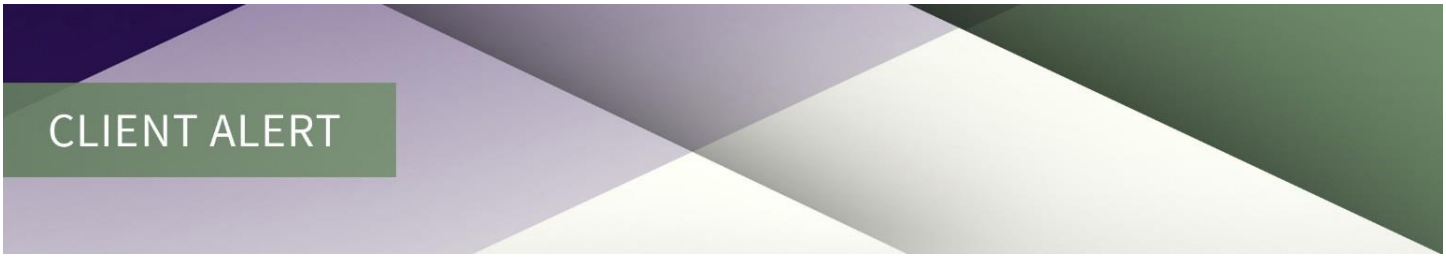

SEC Proposes Amendments to Investment Adviser Custody Requirements

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AUTHORS

Adam Aderton | Benjamin B. Allensworth | James E. Anderson | Justin L. Browder
Anne C. Choe | Michael Selig | Jonathan Tincher

On February 15, 2023, the Securities and Exchange Commission (the "SEC") voted 4-1 to propose amendments to the rule relating to custody of client funds and assets by registered investment advisers, Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940 (the "Advisers Act").[1] If adopted, the proposal would amend and re-designate current Rule 206(4)-2 as new Rule 223-1, which is referred to as the "Safeguarding Rule." The Safeguarding Rule would expand the current Custody Rule to apply to a broader array of asset classes and advisory activities, increase the requirements placed on advisers with custody and the availability of existing exceptions to certain requirements, and increase related recordkeeping and reporting requirements placed on advisers. If adopted, the Safeguarding Rule likely would present significant operational and compliance challenges for certain intermediaries that currently serve as qualified custodians and for investment advisers that focus on strategies involving non-traditional asset classes, including, in particular, crypto assets. Comments are due 60 days after publication in the Federal Register, which has yet to occur as of the date of this publication.

I. Overview of the Safeguarding Rule

The Safeguarding Rule would expand the scope of the current Custody Rule from client "funds and securities" to include all client assets over which an adviser has custody. "Assets" would mean "funds, securities, or other positions held in a

[1] *See* Safeguarding Advisory Client Assets, Advisers Act Release No. IA-6240 (Feb. 15, 2023) (the "Proposing Release"), *available* here. The Safeguarding Rule would apply only to registered investment advisers.

client's account" and would include all assets that investment advisers custody for their clients, including crypto assets, commodities, real estate and other physical assets.[2] An adviser would also be deemed to have custody of client assets solely as a result of having discretionary authority to trade client assets. Like the Custody Rule, the Safeguarding Rule would require advisers with custody of client assets to maintain those assets with a qualified custodian, with limited exceptions. The qualified custodian would be required to have "possession or control" of advisory client assets and hold those assets in a manner specified by the Rule. The SEC's proposal also would, among other things:

- Require that an adviser enter into a written agreement with and obtain certain reasonable assurances from qualified custodians to ensure clients receive certain standard custodial protections when an adviser has custody of their assets.
- Modify the Custody Rule's exception from the obligation to maintain client assets with a qualified custodian for certain privately offered securities, including expanding the exception to include certain physical assets;
- Retain the Custody Rule's requirement for an adviser to undergo a surprise examination by an independent public accountant to verify client assets, but expand the availability of the Custody Rule's audit provision as a means of satisfying the surprise examination requirement;
- Amend the investment adviser recordkeeping rule to require advisers to keep additional, more detailed records of trade and transaction activity and position information for each client account of which it has custody; and
- Amend Form ADV to align advisers' reporting obligations with the Safeguarding Rule's requirements.

II. Scope of the Safeguarding Rule

Consistent with the Custody Rule, the Safeguarding Rule would apply to any investment adviser registered or required to be registered with the SEC that has "custody" of client assets, and to any adviser whose "related persons" have custody in connection with advisory services the adviser provides to clients.[3] The Safeguarding Rule would change the Custody Rule's scope in two important ways: First, the Safeguarding Rule would extend the Rule's coverage beyond client "funds and securities" to client "assets" to include all investments held in a client's account. Second, the Safeguarding Rule would expand the meaning of "custody" to include discretionary authority over client assets.[4]

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[2] *See* Safeguarding Rule 223-1(d)(1).

[3] *See* Proposing Release, at 26; *see also* Safeguarding Rule 223-1. Consistent with the Custody Rule, the Safeguarding Rule would define the term related person as "any person, directly or indirectly, controlling or controlled by [the investment adviser], and any person that is under common control with [the investment adviser]." Safeguarding Rule 223-1(d)(11).

[4] *See* Proposing Release, at 26-27.

Scope of Assets: The Safeguarding Rule would define "assets" as "funds, securities, or other positions held in a client's account."[5] The Safeguarding Rule's use of the term "other positions" in the definition of assets is intended to encompass holdings that may not necessarily be recorded on a balance sheet as an asset for accounting purposes, such as short positions and written options.[6] As discussed below, the definition also would include crypto assets, even when such assets are neither funds nor securities. Additionally, collateral posted in connection with a swap contract on behalf of the client, and physical assets such as artwork, real estate, and physical commodities would be within the scope of the Safeguarding Rule.

