Hogan Lovells

Private Capital Alert
6 March 2023

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SEC proposes overhaul of 'custody rule' to include all assets as part of new 'safeguarding rule'

The U.S. Securities and Exchange Commission (SEC) proposed broad changes to Advisers Act Rule 206(4)-2, popularly known as the "custody rule," on February 15, 2023. The amendments would create a new Rule 223-1 that would broaden the prior custody rule into the "safeguarding rule" by expanding its coverage to all investment assets held in an advisory account and not merely client funds and securities. The expanded reach of the safeguarding rule would include certain assets not considered securities, such as cryptocurrencies and other crypto assets, real estate and other physical assets, financial contracts not subject to SEC regulation, and physical commodities.

In addition, the new safeguarding rule would expand the definition of custody to include the discretionary authority to trade and would require that qualified custodians not only maintain client assets, but have "possession or control" over such assets. The new safeguarding rule would also require investment advisers to enter into written agreements with qualified custodians with respect to certain assurances for client protections.

Background

The SEC adopted the custody rule in 1962, applicable to registered investment advisers (RIAs) or investment advisers required to be registered under the U.S. Investment Advisers Act of 1940 (Advisers Act).[1] The SEC expanded the reach of the custody rule in 2003 and, more substantially, in 2009, in the wake of the Madoff scandal. Since 2009, the SEC has attempted to address multiple technical issues stemming from practical difficulties in meeting the requirements through FAQs and other guidance.

In summary, the custody rule provides that it is a fraudulent, deceptive or manipulative act, practice or course of business within the broad anti-fraud provisions of Section 206(4) of the Advisers Act for an RIA to have custody of client funds or securities unless the adviser meets certain conditions:

- **Qualified custodian.** The appointment of a qualified custodian to take custody of client funds and securities, such as a bank, SEC-registered broker-dealer or similar foreign financial institution;[2]
- **Notice requirement.** Notice to clients upon opening an account with a qualified custodian on a client's behalf, either under the client's name or under the RIA's name as agent;[3]
- **Quarterly statements.** Provision of quarterly account statements to clients identifying the amount of funds and of each security in the account, as well as to each limited partner or member, as applicable, of clients that are limited partnerships and limited liability companies (LLCs);[4] and
- **Surprise audit.** Verification by an examination at least once during each calendar year by an independent public accountant at a time chosen by the accountant without prior notice or announcement, the timing of which varies from year to year (unless alternatively subject to the audit provision discussed below).[5]

1 Notably, neither the current custody rule nor the proposed safeguarding rule apply to advisers exempt from registration, including exempt reporting advisers (ERAs) relying on the private fund and/or venture capital fund adviser exemptions.

2 Rule 206(4)(2)-(a)(1), which is expanded significantly in proposed Rule 223-1(a)(1).

3 Rule 206(4)(2)-(a)(2), which is identical to proposed Rule 223-1(a)(2).

4 Rule 206(4)(2)-(a)(3), which is set forth in proposed Rule 223-1(a)(1)(i)(B). Proposed Rule 223-1(a)(3) would establish a requirement to segregate client assets.

5 Rule 206(4)(2)-(a)(4), which is virtually identical to proposed Rule 223-1(a)(4).

With respect to an account that is (i) a limited partnership, (ii) an LLC, or (iii) other type of pooled investment vehicle, an RIA need not comply with the second and third requirements above, and is deemed to meet the fourth requirement above, if the entity is subject to audit:

- at least annually, with distribution of audited financial statements, prepared in accordance with generally accepted accounting principles (GAAP), to all limited partners (or members or other owners) within 120 days (or 180 days for funds of funds);
- by an independent public accountant that is registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board in accordance with its rules; and
- upon liquidation, with distribution of audited financial statements prepared in accordance with GAAP to all limited partners (or members or other beneficial owners) promptly after the completion of such audit.[6]

It is common for private funds to choose to fulfill the audit requirement under this alternative scheme.

Moreover, under the custody rule and additional 2013 SEC guidance, there is no need for a qualified custodian to hold privately offered securities (such as those issued by limited partnerships or LLCs) that are (i) acquired in a transaction or chain of transactions not involving any public offering, (ii) uncertificated (as broadly interpreted by the SEC), and (iii) transferrable only with prior consent of the issuer or holder.[7]

While the new safeguarding rule overhauls the custody rule in its entirety, for most private funds, compliance with the proposed rule would require some moderate changes from existing practices.

