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Safeguarding Client Assets: SEC Proposes Overhaul of Adviser Custody Rule

Authored by David P. Bartels, Brenden P. Carroll, Mark D. Perlow, Paul S. Stevens Jr., Phillip Garber, Michael Murphy, and Ashley N. Rodriguez

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The U.S. Securities and Exchange Commission, by a vote of four-to-one, proposed a major overhaul of the investment adviser custody rule on February 15, 2023. The proposal would amend and redesignate Rule 206(4)-2 under the Investment Advisers Act of 1940 (Custody Rule), as new Rule 223-1 under Section 223 of the Advisers Act (Proposed Rule).[1]

The Proposed Rule seeks to restructure dramatically the way that qualified custodians provide custody services, as well as the nature and scope of advisers' responsibilities with respect to custody (reflected in the rebranding of the rule as "Safeguarding"). It would attempt to regulate custodians indirectly through a set of required undertakings to advisers and would require burdensome and intrusive new verification audits for private transactions. In these and many other ways, if adopted the Proposed Rule would have a significant impact on advisers, advisory clients, investors and the market for custody services. For example, the Proposed Rule would:

- Disrupt existing custodial practices and arrangements by requiring advisers to enter into written agreements directly with custodians and, under certain circumstances, independent public accountants. Advisers would also need to obtain written assurances from custodians on certain matters (*e.g.,* that the custodian will indemnify the client for losses in the event of the custodian's own negligence, recklessness, or willful misconduct); many existing custody agreements are not consistent with these required assurances, and it is open to doubt whether custodians will provide these assurances to all advisers, or perhaps only to their largest clients.

- Expand the universe of advisers that are deemed to have "custody" by expanding the definition of custody to include discretionary investment authority. This expanded definition is likely to impact collateralized loan obligation (CLO) managers (among others) and significantly increase the number of advisers that are deemed to have custody.

- Expand the type of assets that are subject to the rule to include digital/crypto assets and physical assets, including real estate. The SEC is here trying to reorganize the back-office operations of the digital asset industry to conform with those of traditional asset classes.

- Impose new conditions for serving as a "qualified custodian," including potentially unrealistic conditions for foreign financial institutions.

The Proposed Rule would also increase reporting and recordkeeping requirements (similar to more recent SEC proposals). The Proposed Rule could be costly for the industry and its participants, and it could stifle competition and innovation by driving smaller advisers and custodians away from non-traditional assets or out of business. In justifying the Proposed Rule, the SEC stated that "the evolution of financial products and services…has led to

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1 Safeguarding Advisory Client Assets, Release No. IA-6240 (Feb. 15, 2023) (Release). The three Democratic Commissioners, Chairman Gary Gensler, Commissioner Caroline A. Crenshaw and Commissioner Jaime Lizárraga, and one Republican Commissioner, Commissioner Mark T. Uyeda, voted to propose the Proposed Rule, whereas one Republican Commissioner, Commissioner Hester M. Peirce, dissented. At times, this *Dechert OnPoint* tracks the Release without the use of quotation marks. Terms not defined in this *Dechert OnPoint* have the meaning assigned to them in the Release.

new entrants and new services in the custodial marketplace, including newly launched state-chartered trust companies….” The SEC also asserted that the SEC staff has “observed a general reduction in the level of protections offered by custodians.”

This *OnPoint* summarizes the Proposed Rule and discusses some of the wider implications. Advisers, custodians and investors should consider submitting comment letters to the SEC to address aspects of the proposal by May 8, 2023.

Overview of Proposed Rule

If adopted, among other matters, the Proposed Rule would:

- *Expand the Scope of Assets Covered Under the Rule*: expand the scope of assets covered by the rule to include all client “funds, securities, or other positions held in a client’s account” for which an adviser has custody. Notably, the rule would apply to crypto assets and physical assets of which an adviser has custody.

- *Expand the Scope of Activity Constituting Custody*: expand the definition of custody to include any discretionary authority to trade for a client’s account.

- *Create New Requirements for Arrangements with Custodians*: require advisers with custody of client assets to enter into written agreements with, and obtain “reasonable assurances” from, each qualified custodian on certain matters.