Scope of Activity Subject to the Safeguarding Rule: The Safeguarding Rule would retain the existing categories in the Custody Rule's definition of "custody," and apply when an adviser "holds, directly or indirectly, client assets, or has any authority to obtain possession of them."[7] The current definition of custody includes three categories of arrangements under which an adviser is deemed to have custody of client funds and securities: (1) physical possession; (2) arrangements (including a general power of attorney) whereby the adviser is authorized or permitted to instruct the client's custodian to make withdrawals; and (3) circumstances when the adviser acts as a general partner or in a similar capacity that gives the adviser or its supervised person legal ownership of or access to client funds or securities. The Safeguarding Rule would introduce discretionary trading authority as an arrangement that would be deemed to give an adviser custody of client assets.[8] Specifically, the amended definition of custody would include any arrangement (including, but not limited to, a general power of attorney or discretionary authority) under which the adviser is authorized or permitted to withdraw or transfer beneficial ownership of client assets upon the adviser's instruction to a third party. Consistent with current requirements, an adviser would be required to comply with the Safeguarding Rule in circumstances where the adviser provides advisory services related to a person's assets, even if uncompensated.[9] The Proposing Release requests comment on, but does not specifically address, whether sub-advisers that have discretionary trading authority (but otherwise would not have custody under the Safeguarding Rule) should be provided an exception to all or certain aspects of the Safeguarding Rule.

Crypto Asset Considerations: The proposed definition of "assets" would capture a broad swath of commodities and instruments that may not be funds or securities, including non-security crypto assets. The Proposing Release states that "most crypto assets are likely to be funds or securities," suggesting that the SEC views most crypto assets as already subject to the current Custody Rule.[10] The SEC's views on this issue have been subject to significant debate among

5 Safeguarding Rule 223-1(d)(1).

6 Proposing Release, at 28.

7 *Id.* at 30; Safeguarding Rule 223-1(d)(3).

8 Proposing Release, at 32.

9 *Id.* at 26, n.51.

10 *Id.* at 18.

industry participants and commenters. The majority of crypto asset issuers, exchange operators and custodians, for example, do not treat most crypto assets as securities. In her dissent, Commissioner Hester Peirce noted her disagreement with "the main premise that most crypto assets are securities and the sub-premise that crypto assets sold in a securities offering are necessarily themselves securities."[11]

III. Qualified Custodian Protections

As under the Custody Rule, the Safeguarding Rule would require investment advisers with custody of client assets to maintain those assets with a qualified custodian.[12] Under the Custody Rule, the institutions that are eligible to serve as qualified custodian are limited to federal and state-chartered bank or savings associations, certain trust companies, registered broker-dealers, registered futures commission merchants ("FCMs"), and certain foreign financial institutions ("FFIs"). Under the Safeguarding Rule, these institutions would continue to be eligible to act as qualified custodians, but, in a change from the Custody Rule, only if they have "possession or control" of client assets pursuant to a written agreement between the qualified custodian and the investment adviser.[13] In another change from the Custody Rule, the Safeguarding Rule would modify the definition of foreign financial institution and the requirements applicable to banks and savings associations.[14]

A. Definition of Qualified Custodian

The Safeguarding Rule, like the Custody Rule, would define the term "qualified custodian" to mean a bank or savings association, registered broker-dealer, registered FCMs, or certain type of FFIs that meets the specified conditions and requirements.[15]

Bank and Savings Association Qualified Custodian Proposed Amendments: The Safeguarding Rule would largely retain the current definition of qualified custodian relating to banks and savings associations. Under the Rule, the definition of bank includes both state and nationally chartered banks as well as certain trust companies. However, the Safeguarding Rule would require that a qualifying bank or savings association hold client assets in an account that is designed to protect the assets from creditors of the bank or savings association in the event of the insolvency or failure of the bank or savings association in order to be a qualified custodian.[16] The account terms would need to identify clearly that the

[11] Commissioner Hester M. Peirce, Statement on Safeguarding Advisory Client Assets Proposal (Feb. 15, 2023), *available* here.

[12] Proposing Release, at 41.

[13] *Id.* at 42; *see also* Safeguarding Rule 223-1(a)(1).

[14] Proposing Release, at 42.

[15] *Id.* at 43; *see also* Safeguarding Rule 223-1(d)(10).

[16] The Custody Rule requires that in order to be included in the definition of qualified custodian, a broker-dealer registered under Section 15(b)(1) of the Securities Exchange Act of 1934, must hold the client assets in customer accounts, a futures commission merchant registered under Section 4f(a) of the Commodity Exchange Act must hold the client assets in customer accounts subject to certain additional requirements, and an FFI must customarily

account is distinguishable from a general deposit account and clarify the nature of the relationship between the account holder and the qualified custodian as a relationship account that protects the client assets from creditors of the bank or savings association in the event of the insolvency or failure of the bank or savings association.[17]

Proposed Enhancements to Definition of Foreign Financial Institution: An FFI would be required to satisfy seven new conditions in order to serve as a qualified custodian for client assets under the Safeguarding Rule. To be a qualified custodian, an FFI would need to be:

- Incorporated or organized under the laws of a country or jurisdiction other than the United States, so long as the adviser and the SEC are able to enforce judgments, including civil monetary penalties, against the FFI;[18]
- Regulated by a foreign country's government, an agency of a foreign country's government, or a foreign financial regulatory authority as a banking institution, trust company, or other financial institution that customarily holds financial assets for its customers;
- Required by law to comply with anti-money laundering and related provisions similar to those of the Bank Secrecy Act and regulations thereunder;
- Able to hold financial assets for its customers in an account designed to protect such assets from creditors of the foreign financial institution in the event of the insolvency or failure of the foreign financial institution;
- In possession of the requisite financial strength to provide due care for client assets;
- Required by law to implement practices, procedures, and internal controls designed to ensure the exercise of due care with respect to the safekeeping of client assets; and
- Not operated for the purpose of evading the provisions of the Safeguarding Rule.[19]

Crypto Considerations: Although at least one crypto asset custodian is chartered as a national trust company, the majority of institutional crypto asset custodians today are state-chartered trust companies or Wyoming special purpose depository

hold financial assets for its customers and must keep the advisory clients' assets in customer accounts segregated from its proprietary assets. *See* Rule 206(4)-2(d)(6)(ii), (iii), and (iv). *See also* Safeguarding Rule 223-1(d)(10).