New safeguarding rule at a glance

Topic	Current 'custody rule'	New 'safeguarding rule'
Rule	Rule 206(4)-2.	Rule 223-1.
Applicability	Registered investment advisers only (not exempt advisers).	Registered investment advisers only (not exempt advisers).
Scope	Client funds and securities.	All client assets: client funds, securities, and any other investments held in a client's account; rule covers all assets over which RIA has discretionary authority.
Requirements of qualified custodians	Required to hold client funds and assets in a separate account for each client under that client's name or in accounts that contain only the RIA's funds and securities, under the RIA's name as agent or trustee for the clients.	Must also have "possession or control" of client assets; written agreement with the RIA, and provide written safeguards in respect of client assets over (i) standard of due care; (ii) indemnification against risk of the custodian's negligence, recklessness or willful misconduct; (iii) sub-custodial arrangements; (iv) segregation of client assets; and (v) absence of liens.

6 Rule 206(4)(2)-(b)(4), which is revised as proposed Rule 223-1(b)(4).

7 Rule 206(4)(2)-(b)(2), which is revised as proposed Rule 223-1(b)(2). Privately offered securities need not be held by a qualified custodian so long as (i) the client is a pooled investment vehicle subject to financial statement audits otherwise in accordance with the custody rule, (ii) the security is uncertificated or, if certificated, a change in beneficial ownership of the security may only be made with the consent of the issuer or holders of the outstanding securities of the issuer; (iii) ownership of the security is recorded on the books of the issuer (or its transfer agent); (iv) the certificate contains appropriate legends restricting transfers; and (v) the private security certificate is appropriately held by the adviser and can be replaced upon loss or destruction. See, further, at IM Guidance Update No. 2013-04, Privately Offered Securities under the Investment Advisers Act Custody Rule (August 2013), available at https://www.sec.gov/divisions/investment/guidance/im-guidance-2013-04.pdf.

Topic	Current 'custody rule'	New 'safeguarding rule'
Requirements for foreign financial institutions (FFIs) to serve as qualified custodian	Any FFI that (i) customarily holds financial assets for its customers, provided that (ii) the FFI keeps the advisory clients' assets in customer accounts segregated from its proprietary assets.	New requirements that include: (i) ability for RIA and SEC to enforce judgments; (ii) regulation by the foreign government or its agencies; (iii) compliance with AML provisions similar to Bank Secrecy Act; (iv) holding of assets designed to protect from failure/insolvency of FFI; (v) requisite financial strength to provide due care to client assets; (vi) practices, procedures and internal controls to ensure due care of asset safekeeping; and (vii) purpose other than evading the safeguarding rule.
Exemption for privately offered securities to be held by qualified custodians	Self-executing, as long as the securities meet the definition in the custody rule and the guidelines from the SEC's 2013 guidance.	Additional requirements: (i) written determination that ownership cannot be recorded and maintained by qualified custodian; (ii) safeguards assets from loss or theft; (iii) verification by an independent accountant of all purchases, sales and transfers within one business days' notice; and (iv) annual verification during surprise examination or financial audit. Extends now to certain physical assets as well.
Segregation of assets requirement	None.	Client assets must be (i) titled or registered in client's name; (ii) not commingled with RIA's assets; and (iii) not subject to any right, lien, or claim in favor of the RIA or related persons or creditors.
Audit provision	Available to limited partnerships, LLCs, and other pooled investment vehicles. Eliminates surprise audit requirement, provided that (i) annual distribution of audited financial statements (prepared in accordance with GAAP) within 120 days of fiscal year-end (180 days for funds of funds), (ii) by an independent public accountant, and (iii) final distribution upon liquidation of audited financial statements.	Available to limited partnerships, LLCs, and other pooled investment vehicles or any other entity. In addition to existing requirements, non-U.S. client financial statements must be reconciled with U.S. GAAP and the RIA must have a written agreement with the auditor requiring the auditor to notify the SEC upon the auditor's termination or issuance of a modified opinion.