- *Impose New Conditions on the Use of Foreign Financial Institutions*: impose new requirements on foreign financial institutions (FFIs) to meet the definition of “qualified custodian,” including a requirement that FFIs be subject to anti-money laundering requirements similar to those imposed on U.S. institutions.

- *Impose New Requirements on Privately Offered Securities and Physical Assets*: impose new requirements on privately offered securities and physical assets that cannot be held at a qualified custodian, including new verification requirements.

- *Segregation Requirements*: subject client assets to new segregation requirements, including a requirement that client assets be segregated from the assets of the adviser and its related persons.

- *Audit Provision*: expand the audit provision exception to cover any entity that is subject to an annual audit, codify or expand timelines for distribution of audited financials for funds of funds (and funds of funds of funds), codify existing staff positions on the use of non-U.S. auditing standards for preparation of non-U.S. entity financials, and require a written agreement with the independent public accountant that would require the accountant to notify the SEC under certain circumstances.

- *Recordkeeping Amendments*: amend Rule 204-2 under the Advisers Act (Recordkeeping Rule) to impose new recordkeeping requirements related to the Proposed Rule.

- *Form ADV Amendments*: amend Form ADV to align reporting obligations with the Proposed Rule and increase the custody-related data available to the SEC.

Each of these changes in the Proposed Rule is discussed in more detail below.

Proposed Rule

Expanded Scope of Assets Covered Under the Proposed Rule

The current Custody Rule applies to any adviser registered or required to be registered with the SEC that has custody of a client's "funds or securities." The Proposed Rule would apply to any adviser with custody of a client's "assets," which it defines as "funds, securities, or other positions held in a client's account." The SEC pointed to Section 223[2] of the Advisers Act as legal authority for this expansion. Section 223 was enacted in 2010 and provides that investment advisers "shall take such steps to safeguard client assets" as the SEC may prescribe by rule.[3]

The Proposed Rule does not define "other positions," but the Release states the term "other positions" encompasses all investments, even if such investments are neither funds nor securities. The Release states that "other positions" includes 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." The Release also states that investments that are accounted "in the liabilities column of a balance sheet or represented as a financial obligation of the client[,] including negative cash," would be within the scope of the Proposed Rule.

The Release specifies or indicates that the following investment positions would be included in the scope of the Proposed Rule: all digital/crypto assets, including those that are not funds or securities;[4] assets traded on foreign exchanges; physical assets, including real estate, precious metals, physical commodities (including corn, oil, wheat and other grains, lumber and gold bullion and other precious metals), valuable papers, rare coins, jewelry, antiques and artwork; short positions; written options; futures; financial liabilities or obligations; financial contracts held for investment purposes; collateral posted in connection with swap contracts; physical evidence of non-physical assets that can be used to transfer beneficial ownership, such as physical coupon bonds, physical security certificates, stock certificates and other physical security certificates, private keys, and bearer or registered instruments; physical evidence of physical assets that can be used to transfer physical ownership, such as warehouse receipts for commodities and deeds or other similar indicia of ownership of real estate; and "asset types that develop in the future regardless of their status as funds or securities."

Expanded Scope of Activity Covered Under the Proposed Rule

The Proposed Rule would add to the Custody Rule's definition of custody any "discretionary authority" over client assets. The Proposed Rule defines "discretionary authority" as "authority to decide which assets to purchase and sell for [a] client." The Proposed Rule would also change the definition of custody from any arrangement under which the adviser is authorized or permitted to "withdraw client funds or securities" to any arrangement under which the adviser is authorized or permitted to "withdraw or transfer beneficial ownership of client assets" upon the adviser's instruction. If adopted, these changes would significantly increase the universe of advisers subject to the Custody Rule. According to estimates in the Release, approximately 93 percent of advisers would be deemed to have custody if the Proposed Rule is adopted, up from approximately 57 percent currently.

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2 Although the rule has been designated under Section 223 of the Adviser Act, the SEC indicated that it would still be able to pursue enforcement actions against advisers for failing to safeguard assets under Section 206(4), the statutory authority for the Custody Rule and one of the Advisers Act's antifraud provisions.