[17] Proposing Release, at 46. The Proposing Release does not indicate whether the SEC consulted with federal or state banking authorities in crafting the proposal; however, the SEC is requesting comment on whether these accounts should be required for all banks, or only a subset. The SEC is also requesting comment on whether any alternatives should be considered. *See id.* at 54.

[18] The Proposing Release does not provide an estimate of the number of foreign jurisdictions where SEC judgments cannot be enforced. The SEC is requesting comment on whether or not this should be a requirement. *See id.* at 57.

[19] *Id.* at 47-48; Safeguarding Rule 223-1(d)(10)(iv).

institutions ("SPDIs"). It remains to be seen whether and to what extent state-chartered trust companies and SPDIs would need to change their existing practices to meet the conditions under the Safeguarding Rule if it is adopted as proposed.

B. Possession or Control

Under the Safeguarding Rule, "possession or control" would be defined to mean holding assets such that: (1) the qualified custodian is required to participate in any change in beneficial ownership of those assets; (2) the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership; and (3) the qualified custodian's involvement is a condition precedent to the change in beneficial ownership.[20]

Crypto Considerations: While qualified custodians are generally considered to have "possession or control" of assets that are in their exclusive or physical possession or control, the Proposing Release notes that proving exclusive control of crypto assets may be more challenging. In light of this, the Proposing Release notes that a qualified custodian would have possession or control of a crypto asset if the qualified custodian generates and maintains private keys for the wallets holding advisory client crypto assets in a manner such that an adviser is unable to change beneficial ownership of the crypto asset without the custodian's involvement.[21] To comply with the Safeguarding Rule, an adviser with custody of client crypto assets would generally need to ensure those assets are maintained with a qualified custodian that has possession or control of the assets at all times in which the adviser has custody.[22] As a consequence, the current market practice of trading crypto assets on platforms that are not qualified custodians would constitute a violation of the Safeguarding Rule.[23] The Proposing Release's approach toward this issue has significant potential consequences for advisers that utilize qualified custodians, but trade assets on the custodian's affiliated exchange platform that is operated through a non-qualified custodian entity insofar as the adviser could be deemed to violate the Safeguarding Rule each time that assets are moved from the custody entity to the trading platform for execution.

The requirement that the custodian maintain possession or control of the advisory client assets could also eliminate the ability for advisers subject to the Safeguarding Rule to stake crypto assets on many blockchains and utilize crypto assets within decentralized finance ("DeFi") protocols. In these instances, the adviser's crypto assets generally must be deposited into and locked within a smart contract and would be subject to withdrawal restrictions enforced by the relevant blockchain or DeFi protocol. In his statement regarding the proposal, Commissioner Mark Uyeda bluntly stated that the proposed prohibition of trading by investment advisers on crypto asset platforms that are not qualified custodians

[20] Proposing Release, at 62; Safeguarding Rule 223-1(a)(1)(i) and (d)(2)(8).

[21] Proposing Release, at 67.

[22] *Id.*

[23] *Id.* at 68.

"appears to mask a policy decision to block access to crypto as an asset class. It deviates from the Commission's long-standing position of neutrality on the merits of investments."[24]

C. Written Agreement

Under the Safeguarding Rule, an investment adviser would be required to maintain client assets with a qualified custodian pursuant to a written agreement between the qualified custodian and the investment adviser (or between the adviser and client if the adviser is also the qualified custodian).[25] For certain protections for which the qualified custodian's duty runs primarily or exclusively to the advisory client, the Safeguarding Rule would require the adviser to obtain reasonable assurances of certain minimum investor protection elements for advisory clients.[26] The agreements would be required to incorporate certain minimum investor protection elements for advisory clients.[27] The following elements would all be required to be part of a written agreement with the client.

1. Reasonable Assurances

Due Care: The Safeguarding Rule would require that an adviser with custody obtain reasonable assurances in writing from the qualified custodian that 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 types of loss.[28] The Proposing Release notes that the appropriateness of the measures required to be taken under this standard may vary depending on the asset. For example, the exercise of due care may require that crypto assets be stored in a cold wallet, but depending on the circumstances, such as when a client seeks to buy and sell crypto assets very frequently, due care may mean the use of hot wallets in combination with robust policies and procedures.[29]

Indemnification: An adviser would be required to obtain reasonable assurances in writing from the qualified custodian that 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 in the event of the qualified custodian's own negligence, recklessness, or willful

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[24] Commissioner Mark T. Uyeda, Statement on Proposed Rule Regarding the Safeguarding of Advisory Client Assets (Feb. 15, 2023), *available* here.

[25] The Proposing Release assumes "an internal burden of 1 hour each to prepare the written agreement" for an adviser and custodian as the basis for its estimation of the initial compliance costs. Proposing Release, at 354.

[26] Proposing Release, at 74; Safeguarding Rule 223-1(a)(1)(i).

[27] Proposing Release, at 77. The SEC further is proposing to require that the adviser reasonably believe that the contractual provisions and the reasonable assurances obtained by the adviser have been implemented by the qualified custodian. Further, as under the Custody Rule, the Safeguarding Rule would continue to permit an adviser or its related person to serve as a qualified custodian for client assets. *Id.* at 82.