Expansion of safeguarding rule's scope

Application to all client assets

Perhaps the most substantial change proposed by the SEC is for the new safeguarding rule to cover all investment assets over which an RIA has custody, not just client funds and securities. Assets would be defined to include "funds, securities, or *other positions held in a client's account*."[8]

Significantly, client assets would include all crypto assets, even if such crypto assets are not deemed securities. The SEC would also consider such additional assets to 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 considered client funds or securities covered by the current custody rule. Additionally, physical assets, such as artwork, real estate, precious metals, or other physical commodities would fall within the scope of the proposed

8 Rule 223-1-(d)(1).

rule. The SEC intends the new "assets" definition to be evergreen, encompassing new investment types as they continue to evolve and multiply.

The SEC has proposed the new rule under the broader authority granted under Section 223 of the Advisers Act, adopted pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) and which explicitly directs RIAs to safeguard all client assets (not just securities). The current custody rule, like many other RIA rules (including the marketing rule and the political contributions rule), was originally adopted in the anti-fraud provisions of Section 206.

Definition of "custody" and "discretionary authority"

The safeguarding rule would generally preserve the existing definition of custody – namely, "holding, directly or indirectly, client assets, or having any authority to obtain possession of them," including (i) physical possession (unless such possession is inadvertent and cured within three business days), (ii) certain arrangements when the adviser is authorized or permitted to instruct the client's custodian, and (iii) circumstances when the adviser acts in certain capacities.[9]

In addition, however, the SEC proposes to extend the custody to cover those situations where an RIA has discretionary trading authority to decide which assets to purchase and sell for the client.[10] The SEC proposes to exempt from the surprise audit requirement discretionary authority that is limited to instructing the client's qualified custodian to transact in assets that settle on a delivery versus payment (DVP) basis.

Additional qualified custodian protections

The proposed rule would add new requirements to strengthen the role of the qualified custodian and the safeguards provided to advisory clients by qualified custodians.

Definition of qualified custodian

In part, the SEC does this by proposing a broader definition of "qualified custodian" in several ways.[11] The proposed rule would require banks or savings associations to hold client assets in an account designed to protect the asserts from creditors in the case of insolvency or failure of the bank or savings association. It would also introduce new rules for "foreign financial institutions," (FFIs) to qualify.[12] While the SEC states that these new requirements respond to recent events in crypto asset markets, they would nonetheless apply to private funds or other advisory accounts that make non-U.S. investments also held in custody by FFIs (especially given that many U.S. banks and custodians do not offer custodial services for non-U.S. securities). Notably, FFIs would have to meet the following requirements:

- be incorporated or organized under the laws of a country or jurisdiction other than the United States, provided that both the RIA and the SEC are able to enforce judgments, including civil monetary penalties, against the FFI;
- be regulated by a foreign country's government, an agency of a foreign country's government, or a foreign financial regulatory authority as defined in Section 202(a)(24) of the Advisers Act as a banking institution, trust company or other financial institution that customarily holds financial assets for its customers;
- be required by law to comply with anti-money laundering and related provisions similar to those of the Bank Secrecy Act and regulations thereunder;
- hold financial assets for its customers in an account designed to protect such assets from creditors of the FFI in the event of the insolvency or failure of the FFI;
- have the requisite financial strength to provide due care for client assets;
- be required by law to implement practices, procedures and internal controls designed to ensure the exercise of due care with respect to the safekeeping of client assets;

9 Rule 206(4)(2)-(d)(2), which is revised as proposed Rule 223-1(d)(3).

10 Proposed Rule 223-1(d)(4) creates the new definition of "discretionary authority."

11 Proposed Rule 223-1(d)(10).

12 Proposed Rule 223-1(d)(10)(iv).

- be required by law to implement practices, procedures and internal controls designed to ensure the exercise of due care with respect to the safekeeping of client assets; and
- not be operated for the purpose of evading the provisions of the safeguarding rule.

Possession or control

In a change from the current rule, the new safeguarding rule would require that a qualified custodian have "possession or control" of client assets. As defined, "possession or control" would require that the qualified custodian participate in any change in the beneficial ownership of the assets, the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership, and the qualified custodian's involvement would be a condition to the change in beneficial ownership.[13]

Arguing that protections should rise to the standards applicable to broker-dealers or national banks and that the new rule codifies existing practices by most qualified custodians, the SEC hopes this change will prevent loss or unauthorized transfers of ownership of the client's assets and provide assurances that the regulated party (i.e., the qualified custodian) hired for safekeeping purposes is involved in any change in the beneficial ownership of the assets.[14]

Written agreement

The SEC would, moreover, require that the RIA maintain assets with a qualified custodian pursuant to a written agreement with the qualified custodian directly (or between the adviser and the client if the adviser is also the qualified custodian). The written agreement would include minimum investor protections. The SEC would also require an RIA to obtain certain reasonable assurances in writing from the qualified custodian.

