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SEC OVERHAUL OF CUSTODY RULE: IMPLICATIONS FOR QUALIFIED CUSTODIANS

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On February 15, 2023, the Securities and Exchange Commission ("Commission") proposed a new rule[1] for registered investment advisers that would replace Rule 206(4)-2 ("current rule") under the Investment Advisers Act of 1940 ("Advisers Act") with new Rule 223-1 under the Advisers Act ("proposed rule") and make related changes to the Rule 204-2, which governs investment adviser books and records, and Form ADV. Relying on its authority under section 411 of the Dodd-Frank Act, the Commission has proposed broadening the application of the current rule beyond client funds and securities to include any client assets of which an adviser has custody, including digital assets. The proposed rule would also: (i) legislate new minimum custodial protections, including mandating certain contractual terms of written agreements between custodians and advisers; (ii) modify the exception for certain privately offered securities, including expanding the exception to include certain physical assets; (iii) expand the availability of the "audit exception" to the surprise exam; and (iv) require more detailed records of trade and transaction activity and position information for each client account of which an adviser has custody.

Background

Originally adopted in 1962, the Commission most recently amended the current rule in 2009 after several enforcement actions against investment advisers involving fraudulent conduct that included misappropriation or other misuse of client assets involving affiliates of the adviser. Since that time, according to the Commission, updates are needed "to recognize the evolution in products and services investment advisers offer to their clients and to strengthen and clarify existing custody protections, while also proposing complementary refinements to how advisers report custody information on Form ADV and the books and records they are required to keep that are designed to improve our oversight and risk-assessment abilities." Like the current rule, the proposed rule would require advisers with custody of client assets to maintain those assets with a qualified custodian, with very limited exceptions. However, the proposed rule would introduce significant changes to the role of qualified custodians and their obligations to regulators, advisers, and investors, which is the focus of this article.

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Scope of Assets and Activity

The new proposed rule would revise the definition of "custody" to include any assets over which an adviser exercises discretionary trading authority. The proposed rule would define "assets" as "funds, securities, or other positions held in a client's account." The term "other positions" in the definition of assets encompasses holdings that may not necessarily be recorded on a balance sheet as an asset for accounting purposes, including, for example, short positions and written options, and would encompass 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. Assets under the rule also would include financial contracts held for investment purposes, collateral posted in connection with a swap contract on behalf of the client, and other assets that may not be clearly funds or securities covered by the current rule. Physical assets, including real estate, precious metals, or physical commodities, would be within the scope of the proposed rule.

Possession and Control

In a change from the current rule, the proposed rule would require that an investment adviser maintain client assets with a qualified custodian that has possession or control of those assets. For the purposes of the proposed rule, "possession or control" would be defined to mean holding assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets, the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership, and the qualified custodian's involvement is a condition precedent to the change in beneficial ownership.

Digital Assets

Importantly, the proposed rule's definition of assets would include investments such as digital assets, even in instances where such assets are neither funds nor securities. Yet, Commissioner Mark Uyeda, in his statement on the proposed rule,[2] observed that the proposing release (i) acknowledged that banking regulators have safety and soundness concerns with respect to a bank's ability to custody crypto assets but (ii) suggested that an adviser that trades crypto assets on a platform would, in many cases, violate the proposed rule because such platforms likely do not meet the qualified custodian standard.

New Qualified Custodian Definition

The proposed rule, like the current rule, would define the term "qualified custodian" to mean a bank or savings association, registered broker-dealer, registered futures commission merchant, or certain type of foreign financial

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institution ("FFI") that meets the specified conditions and requirements. However, in connection with the proposed rule's focus on setting certain minimum protections for client assets, the rule would require that a qualifying bank or savings association hold client assets in an account designed to protect such assets from creditors of the bank or savings association in the event of the insolvency or failure of the bank or savings association (*i.e.*, an account in which client assets are easily identifiable and clearly segregated from the bank's assets) in order to qualify as a qualified custodian. Additionally, the proposed rule would require that an FFI satisfy seven new conditions in order to serve as a qualified custodian for client assets. The conditions are based on the factors relevant to the safekeeping of "Foreign Assets" by the types of foreign financial entities that can act as an "Eligible Foreign Custodian" as defined in Rule 17f-5 under the Investment Company Act of 1940:

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

Minimum Custodial Protections

In a significant departure from the current rule, the proposed rule would mandate that an adviser enter into a written agreement with and obtain certain reasonable assurances from qualified custodians to satisfy "certain fundamental protections" that should be provided to a custodial customer when the adviser has custody:

- A qualified custodian should exercise due care and implement appropriate measures to safeguard the advisory client's assets;
- A qualified custodian should indemnify an advisory client when its negligence, recklessness, or willful misconduct results in that client's loss;
- A qualified custodian should not be relieved of its responsibilities to an advisory client as a result of sub-custodial arrangements;
- A qualified custodian should clearly identify an advisory client's assets and segregate an advisory client's assets from its proprietary assets;
- The client's assets should remain free of liens in favor of a qualified custodian unless authorized in writing by the client;
- A qualified custodian should keep certain records relating to those assets;
- A qualified custodian should cooperate with an independent public accountant's efforts to assess its safeguarding efforts;
- Advisory clients should receive periodic custodial account statements directly from the qualified custodian;
- A qualified custodian's internal controls relating to

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its custodial practices should be evaluated periodically for effectiveness; and

- A custodial agreement should reflect an investment adviser's agreed-upon level of authority to effect transactions in the advisory client's account.

According to the Commission, some of these protections are best promoted via written agreement between the adviser and custodian; others are best promoted via the adviser obtaining reasonable assurances in writing from the qualified custodian that the protections will be provided to the advisory client. However, the proposed rule would also require advisers to have a reasonable belief that the qualified custodian is complying with the contractual obligations of the agreement and continuing to provide the protections on an ongoing basis for client assets for which the adviser obtained reasonable assurances from the qualified custodian.

Additionally, the proposed rule would require that the written agreement with the qualified custodian specify the investment adviser's agreed-upon level of authority to effect transactions in the custodial account as well as any applicable terms or limitations. As with numerous other aspects of the proposed rule, the Commission recognized the concerns faced by custodians in implementing such a requirement, including the operational difficulties, greater risk, and potential liability, but nonetheless proposed this requirement.

Surprise Examination

The proposed rule would include a limited exception from the surprise examination requirement for an adviser whose custody of client assets arises solely from discretionary authority so long as (i) the client assets are maintained with a qualified custodian (*e.g.*, securities not kept with a custodian pursuant to the "privately offered securities" exception would be disqualified from this exception) and (ii) the adviser's trading under discretionary authority is limited to client assets that settle exclusively on a "delivery-versus-payment" (DVP) basis.

Next Steps

Our in-depth analysis of the proposed rule will be available in the coming days and the Commission's 434-page release may draw considerable feedback, given the proposed rule's implications for investors, investment advisers, and custodians. The comment period will be open for 60 days following publication of the proposing release in the Federal Register.

ENDNOTES:

[1] *See* https://www.sec.gov/rules/proposed/2023/ia-6240.pdf.

[2] *See* https://www.sec.gov/news/statement/uyeda-statement-custody-021523.

CFTC PARTNERS WITH SEC AND DOJ TO BRING COORDINATED DEFI ENFORCEMENT ACTION TARGETING ORACLE MANIPULATION

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The Situation: Decentralized finance ("DeFi") is a rapidly growing sector that, by definition, eschews centralized financial institutions altogether. Misconduct that has accompanied that growth has drawn the attention of the Commodity Futures Trading Commission ("CFTC"), which has brought three DeFi cases in the last 12 months.

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