[28] *Id.* at 84; Safeguarding Rule 223-1(a)(1)(ii)(A).

[29] Proposing Release, at 85-86.

misconduct.[30] In the SEC's view, this requirement would likely expand the protections provided by qualified custodians to advisory clients because of the application of a simple negligence standard for liability as opposed to the standard of gross negligence observed by the SEC staff in some instances.[31]

Sub-Custodian or Other Similar Arrangements: An adviser would be required to obtain reasonable assurances in writing from the qualified custodian that the existence of any sub-custodial, securities depository, or other similar arrangements with regard to client assets will not excuse any of the qualified custodian's obligations to the client.[32]

Segregation of Client Assets: An adviser would be required to obtain reasonable assurances in writing from the qualified custodian that the qualified custodian will clearly identify client assets as such, hold them in a custodial account, and segregate them from the qualified custodian's proprietary assets and liabilities.[33] The Proposing Release notes that the segregation requirement is not intended to preclude traditional operational practices in which client assets are held in omnibus accounts or otherwise commingled with assets of other clients.[34] In light of the proposed segregation requirements, the Safeguarding Rule would not include the Custody Rule's requirement to maintain client funds and securities with a qualified custodian: (1) in a separate account for each client under the client's name; or (2) in accounts that contain only client funds and securities under an adviser's name as agent or trustee for the clients.[35]

No Liens Unless Authorized in Writing: The Safeguarding Rule would require an adviser to obtain reasonable assurances in writing that 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.[36]

2. Additional Required Terms

Under the Safeguarding Rule, an adviser's written agreement with a qualified custodian would be required to contain the following additional terms.

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[30] *Id.* at 87; Safeguarding Rule 223-1(a)(1)(ii)(B). The Proposing Release notes that SEC staff have observed that custodians often include indemnification clauses in their custodial agreements with retail customers that are less favorable than in agreements with institutional investors. Proposing Release, at 88.

[31] Proposing Release, at 87-89.

[32] *Id.*; Safeguarding Rule 223-1(a)(1)(ii)(C).

[33] Proposing Release, at 91; Safeguarding Rule 223-1(a)(1)(ii)(D).

[34] Proposing Release, at 93.

[35] *Id.*; Rule 206(4)-2(a)(1).

[36] Proposing Release, at 95; Safeguarding Rule 223-1(a)(1)(ii)(E).

Provision of Records: The written agreement with the qualified custodian would be required to include a provision requiring the qualified custodian promptly, upon request, to provide records relating to client assets to the SEC or an independent public accountant for purposes of compliance with the Safeguarding Rule.[37]

Account Statements: The Safeguarding Rule would require that the written agreement provide that the qualified custodian will send account statements (unless the client is an entity whose investors will receive audited financial statements as part of the financial statement audit process pursuant to the audit provision of the Safeguarding Rule), at least quarterly, to the client and the investment adviser, identifying the amount of each client asset in the custodial account at the end of the period as well as all transactions in the account during that period, including advisory fees.[38] The account statements could also be delivered to the client's (or pooled investment vehicle investor's) independent representative.

In circumstances where an investor in a pooled investment vehicle is itself a pooled vehicle that is controlling, controlled by, or under common control with the adviser or its related persons (a "control relationship"), the contract with the qualified custodian must require quarterly account statements to be delivered by the qualified custodian to all of the investors in each pooled investment vehicle client, which includes looking through to investors in the underlying pooled vehicles (and any pooled vehicles in a control relationship with the adviser or its related persons, such as in a master-feeder fund structure).[39] Outside of a control relationship, such as when a private fund investor is an unaffiliated fund of funds, the qualified custodian would not need to look through the structure and could deliver the quarterly statement to the unaffiliated fund of funds' adviser or other designated party.[40] In addition, in a change from the Custody Rule, the Safeguarding Rule would require the written agreement to contain a provision prohibiting the qualified custodian from identifying assets on account statements for which the qualified custodian lacks possession or control, unless requested by the client.[41]

Internal Control Report: The written agreement with the qualified custodian would be required to provide that the qualified custodian, at least annually, will obtain, and provide to the investment 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.[42] In circumstances where the adviser or related person is the qualified custodian, the Safeguarding Rule will

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37 Proposing Release, at 96-97; Safeguarding Rule 223-1(a)(1)(i)(A).

38 Proposing Release, at 97-98; Safeguarding Rule 223-1(a)(1)(ii)(B).

39 Proposing Release, at 99; Safeguarding Rule 223-1(c).

40 *Id.*

41 *Id.* If a client requests inclusion of such assets, the account statement may identify the assets, but only if the account statement clearly indicates that the custodian does not have possession or control of the assets. *Id.* at 100.

42 *Id.* at 101. The Safeguarding Rule would define "independent public accountant" to mean a public accountant that meets the standards of independence described in Rule 2-01 of Regulation S-X. *Id.* at 103.

retain the Custody Rule's approach by requiring the independent public accountant that prepares the internal control report to verify that client assets are reconciled to a custodian other than the adviser or its related person.[43] In addition, the Safeguarding Rule would continue to require that if the qualified custodian is a related person or the adviser, the independent public accountant is registered with and subject to regular inspection as of the commencement of the engagement period, and as of each calendar year-end, by the Public Company Accounting Oversight Board ("PCAOB").[44]

Adviser's Level of Authority: The Safeguarding Rule would require that the written agreement with the qualified custodian specify the adviser's agreed-upon level of authority to effect transactions in the custodial account as well as any applicable terms or limitations.[45] The agreement must permit the adviser and the client to reduce the specified level of authority.

