulate the business of custodians through the guise of regulations telling advisers what a custodian must do, and would usurp the regulation of custodians by other federal regulators and foreign authorities), Comment Letter from Major L. Clark, III, Deputy Chief Counsel, Office of Advocacy, U.S. Small Business Administration and Meagan E. Singer, Assistant Chief Counsel, Office of Advocacy, U.S. Small Business Administration (May 5, 2023 (SBA Letter) (many of the proposed changes appear to be aimed at correcting issues with qualified custodians), U.S. Chamber of Commerce Letter (The SEC's attempt at backdoor regulation of custodians in this Proposal is neither appropriate nor lawful.).

[47] *See* Comment Letter from Peter C. Dean, General Counsel, New York Department of Financial Services (May 8, 2023) (NYDFS Letter).

[48] *See* ICI Letter, *infra* n.49.

[49] *See* Comment Letter from Dorothy M. Donohue, Deputy General Counsel, Investment Company Institute (May 8, 2023) (ICI Letter).

[50] Proposing Release, *supra* n.2 at 14675.

[51] Proposing Release, *supra* n.2 at 14707.

[52] *See* Comment Letter from Nelson N. Lee, Senior Vice President and Senior Counsel, Capital Research and Management Company and Tim Moon, Counsel, Capital Research and Management Company (May 8, 2023) (Capital Research Letter); *see* NSCP Letter, *supra* n.38.

[53] *See* Comment Letter from KPMG LLP (May 8, 2023) (KPMG Letter); Comment Letter from Ernst & Young LLP, (May 8, 2023) (E&Y Letter) and Comment Letter from Deloitte & Touche LLP (May 3, 2023) (Deloitte Letter), Comment Letter from PricewaterhouseCoopers LLP (May 8, 2023) (PWC Letter) (suggesting a risk-based approach that allows independent public accountants to develop a response that is efficient and effective—tailoring the nature, timing, and extent of their examination or audit procedures to appropriately address the assessed risks of material misstatement relevant to the nature and unique risks of an asset class).

[54] *See* KPMG Letter, *supra* n.53.

[55] *See* E&Y Letter, *supra* n.53.

[56] *See* E&Y Letter, *supra* n.53; *see* PWC Letter, *supra* n.53.

[57] *See* SIFMA Letter, *supra* n.46.

[58] *See* PWC Letter, *supra* n.54.

[59] Proposing Release, *supra* n.2 at 14675.

[60] Proposed rule 223-1(b)(7),

[61] Proposing Release, *supra* n.2 at 14675.

[62] *See* Investment Adviser Association, SEC Staff No-Action Letter (Feb. 21, 2017).

[63] *See* Comment Letter from Andrew Hartnett, NASAA President and Deputy Commissioner, Iowa Insurance Division, North American Securities Administrators Association (May 8, 2023).

[64] Proposing Release, *supra* n.2 at 14726.

[65] Proposing Release, *supra* n.2 at 14729.

[66] Proposing Release, *supra* n.2 at 14678.

[67] However, *see* Comment Letter from Bernie Clark, Managing Director, Head of Advisor Services, Charles Schwab & Co., Inc. (May 8, 2023) (adopting a uniform compliance date for both small and large firms creates more certainty and consistency across the industry).

[68] *See* SIMFA Letter, *supra* n.46, Capital Research Letter, *supra* n.52.

[69] *See, e.g.*, Comment Letter from Elliot Ganz, Head of Advocacy, Co-Head of Public Policy, LSTA (March 7, 2023), Comment Letter from Michael S. Hong, Chair, Private Investment Funds Committee, Patrick Campbell, Chair and Adam Felsentahl, Chair, Compliance Committee, New York City Bar Association Committee on Private Investment Funds and Committee on Compliance (April 14, 2023), and Comment Letter from ABA Securities Association, Alternative Credit Council, Alternative Investment Management Association, American Bankers Association, American Investment Council, Association of Global Custodians, Independent Community Bankers of America, Investment Adviser Association, Investment Company Institute, LSTA, Managed Funds Association, and Securities Industry and Financial Markets Association (March 3, 2023).

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