3 Congress adopted Section 223 in response to multiple high-profile instances of misappropriation by advisers of client assets.

4 The Release notes, however, that "most crypto assets are likely to be funds or crypto asset securities covered by the current [Custody Rule]."

In the 2003 and 2009 amendments to the Custody Rule, the SEC recognized that "authorized trading" was not within the definition of "custody." In reliance on that position, many types of funds and accounts have been structured in such a manner that the adviser to those accounts is not deemed to have custody of client assets under the current Custody Rule. Under the Proposed Rule, the elimination of the authorized trading exception would result in a significant number of advisers becoming subject to the rule's requirements for the first time.

For example, CLOs have typically been structured in a manner such that the collateral manager to that CLO would not be deemed to have custody over CLO assets under the current Custody Rule. However, collateral management agreements typically provide a collateral manager with authorities that could meet the "discretionary authority" test of the Proposed Rule. Accordingly, collateral managers may be deemed to have "custody" under the Proposed Rule and become subject to the rule's requirements for the first time, including, for example, the surprise exam requirement. An exception from the surprise exam requirement may be available for CLOs that undergo an annual audit and satisfy the requirements of the audit exception. However, the expense of a surprise exam, or compliance with the audit exception, is not typically contemplated in CLO governing documents.

The Proposed Rule would retain the current exception for registered investment companies; however, certain aspects of the Proposed Rule may have indirect effects on trading and settlement of investments by registered investment companies, for example, if market practices that arise from the indirect requirements placed upon qualified custodians by an adopted rule become industry standards.

Qualified Custodian Requirements

The Proposed Rule would generally preserve the types of financial institutions deemed to meet the definition of "qualified custodian" under the Custody Rule. However, the Proposed Rule would impose additional requirements on banks and savings associations to protect investors in the event of bank insolvency or failure and would also impose additional requirements on FFIs.

New Segregation Requirements for Bank Custodians

The Proposed Rule would amend the definition of a "qualified custodian" to require a bank or savings association to hold client assets in an account that is designed to protect such assets from the bank or savings association's creditors in the event of insolvency or failure. The SEC suggested in the Release that an account would be so designed if the client assets were clearly segregated from the bank's assets and easily identifiable as the client's assets. In addition, the SEC noted in the Release that the account terms should clarify that the relationship between the client and the qualified custodian protects the client assets, in the event of an insolvency or failure, from the bank or saving association's creditors. The SEC views this requirement as being aligned with similar protections required for broker-dealers, futures commission merchants and FFIs serving as qualified custodians.

New Requirements for Foreign Financial Institutions

The Proposed Rule would impose seven new requirements on FFIs to meet the definition of "qualified custodian." The SEC noted that the new requirements would align the protections required of an FFI with those of a domestic qualified custodian and cited recent events in crypto markets as the impetus for requiring enhanced custodial safeguards of client assets held outside the United States. For an FFI to be a qualified custodian under the Proposed Rule, it would need to be:

- Incorporated or organized under the laws of a foreign country, and the adviser and the SEC would need to be able to enforce judgments against the FFI. The Release states that a FFI could satisfy this requirement by appointing an agent for service of process, or by having offices, in the United States.

- Regulated by a foreign government or 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 provisions similar to those of the Bank Secrecy Act and regulations thereunder. The Release states that an FFI could satisfy this condition if the institution is required to comply with the laws or regulations of a member jurisdiction of the Financial Action Task Force (FATF) and the institution is not otherwise identified on a sanctions list maintained by the U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) or Financial Crimes Enforcement Network (FinCEN).

- Holding financial assets for its customers in accounts designed to protect such assets from the FFI's creditors in the event of insolvency or failure.

- Having the requisite financial strength to provide due care for client assets. The Release states that a determination as to the financial strength of a FFI could be based on indicators of financial health that are comparable to the standards that apply to U.S. banks and other regulated financial institutions, noting that governments and banking regulators typically require foreign banking institutions to satisfy regulatory capital requirements.