IV. Certain Assets Unable to Be Maintained with a Qualified Custodian

Under the Custody Rule, there is an exception to the requirement to maintain client funds and securities with a qualified custodian for "privately offered securities."[46] The definition of privately offered securities under the Custody Rule includes securities that are: (1) acquired from the issuer in a transaction or chain of transactions not involving any public offering; (2) uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client; and (3) transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.[47] For an adviser to a limited partnership or similar pooled investment vehicle to rely on this exception, the adviser also must comply with the Custody Rule's audit provision.[48] The Safeguarding Rule would alter the availability of this exception by adding the following conditions:

- The adviser must reasonably 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 transfers of beneficial ownership, of such assets.

- The adviser must reasonably safeguard the assets from loss, theft, misuse, misappropriation, or the adviser's financial reverses, including the adviser's insolvency.

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43 *Id.* at 104.

44 *Id.* at 104; Safeguarding Rule 223-1(a)(1)(i)(C)(1).

45 Proposing Release, at 105; Safeguarding Rule 223-1(a)(1)(i)(D).

46 Proposing Release, at 130.

47 *Id.*

48 *Id.*

- An independent public accountant, pursuant to a written agreement between the adviser and the accountant, must:
    - Verify 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
    - Notify the SEC within one business day upon finding any material discrepancies during the course of performing its procedures.
- The adviser must notify 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 the transaction.
- The existence and ownership of each of the client's privately offered securities or physical assets that is not maintained with a qualified custodian must be verified during the annual surprise examination or as part of a financial statement audit.[49]

A. Definition of Privately Offered Security and Physical Assets

The Safeguarding Rule's definition of privately offered securities would retain the elements of the Custody Rule's description that require the securities to be acquired from the issuer in a transaction or chain of transactions not involving any public offering, and transferable only with the prior consent of the issuer or holders of other outstanding securities of the issuer.[50] Like the Custody Rule, the Safeguarding Rule would require the securities to be uncertificated and ownership to be recorded only on the books of the issuer or its transfer agent in the name of the client.[51] However, the Safeguarding Rule also would require that the securities be capable of only being recorded on the nonpublic 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 under the Advisers Act.

The Safeguarding Rule does not define the term "physical asset" or include specific types of assets as examples.[52] However, the Proposing Release explains that real estate and physical commodities such as, corn, oil, and lumber would

[49] Safeguarding Rule 223-1(b)(2).

[50] Rule 206(4)-2(b)(2)(i). "Privately offered securities" are defined by Rule 206(4)-2(b)(2) as securities that are (1) acquired from the issuer in a transaction or chain of transactions not involving any public offering, (2) uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client, and (3) transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer. *See also* Safeguarding Rule 223-1(d)(9).

[51] Proposing Release, at 134. The term uncertificated would generally have the same meaning as set forth in Article 8 of the Uniform Commercial Code. Additionally, the Proposing Release notes the SEC would not view a security to be certificated where the certificate cannot be used to redeem, transfer, purchase, or otherwise effect a change in beneficial ownership of the security for which the certificate is issued. *Id.* at 135.

[52] *Id.* at 135-136.

be considered physical assets, while assets like cash, stocks, bonds, options, futures and funds would not, even if they provide exposure to physical assets.[53] 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 would not, themselves, qualify as physical assets and would not qualify for the exception from the qualified custodian requirement. Similarly, certain other forms of 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. 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.

Crypto Considerations: The Proposing Release expressly indicates that crypto asset securities and non-securities issued on public, permissionless blockchains would not satisfy the conditions of privately offered securities under the Safeguarding Rule.[54] The Proposing Release further indicates that such crypto assets would not be eligible to be self-custodied by the adviser through cold wallets or similar mechanisms. Crypto assets that are not securities would not qualify for the exception, the Proposing Release explains, because they do not satisfy the definition of a privately offered security under Safeguarding Rule 223-1(d)(9).

B. Adviser's Reasonable Determination

To be eligible for the privately offered securities exception, the Safeguarding 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.[55] The Proposing Release notes that an adviser's reasonable determination of whether a qualified custodian is able to maintain possession or control of a particular asset would generally involve an analysis of the asset and the available custodial market.[56] To do this, an adviser generally would need to obtain a reasonable understanding of the marketplace of custody services available for each client asset for which it has custody. The adviser's written documentation of its determination would need to contain material facts concerning its understanding of the custodial marketplace and a description of the client asset in issue. The Safeguarding Rule does not specify the frequency with which an adviser must make this determination.

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53 *Id.* at 136.

54 *Id.* at 135.

55 *Id.* at 136.

56 *Id.* at 137.

C. Adviser Reasonably Safeguards Assets

To rely on the privately offered securities exception, an adviser would be required reasonably to safeguard any privately offered securities or physical assets that are not maintained with a qualified custodian from loss, theft, misuse, misappropriation, or the adviser's financial reverses, including the adviser's insolvency.[57] With respect to privately offered securities, the Proposing Release explains that an adviser might "reasonably safeguard" an asset by looking to reasonable commercial standards, which may draw from a variety of protections such as enhanced recordkeeping, additional change of control terms in governance agreements, and designation of an agent required to be involved in transfers of beneficial ownership, among others.[58] With respect to physical assets, the Proposing Release explains that reasonable commercial standards may include storage in a secure facility or vault that adheres to exchange, clearing house, or other licensing requirements for participation in certain commodities markets; dual control procedures for access to assets in safekeeping; maintenance of records to evidence movement or transfer of assets (including details on depositor, beneficiary and/or the legal owner); periodic reconciliation of records with assets held (e.g., vault counts); separation of duties for movement or transfer of assets, recordkeeping and reconciliation; periodic audits; smoke detection and fire suppression systems; and insurance coverage for any custody-related losses incurred by its clients.[59] In addition, physical assets could be maintained with a third party that the adviser concludes could safeguard the assets in accordance with reasonable commercial standards.[60]

D. Notification and Prompt Independent Public Accountant Verification

To rely on the privately offered securities exception, an adviser would be required to enter into a written agreement with an independent public accountant.[61] The Safeguarding Rule would require the adviser to notify the independent public accountant of any purchase, sale, or other transfer of beneficial ownership of such assets within one business day.[62] The independent public accountant would need to verify the purchase, sale, or other transfer promptly upon receiving the required transfer notice.[63] The accountant further would be required to notify the SEC by electronic means directed to the

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57 *Id.* at 139.