- Required by law to adopt practices, procedures and internal controls designed to ensure the exercise of due care with respect to the safekeeping of client assets. The Release states that this requirement should ensure that the FFI's practices, procedures and internal controls are not materially different from those of U.S. qualified custodians, including with respect to the safekeeping of certificated and uncertificated assets, security and data protections and recordkeeping.

- Not operated for the purpose of avoiding the requirements of the Proposed Rule.

The Release recognizes that many FFIs may be unable to meet these requirements. These changes could make it difficult for advisers to offer investment strategies focused on emerging markets.

New Written Agreement with, and "Reasonable Assurances" from, each Qualified Custodian

The Proposed Rule would require a new written agreement between the adviser and each qualified custodian that holds and maintains client assets. Each qualified custodian would also need to agree to certain minimum provisions in the agreement with the adviser, and the adviser would need to reasonably believe that such provisions have been implemented in order for the adviser to be in compliance with the Proposed Rule.

In addition to a written agreement requirement, the Proposed Rule would require the adviser to obtain certain reasonable assurances in writing from each qualified custodian, and the adviser would need to maintain an ongoing reasonable belief that the custodian is complying with the required assurances.

This element of the Proposed Rule would be a significant change from existing commercial norms, where qualified custodians enter into custody agreements with each client and advisers are typically not a party to such agreements.

Qualified Custodian Must Have Possession or Control of Client Assets

Where the current Custody Rule states simply that a qualified custodian must maintain client funds and securities, the Proposed Rule provides that a qualified custodian must maintain "possession or control" of client assets pursuant to a written agreement between the adviser and each qualified custodian. The Proposed Rule sets forth a three-prong test to determine if "possession or control" is established. A qualified custodian would have possession or control of client assets if:

- The qualified custodian is required to participate in any change in beneficial ownership of client assets;
- The qualified custodian's participation would effectuate the transaction required for the change in beneficial ownership; and
- The qualified custodian's participation is a condition precedent to the change in beneficial ownership.

The Release indicates that the definition of "possession or control" is designed to be consistent with the custody requirements imposed by a custodian's primary regulator. The Proposed Rule provides an exception from this requirement for privately offered securities and physical assets that are unable to be maintained with a qualified custodian in a manner by which a qualified custodian can maintain possession or control (see below).

The Release states that the qualified custodian's required participation in changes in beneficial ownership of client assets will serve several important safeguarding functions, including by providing assurance to clients that the party hired for safekeeping services is involved in any change in beneficial ownership and by ensuring the integrity of account statements provided by qualified custodians.

The SEC acknowledged in the Release that demonstrating possession or control of crypto assets may be more challenging for qualified custodians than for traditional assets such as stocks and bonds. Given the nature of crypto assets, which can be transferred by anyone who possesses the corresponding private keys, a custodian may effectively be required to prove a negative to demonstrate exclusive possession or control (*e.g.*, that no other party has a copy of the respective private keys). The SEC asserted, however, that demonstrating that a qualified custodian maintains "possession or control" also can be accomplished where the custodian's involvement is required in order to effect any change of beneficial ownership of the crypto assets. This can be demonstrated, for example, where a custodian holds private keys in a multi-signature or multi-party computational solution. In these solutions, the custodian will hold one of a number of shards required in order to recompose a crypto asset's private keys. Depending on the implementation, however, some solutions may not comply with the Proposed Rule (such as where two of three keys are required to effect a transaction and the custodian holds only one). The SEC further acknowledged that due to the prevailing methods used by crypto trading platforms that directly settle on such platforms, investors are often required to pre-fund trades by transferring their crypto assets or funds to the trading platforms prior to settlement. As a result, this practice would generally result in violations of the Proposed Rule for advisers that have custody of assets traded on crypto trading platforms that do not qualify as qualified custodians. The Release does acknowledge that certain SEC-registered crypto asset securities are traded on alternative trading systems that do not require pre-funding of trades, but it also notes that these systems do not allow trading of crypto assets that are not securities.

The Release overall is noncommittal as to the extent to which an adviser could satisfy its obligations under the Proposed Rule with respect to crypto assets using existing crypto trading platforms, a point which was emphasized by Commissioners Peirce and Uyeda. Commissioner Peirce noted, in particular, that the approach to crypto under the Proposed Rule would likely shrink "the ranks of qualified crypto custodians" and "could leave investors in crypto assets *more* vulnerable to theft or fraud."[5] Commission Uyeda noted that the Release

5 Commissioner Hester M. Peirce, Statement on Safeguarding Advisory Client Assets Proposal (Feb. 15, 2023).

"indicates that it is unlikely that crypto assets can be maintained at qualified custodians or traded on crypto trading platforms in compliance with the proposed rule."[6]

Minimum Provisions of Agreements Between Adviser and each Qualified Custodian

Under the Proposed Rule, the written agreements between the adviser and each qualified custodian would need to contain the following provisions, and the adviser would need to have a reasonable belief that these provisions have been implemented:

- *Provision of Records*: require the qualified custodian to promptly, upon request, provide records relating to client assets to the SEC or an independent public accountant for purposes of complying with the Proposed Rule.

- *Account Statements*: require the qualified custodian to send account statements at least quarterly to the client and the adviser that identify the amount of client assets in the custodial account as well as the transactions that took place in the account during the period covered by the report.[7] The written agreement must further prohibit a qualified custodian from identifying assets on account statements over which the qualified custodian does not have possession or control, unless requested by the client. The requirement that the qualified custodian send account statements to the adviser as well as the client is a change from the Custody Rule, which requires only that the investment adviser have a reasonable belief that the qualified custodian sends a quarterly statement to the client.

- *Internal Control Report*: require the qualified custodian to provide the investment adviser with a written internal control report at least annually. Such internal control report must include an independent public accountant's opinion as to whether controls designed to ensure the safeguarding of client assets are in place, are suitably designed and are operating effectively. The Release indicates that a SOC 1, Type 2 report, or its equivalent, would satisfy this requirement.

- *Adviser's Level of Authority*: specify the adviser's agreed-upon level of authority to effect transactions in the client's custodial account. The Proposed Rule also requires that the agreement must permit the adviser and the client to reduce that level of authority.

Consistent with the Custody Rule, the Proposed Rule would permit an adviser or its related person to serve as qualified custodian, provided the adviser or its related persons who act as a qualified custodian satisfy certain additional requirements.

Written Assurances from each Qualified Custodian

Under the Proposed Rule, an adviser would have to both obtain written "reasonable assurances" from a qualified custodian, and maintain an ongoing reasonable belief, that the qualified custodian will:

- *Due Care*: exercise due care in accordance with reasonable commercial standards and implement appropriate measures to safeguard client assets from theft, misuse, misappropriation or other similar types of loss. The SEC acknowledged that appropriate measures will vary with the type of asset to be safeguarded.

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6 Commissioner Mark T. Uyeda, Statement on Proposed Rule Regarding the Safeguarding of Advisory Client Assets (Feb. 15, 2023).

7 This provision would not be required for custodial arrangements in which the client is an entity whose investors will receive audited financial statements under the audit provision of the Proposed Rule.

- *Indemnification*: indemnify the client, and have adequate insurance arrangements in place to protect the client, against the risk of loss due to the qualified custodian's own negligence, recklessness or willful misconduct.
- *Sub-custodian or Other Similar Arrangements*: not be excused from any of its obligations to the client due to the existence of any sub-custodial, securities depository or other similar arrangements with regard to the client's assets. The Release states that such assurances would reduce the qualified custodian's ability to avoid responsibility for any losses suffered by the client caused by the custodian's decision to outsource part of its custodial functions.
- *Segregation of Client Assets*: clearly identify the client's assets and segregate them from the qualified custodian's proprietary assets and liabilities.[8]
- *No Liens Unless Authorized in Writing*: 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 authorized by the client in writing. This requirement would not prohibit typical lending arrangements whereby a qualified custodian extends funds or leverage to a client collateralized by the assets in the client's account. It would, however, require the adviser to obtain reasonable assurances that the client has authorized in writing any interests in the client's assets in favor of the qualified custodian that might arise from such arrangements.