58 *Id.* at 140.

59 *Id.* at 141.

60 *Id.* at 142.

61 Safeguarding Rule 223-1(b)(2)(iii).

62 Safeguarding Rule 223-1(b)(2)(iv).

63 Safeguarding Rule 223-1(b)(2)(iii)(A).

Division of Examinations within one business day upon finding any material discrepancies during the course of performing its procedures.[64]

E. Surprise Examination or Audit

Like the Custody Rule, the Safeguarding Rule would require advisers relying on the privately offered securities exception to undergo an annual surprise examination or rely on the audit provision of the Rule. In a change from the Custody Rule, the Safeguarding Rule would require each privately offered security or physical asset not maintained with a qualified custodian to be verified by an independent public accountant.[65]

V. Segregation of Client Assets

In addition to the requirement to obtain reasonable assurance of segregation of client assets at a qualified custodian, the Safeguarding Rule would require an adviser to segregate client assets from the adviser's assets and its related persons' assets in circumstances where the adviser has custody. Specifically, the Safeguarding Rule would require that client assets over which the adviser has custody:

- 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 its related persons' assets; and
- 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.[66]

The Safeguarding Rule would permit an adviser to identify the assets "for the benefit of" a particular client where assets may not be "titled or registered" in the client's name.[67] To the extent a client agrees to, or authorizes in writing, certain arrangements—such as those typical in a margin account, or arrangements in which an adviser deducts fees directly from client assets—the adviser would be excepted from the proposed prohibition against subjecting the client's assets to any right, charge, security interest, lien, or claim in favor of the investment adviser or a qualified custodian.[68]

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64 Safeguarding Rule 223-1(b)(2)(iii)(B).

65 Safeguarding Rule 223-1(b)(2)(v).

66 Proposing Release, at 165-166; Safeguarding Rule 223-1(a)(1).

67 Proposing Release, at 166.

68 Safeguarding Rule 223-1(a)(3)(iii).

VI. Investment Adviser Delivery of Notice to Clients

The Safeguarding Rule, like the Custody Rule, would require an adviser to notify its client in writing promptly upon opening an account with a qualified custodian on the client's behalf.[69] The notice would continue to include the qualified custodian's name, address, and the manner in which the investments are maintained and also would be required to include the custodial account number.[70] If the client is a pooled investment vehicle, the notice must be sent to all of the investors in the pool, with a similar look through for investors in underlying funds as for delivering account statements.[71] If adopted, this provision would require an adviser to send account opening notices only to clients for which it has opened new client accounts with a qualified custodian after the effective date of the Rule.[72]

VII. Amendments to the Surprise Examination Requirement

Under the Custody Rule, advisers with custody, subject to certain exceptions, must undergo an annual surprise verification by an independent public accountant subject to oversight by the PCAOB.[73] The Safeguarding Rule would add a new requirement that an adviser must reasonably believe that the written agreement with the custodian has been implemented.[74]

VIII. Exceptions from the Surprise Examination

A. Entities Subject to Audit

Similar to the Custody Rule, an adviser that obtains an audit of a client that is a limited partnership (or limited liability company, or another type of pooled investment vehicle or any other entity) at least annually and upon an entity's liquidation would be deemed to have complied with the surprise examination requirement under the Safeguarding Rule and would be exempt from the client notice and account statement delivery requirements.[75] The following requirements would apply to audits under the Safeguarding Rule:

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69 Safeguarding Rule 223-1(a)(2).

70 Proposing Release, at 174.

71 *Id.* at 175.

72 *Id.*

73 *Id.* at 176.

74 *Id.* at 177.

75 Safeguarding Rule 223-1(b)(4). The majority of the SEC's enforcement actions involving the Custody Rule in recent years have arisen from failure to satisfy the audit exemption to the surprise examination requirement. *See, e.g.*, SEC Charges Two Advisory Firms for Custody Rule Violations, One for Form ADV Violations, and Six for Both, Press Release, Securities and Exchange Commission (Sept. 9, 2022), *available* here.

- The audit must be performed by an independent public accountant that meets the standards of independence in Rule 2-01 of Regulation S-X and is subject to PCAOB oversight;[76]

- The audit must meet the definition of "audit" in Rule 1-02(d) of Regulation S-X, with the professional engagement period to begin and end as indicated in Rule 2-01(f)(5) of Regulation S-X;

- Audited financial statements must be prepared in accordance with U.S. Generally Accepted Accounting Principles ("U.S. GAAP") or, in the case of financial statements of entities organized under non-U.S. law or that have a general partner or other manager with a principal place of business outside the United States, must contain information substantially similar to statements prepared in accordance with U.S. GAAP and material differences with U.S. GAAP must be reconciled;

- Within 120 days (or 180 days in the case of a fund of funds or 260 days in the case of a fund of funds of funds) of an entity's fiscal year-end, the entity's audited financial statements, including any reconciliations to U.S. GAAP or supplementary U.S. GAAP disclosures, as applicable, are distributed to investors in the entity (or their independent representatives);[77] and

- Pursuant to a written agreement between the auditor and the adviser or the entity, the auditor notifies the Commission upon certain events.[78] This is a new requirement for the annual audit.