These new requirements would represent a significant departure from existing market practices, and would essentially dictate contractual terms with entities that are not directly regulated by the SEC. The Release acknowledges that custody arrangements vary widely and that many do not conform to the minimum requirements of the Proposed Rule. Custodians would have to agree to these new arrangements and related terms, which would likely impose substantial additional burdens and costs on custodians. It is not clear whether any or all custodians would agree to these new arrangements and related terms or, if they did, whether they would seek to pass along any of the related costs.

New Requirements for Privately Offered Securities and Physical Assets that Cannot be Maintained with a Qualified Custodian

Under the Proposed Rule, an adviser would be exempt from complying with the qualified custodian requirements with respect to privately offered securities and physical assets, under stricter and more burdensome conditions than under the current Custody Rule.

The Release acknowledges that there are impediments to most privately offered securities and certain physical assets being maintained with a qualified custodian and that the marketplace for custody services for such assets is thin. The Proposed Rule, like the current Custody Rule, would provide an exception from the qualified custodian requirements for such assets, in recognition of these realities. However, the Proposed Rule would impose new requirements for privately offered securities and physical assets that cannot be maintained at a qualified custodian.

Under the Proposed Rule, an adviser with custody of privately offered securities or physical assets would not be required to comply with the qualified custodian requirements of the Proposed Rule if:

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8 The requirement to obtain assurances that the qualified custodian will segregate client assets would supplant 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.

- The adviser reasonably determines and documents in writing that ownership cannot be recorded and maintained in a manner by which a qualified custodian can maintain possession or control of such assets. The Release indicates that this determination would be a fact-specific inquiry but would generally turn on the custodial solutions available in the market and whether any qualified custodians are capable of, and willing to, custody the privately offered securities.
- The adviser reasonably safeguards the assets from loss, theft, misuse, misappropriation or the adviser's financial reverses, including the adviser's insolvency.
- The adviser enters into a written agreement with an independent public accountant, pursuant to which the accountant verifies any purchase, sale or transfer of beneficial ownership of such assets promptly upon receiving notice from the adviser of such transaction and notifies the SEC within one business day upon finding any material discrepancies during the course of performing its procedures.
- The adviser notifies the independent public accountant of any transactions requiring the accountant's verification within one business day.
- The existence and ownership of each of the client's privately offered securities or physical assets that are not maintained with a qualified custodian are verified during the annual surprise examination or as part of a financial statement audit. The Release explains that this requirement would ensure that a loss of a client's privately offered securities or physical assets does not go undetected for an extended period of time.

The SEC justified these new requirements by, among other rationales, pointing to the rapid increase in the size of the privately offered securities market since the exception was created, discounting facts cited in prior amendments to the Custody Rule that make privately offered securities less susceptible to misappropriation risk and pointing to perceived inadequacies of existing verification processes during surprise exams and financial statement audits.

We anticipate that industry participants will comment specifically on the costs and feasibility of these proposed requirements.

Definitions of Privately Offered Security and Physical Asset

The Proposed Rule would generally leave intact the definition of "privately offered securities." However, it would impose a requirement that privately offered securities are only capable of being recorded on the non-public books of the issuer or its transfer agent in the name of the client as it appears in the records the adviser must keep under the Recordkeeping Rule. The Release acknowledges that crypto asset ownership involving public blockchains is generally evidenced though public keys or wallet addresses. As a result, crypto assets issued on such blockchains would not be able to satisfy the conditions for the privately offered securities exception under the Proposed Rule. This is problematic for advisers with possession of client crypto assets for which no custodian provides custody services and appears to leave no avenue for compliance with the Proposed Rule.

The Proposed Rule does not provide a definition for the term "physical assets," and the Release states that what constitutes a physical asset is a facts-and-circumstances analysis.

Segregation of Client Assets

In addition to the requirement that advisers obtain reasonable assurance that client assets are segregated from the qualified custodian's assets, the Proposed Rule would separately require that client assets over which the adviser has custody 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 its related persons' assets.
- Not be subject to any interest of any kind in favor of the adviser, its related persons or its creditors, except to the extent authorized by the client in writing.

The Release indicates that the purpose of these requirements is principally to ensure segregation of client assets from the adviser's and its related persons' assets.