Similar to under the Custody Rule, an adviser could treat a special purpose vehicle ("SPV") as a separate client, in which case the adviser will have custody of the SPV's assets, or alternatively may treat the SPV's assets as assets of the pooled investment vehicles of which it has custody indirectly under the Safeguarding Rule.[79] If the adviser is relying on the audit provision and treats the SPV as a separate client, the Safeguarding Rule would require the adviser to comply separately with the Safeguarding Rule's audited financial statement distribution requirements. In that case, the adviser would be

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[76] The Proposing Release notes that an accountant's compliance with the PCAOB's interim inspection program for auditors of broker-dealers would satisfy the requirement for regular inspection by the PCAOB under the Safeguarding Rule until the effective date of a permanent program for the inspection of broker-dealer auditors that is approved by the SEC. Proposing Release, at 191-192. An accounting firm would not be considered to be "subject to regular inspection," however, if it is included on the list of firms that is headquartered or has an office in a foreign jurisdiction that the PCAOB has determined it is unable to inspect or investigate completely because of a position taken by one or more authorities in that jurisdiction in accordance with PCAOB Rule 6100. *Id.* at 192.

[77] The Proposing Release notes that the SEC staff would take a no-action position in the event that an adviser fails to distribute audited financial statements within the specified time frame because of unforeseeable circumstances if the adviser reasonably believed that the audited financial statements would be distributed by the applicable deadline. *Id.* at 198.

[78] Notice by the accountant to the SEC Division of Examinations would be required: (1) within one business day of issuing an audit report to the entity that contains a modified opinion; and (2) within four business days of resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed. Safeguarding Rule 223-1(b)(4)(v).

[79] Proposing Release, at 200.

required to distribute the SPV's audited financial statements to the pooled investment vehicle's beneficial owners. If, however, the adviser is relying on the audit provision and treats the SPV's assets as the pooled investment vehicle's assets of which it has custody indirectly, the SPV's assets would be required to be considered within the scope of the pooled investment vehicle's financial statement audit.

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, regardless of whether the SPV is a single purpose vehicle, multi-fund single purpose vehicle, or a multi-purpose vehicle (as applicable), provided that the SPV's assets would be considered within the scope of the financial statement audit of the pooled investment vehicle client(s) and the SPV has no owners other than the adviser, the adviser's related persons or the pooled investment vehicle clients that are controlled by the adviser or the adviser's related persons.[80]

If, however, the adviser uses an SPV to purchase one or more investments for one or more pooled investment vehicle clients and third parties that are not pooled investment vehicles controlled by the adviser or the adviser's related persons, the adviser would not be permitted to treat the SPV's assets as those of the pooled investment vehicle clients of which the adviser or the adviser's related persons has custody indirectly for purposes of the Safeguarding Rule.[81] Advisers will need to consider the impact of this limitation and determine whether an SPV must be treated as a separate client for purposes of the Safeguarding Rule.

B. Safeguarding Rule Discretionary Authority

The Safeguarding Rule would provide an exception from the surprise examination requirement if the adviser's sole basis for having custody is its possession of discretionary authority with respect to client assets that are maintained with a qualified custodian and 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 ("DVP") basis.[82] The exception would not be available in relation to client assets that do not settle on a DVP basis (e.g., certain privately offered securities), or if the adviser otherwise has custody of the client's assets (e.g., via power of attorney) unless an independent exception would apply (e.g., fee deduction).[83]

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80 *Id.*

81 *Id.* at 201.

82 Safeguarding Rule 223-1(b)(8). In DVP transactions, a client's custodian is under instructions to transfer assets out of the client's account only upon a corresponding transfer of assets into the account.

83 Proposing Release, at 208-09.

C. Standing Letters of Authorization

The Safeguarding Rule includes an exception from the surprise examination requirement if an adviser has custody of those assets solely because of a standing letter of authorization ("SLOA").[84] The Safeguarding Rule would define an SLOA as 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.[85] In such an arrangement, the client's qualified custodian would not be permitted to be a related person of the adviser. The authorization would be required to include the client's signature, the third-party recipient's name, and either the third party's address or the third party's account number at a custodian to which the transfer should be directed.[86] The authorization also would need to provide that the adviser has no ability or authority to designate or change any information about the recipient, including name, address, and account number.[87]

IX. Proposed Amendments to Recordkeeping Requirements

The Safeguarding Rule would amend Rule 204-2 to require an investment adviser that has custody of client assets to maintain a more detailed and broader scope of records than the existing requirements for such records.[88] The revised recordkeeping requirements would include:

- Retaining copies of required client notices and any responses;
- Creating and retaining records documenting client account identifying information, including copies of account opening records;
- Creating and retaining records of custodian identifying information, including copies of required qualified custodian agreements, copies of all records received from the qualified custodian relating to client assets, a record of the basis underlying the 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;

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84 Safeguarding Rule 223-1(b)(7).

85 Proposing Release, at 211.

86 *Id.* at 211-212.

87 *Id.* at 212; Safeguarding Rule 223-1(d)(12).

88 Proposing Release, at 217. Advisers would be required to maintain the proposed records for a period of not less than five years as required under the current books and recordkeeping rule. *See* Rule 204-2(e)(1).

- Creating and retaining a record that indicates the basis of the adviser's custody of client assets, including whether the adviser has discretionary authority or authority to deduct advisory fees from the account;
- Retaining copies of account statements delivered to clients;[89]
- Retaining copies of, and records relating to, standing letters of authorization;[90] and
- Retaining records related to the engagement of an independent public accountant pursuant to the Safeguarding Rule.[91]

Regarding transaction and position information in client accounts, the proposed amendments would include several modifications that would clarify certain obligations of the current recordkeeping rule's requirements.[92] First, the SEC proposed to modify the current requirement that an adviser maintain records related to a client's position in each security. The proposed amendments to Rule 204-2 would replace the current references to "security" or "securities" with "asset(s)" to align this requirement with the broader scope of the Safeguarding Rule. Second, the proposed amendments to Rule 204-2 would require an adviser's records to reflect, in addition to trade activity, other transaction activity in client accounts, which would be interpreted broadly to include all debits and credits to or from the account, including deposits, transfers, and withdrawals as well as cash flows, corporate action activity, maturities, expirations, expenses and income posted.[93] An adviser's records also would be required to include the date and price or amount of any purchases, sales, receipts, deliveries, including any one-way delivery of assets, and free receipt and delivery of securities and certificate numbers, deposits, transfers, withdrawals, cash flows, corporate action activity, maturities, expirations, expenses, income posted to the account, and all other debits and credits. The proposed amendments further would modify the current requirement that advisers keep copies of confirmations of all transactions effected by or for a client in the client's account.[94] The proposed amendments instead would expressly require advisers to keep 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.