Amendments to the Surprise Examination Requirement

Reasonable Belief Requirement

The Proposed Rule would maintain the requirement that the adviser and an independent public accountant enter into a written agreement pursuant to which the accountant would conduct a surprise examination. However, the Proposed Rule would impose a requirement that the adviser also reasonably believe that the accountant will perform its examination in accordance with the agreement. According to the SEC, this requirement was intended to address circumstances where advisers failed to ensure that these surprise examinations actually occurred. The Release notes that "advisers generally should enter into a written agreement with the accountant based upon a reasonable belief that the accountant is capable of, and intends to, comply with the agreement and the obligations the accountant is responsible for under the surprise examination requirement." The Release notes, for example, that advisers generally should ensure that the accountant can access the SEC's filing system to make the Form ADV-E filing.

Expanded Availability of the Audit Provision

The current Custody Rule's audit exception is available for any "pooled investment vehicle." The Proposed Rule would expand the scope of the audit exception to apply to any "entity." The Release indicates that this would codify and expand upon certain prior SEC staff no-action positions, and states that pension plans, retirement plans, college savings plans and other entities would be covered by this provision under the Proposed Rule.

Extended Deadlines for Distribution of Audited Financials and U.S. Generally Accepted Accounting Principles Requirements

The Proposed Rule would codify existing no-action relief for funds of funds to distribute audited financials to their investors within 180 days of the fund's fiscal year end, and funds of funds of funds to distribute audited financials to investors within 260 days of the fund's fiscal year end. The Release notes that if an adviser were unable to distribute audited financials within these timeframes due to reasonably unforeseen circumstances, that the failure to distribute the financials would not provide a basis for enforcement provided that the adviser had a reasonable belief that the financials would be distributed by the deadline.

The Proposed Rule would also codify the SEC staff's current approach of permitting non-U.S. vehicles to utilize the audit provision provided that the financial statements are prepared in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP) or, provided that any material differences are reconciled to U.S. GAAP, substantially similar requirements.

New Audit Provision Contract and Notice Requirements for Independent Public Accountants

To rely on the audit provision under the Proposed Rule, the adviser or the entity client would be required to enter into a written agreement with the independent public accountant conducting the audit. Under the terms of the agreement, the independent public accountant would be required to notify the SEC within one business day if the accountant issues a modified opinion (*i.e.*, is qualified, adverse or a disclaimer of opinion) or the auditor is dismissed, and within four business days if the auditor resigns, is dismissed or terminated from an engagement or removes itself from consideration to continue as the entity's auditor.

Exception for Advisers with Limited Delivery-Versus-Payment Authority

The SEC proposed to include an exception from the surprise examination requirement for advisers that have custody of client assets solely due to having discretionary authority to trade such assets. This exception, however, would apply only when the client assets are maintained with a qualified custodian and the adviser's discretionary authority is limited to instructing the qualified custodian to trade the client assets on a delivery versus payment (DVP) basis. Notwithstanding the availability of this exception, the Release recognizes that qualified custodians have been generally unwilling in the past to accept adviser requests to limit the adviser's authority to DVP instructions.

Exception for Standing Letters of Authorization

Consistent with existing SEC staff relief, the Proposed Rule would also include an exception from the surprise examination requirement for advisers that have custody of client assets solely due to having a standing letter of authorization (SLOA). Under the Proposed Rule, a SLOA would be any arrangement among the adviser, the client and the qualified custodian that authorizes the adviser to direct the qualified custodian to disburse client assets to a third-party according to a specified schedule.

Amendments to the Recordkeeping Rule

The SEC proposed various amendments to the Recordkeeping Rule. The amendments are intended to ensure a complete custodial record is maintained. Under the Proposed Rule, advisers would be required to maintain:

- *Client Communications*: copies of all written notices required to be sent to clients under the Proposed Rule and any client responses. Copies of custodial account opening notifications and any notices of changes to the qualified custodian's name, address and account number would need to be maintained under this requirement.

- *Client Accounts*: records pertaining to client account information; custodian identification, including copies of each agreement with a qualified custodian and documents forming the basis for the reasonable assurances obtained by the adviser; the reasons why an adviser has custody over assets in a client account, including whether the adviser has discretionary authority or the ability to deduct fees from the client's account; account statements received or sent by the adviser; transaction and holdings information; and SLOAs.

- *Account Activity*: copies of any account statement delivered by the qualified custodian to the client and to the adviser as well as any account statement the adviser delivers to the client. An adviser would also need to maintain records of all transaction activity in a client's account, which would include all debits and credits into the account. This would expand the Recordkeeping Rule's current requirement to maintain records related to a client account's trading activity.

- *Independent Public Accountant Engagements*: all audited financial statements prepared under the Proposed Rule; internal control reports received by the adviser; and copies of written agreements between the adviser and accountant.

- *Standing Letters of Authorization*: any copies of, and records pertaining to, a SLOA issued by a client.

Form ADV Amendments

The final element of the SEC's proposal involves changes to Form ADV Part 1A. Among other amendments, a new subsection would be added in which an adviser would indicate its reliance on certain exceptions to the Proposed Rule. The Form ADV amendments would further require an adviser to indicate if it has custody of client assets directly, indirectly through a related person or due solely to its ability to deduct fees from the client's account or because it has discretionary authority.

If adopted, the Form ADV amendments would require an adviser to report the amount of client assets over which it has custody and break down that amount into different categories that give rise to custody. The categories would include custody due to: (1) having the ability to deduct fees; (2) discretionary trading authority; (3) serving as general partner, managing member or trustee for private fund clients; (4) serving as general partner, management member or trustee for non-private fund clients; (5) having check writing authority or a general power of attorney over client-assets; (6) acting pursuant to a SLOA; (7) having physical possession of client assets; (8) serving as a qualified custodian; (9) a related person having custody; and (10) any other reason.

Additionally, the Form ADV amendments would require an adviser with custody of client assets to provide identifying information about the qualified custodian at which those assets are maintained as well as identifying information about accountants that complete surprise examinations, financial statement audits or verification of client assets as required under the Proposed Rule.

Key Dates and Timing

If adopted, the Proposed Rule and related amendments to the Recordkeeping Rule and Form ADV would have a transition period of one year from the effective date of the Proposed Rule. For advisers with less than $1 billion in assets under management, the SEC proposes an extended transition period of eighteen months.

Conclusion

The Proposed Rule would represent a substantial update to the current Custody Rule. The Proposed Rule would impose significant new requirements on advisers and would make an adviser's compliance largely contingent on financial institutions, which the SEC does not regulate directly, agreeing to specified commercial standards. If adopted, significant amendments may be required to existing commercial arrangements among investors, clients, advisers, custodians and independent accounting firms. New or updated commercial arrangements with such service providers would likely come at much higher cost. Advisers would have administrative burdens associated with updating these commercial arrangements and would bear new administrative expenses related to ongoing compliance obligations. For certain clients or client assets, it is also possible that a market comprised of qualified custodians that fully comply with the Proposed Rule may never develop or may be so thin that the risks and costs to clients become significant. Furthermore, the market might develop in ways that disadvantage or disenfranchise certain types of advisers that custodians may not want to serve on commercially reasonable terms. In light of these challenges, coming into compliance would be particularly difficult within the SEC's proposed one-year transition period for large advisers and eighteen months for small advisers.

Stakeholders may wish to provide their views to the SEC during the public comment period for the Proposed Rule, which ends May 8, 2023.

This update was authored by:

David P. Bartels
Partner
Washington, D.C.
+1 202 261 3375
david.bartels@dechert.com

Brenden P. Carroll
Partner
Washington, D.C.
+1 202 261 3458
brenden.carroll@dechert.com

Mark D. Perlow
Partner
San Francisco
+1 415 262 4530
mark.perlow@dechert.com

Paul S. Stevens Jr.
Partner
Washington, D.C.
+1 202 261 3353
paul.stevens@dechert.com

Phillip Garber
Associate
San Francisco
+1 415 262 4554
phillip.garber@dechert.com

Michael Murphy
Associate
Boston
+1 617 728 7155
michael.murphy@dechert.com

Ashley N. Rodriguez
Associate
Washington, D.C
+1 202 261 3446
ashley.rodriguez@dechert.com