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89 If the client is a pooled investment vehicle, the record would need to reflect the delivery of account statements, notices, or financial statements, as applicable, to all investors in such client pursuant to the Safeguarding Rule. Proposing Release, at 223.

90 These records generally 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. *Id.* at 226.

91 Specifically, these documents include: (1) all audited financial statements prepared under the Safeguarding Rule; (2) a copy of each internal control report received by the adviser; and (3) a copy of any written agreement between the independent public accountant and the adviser or the client, as applicable, required under the Safeguarding Rule.

92 *Id.* at 223.

93 *Id.* at 224.

94 *Id.*

X. Proposed Changes to Form ADV

The SEC proposed amendments to Form ADV to align with the Safeguarding Rule. Item 9 of Part 1A would collect information about an adviser's custody of "client assets" including a client's funds, securities, and other positions held in a client's account.[95]

- Item 9.A.(1) would require an adviser to indicate, in a single place, if they directly, or indirectly through a related person, have custody of client assets, including if custody is solely due to an adviser's ability to deduct fees from client accounts or because the adviser has discretionary authority.
- Item 9.A.(2) would preserve information currently reported in Item 9 about the amount of client assets and number of clients falling into each category of custody (i.e., direct or indirect) and further require an adviser to report similar information about client assets over which they have custody resulting from: (1) having the ability to deduct advisory fees; (2) having discretionary trading authority; (3) serving as a general partner, managing member, trustee (or equivalent) for clients that are private funds; (4) serving as a general partner, managing member, trustee (or equivalent) for clients that are not private funds; (5) having a general power of attorney over client assets or check-writing authority; (6) having a standing letter of authorization; (7) having physical possession of client assets; (8) acting as a qualified custodian; (9) being a related person with custody that is operationally independent; and (10) any other reason.
- Item 9.B would require an adviser to indicate whether it is relying on any of the exceptions from the Safeguarding Rule and, if so, to indicate on which exception(s) the adviser is relying.
- Item 9.C(1) would require an adviser to report whether client assets over which they or a related person have custody are maintained at a qualified custodian and the number of clients and approximate amount of client assets maintained with a qualified custodian.[96]
- Item 9.C.(1) also would require an adviser to report certain identifying information about each qualified custodian holding client assets.
    - Full legal name of the qualified custodian;
    - Location of the qualified custodian's office responsible for the services provided;

[95] *Id.* at 229-30.

[96] *Id.*

- Contact information for an individual to receive regulatory inquiries;
- Type of entity;
- Legal Entity Identifier (if applicable);
- Number of clients and approximate amount of client assets (rounded to the nearest $1,000) maintained by the qualified custodian; and
- Whether the qualified custodian is a related person, and if so, the identifying information for the independent public accountant engaged to prepare the proposed internal control report and verification required under the Safeguarding Rule.

- Item 9.C.(3) would require advisers to report information about accountants completing surprise examinations, financial statement audits, or verification of client assets under the Safeguarding Rule.[97]

The Safeguarding Rule would retain the current requirement that advisers file an other-than-annual amendment to Form ADV promptly if certain information provided in response to Item 9 becomes inaccurate in any way.[98] Specifically, an adviser would be required to file promptly an other-than-annual amendment to Form ADV if any of an adviser's responses regarding the following becomes inaccurate in any way: (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; (2) whether the adviser is relying on certain exceptions to the Safeguarding Rule; (3) whether client assets are maintained with a qualified custodian; (4) whether the adviser or a related person serves as a qualified custodian under the Safeguarding Rule; (5) whether client assets are not maintained by a qualified custodian; (6) whether the adviser is required to obtain a surprise examination by an independent public accountant under the Safeguarding Rule; or (7) whether the adviser is relying on the audit provision.[99]

XI. Existing SEC Staff No-Action Letters and Other Staff Statements

The Proposing Release noted that the staff of the SEC Division of Investment Management is reviewing certain of its no-action letters and other staff statements addressing the application of the Custody Rule to determine whether they should be withdrawn if the Safeguarding Rule is adopted. A list of the letters and other staff statements under review is included in the Proposing Release.

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97 *Id.* at 233.

98 *Id.*

99 *Id.* An adviser would be required to update the other information reported in Item 9 in its annual updating amendment *Id.* at 234-35.

XII. Proposed Transition Period and Compliance Date

The SEC proposed a one-year transition period for advisers with more than $1 billion in regulatory assets under management ("RAUM") to come into compliance with the Safeguarding Rule, if adopted, as well as corresponding amendments to Rule 204-2 and Form ADV.[100] For advisers with up to $1 billion in RAUM, the compliance date would be 18 months.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

Adam Aderton
202 303 1224
aaderton@willkie.com

Benjamin B. Allensworth
202 303 1273
ballensworth@willkie.com

James E. Anderson
202 303 1114
janderson@willkie.com

Justin L. Browder
202 303 1264
jbrowder@willkie.com

Anne C. Choe
202 303 1285
achoe@willkie.com

Michael Selig
212 728 3836
mselig@willkie.com

Jonathan Tincher
202 303 1176
jtincher@willkie.com

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[100] *Id.* at 240.