In particular, the written agreement between the adviser and the qualified custodian should include the following protections:[15]

- the qualified custodian should keep certain records relating to the client's assets;
- the qualified custodian should cooperate with an independent public accountant's efforts to assess its safeguarding efforts;
- advisory clients should receive periodic custodial account statements at least quarterly directly from the qualified custodian (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);
- the qualified custodian's internal controls relating to its custodial practices should be evaluated periodically for effectiveness; and
- the custodial agreement should reflect an investment adviser's agreed-upon level of authority to effect transactions in the advisory client's account.

Moreover, as noted above, the adviser should procure the following reasonable assurances for its clients in writing, under the new rule, as a means of expanding and formalizing the standard of protection for client assets: [16]

- the qualified custodian should exercise due care (a standard similar to that of custodians required under Rule 17f-4 under the U.S. Investment Company Act of 1940) and implement appropriate measures to safeguard the advisory client's assets;
- the qualified custodian should indemnify an advisory client when its negligence, recklessness, or willful misconduct results in that client's loss;
- the qualified custodian should not be relieved of its responsibilities to an advisory client as a result of sub-custodial arrangements;

13 Proposed Rule 223-1(d)(8).

14 Notably, the SEC acknowledges that the "possession or control" element may be more challenging for crypto assets, especially in circumstances where an advisory client and a qualified custodian might simultaneously hold copies of the advisory client's private key material to access the associated wallet with the crypto assets. In addition, the SEC notes that the current practice by crypto trading platforms to require investors to pre-fund trades (through crypto assets, or fiat currency) would violate the safeguarding rule, since such crypto trading platforms are not generally qualified custodians.

15 Proposed Rule 223-1(a)(1)(i).

16 Proposed Rule 223-1(a)(1)(ii).

- the qualified custodian should clearly identify an advisory clients assets and segregate an advisory client's assets from its proprietary assets; and
- the client's assets should remain free of liens in favor of a qualified custodian unless authorized in writing by the client.

While the proposed changes would increase the burden and, potentially, liability of qualified custodians to RIAs and their clients, the SEC notes that advisers should enter into agreements only with a reasonable belief that the qualified custodian is capable of compliance, and intends to comply with the contractual provisions. The RIA should also have the same reasonable belief regarding the reasonable assurances obtained from the qualified custodian, and that the RIA should have a reasonable belief during the term of the written agreement that the qualified custodian is complying with the agreement and continuing to provide the protections agreed as to client assets.

New requirements to exempt privately offered securities

While the SEC proposes to expand the current exemption for privately offered securities to certain physical assets, it would impose considerable new restrictions on RIAs to take advantage of the exemption.[17] These proposed amendments will be of special interest to many private funds, many of which typically hold privately offered securities (i.e., in the form of limited partner interests and/or LLC member interests).[18]

The new rule only slightly revises the definition of "privately offered security" as any security (i) acquired from the issuer in a transaction or chain of transactions not involving a public offering, (ii) uncertificated and "the ownership of which can only be recorded on the non-public books of the issuer or its transfer agent in the name of the client as it appears in the records [the RIA is] required to keep under Rule 204-2," and (iii) that is transferable only with prior consent of the issuer or holders of the outstanding securities.[19]

RIAs will be required for the first time to take the following five affirmative steps to meet this exemption:

- determine and document in writing that ownership cannot be recorded and maintained in a manner in which qualified custodians can maintain possession, or control transfers of beneficial ownership of such assets;
- safeguards the assets from loss, theft, misuse, misappropriation, or the adviser's financial reverses, including its insolvency (through enhanced recordkeeping or other internal controls);
- procure that an independent public accountant, pursuant to a written agreement with the RIA, both (i) verifies any purchase, sale, or other transfer of beneficial ownership of such assets promptly upon receiving notice from the RIA of any purchase, sale or other transfer of beneficial ownership of such assets and (ii) notifies the SEC within one business day upon finding any material discrepancies during the course of performing its procedures;
- 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; and
- verify the existence and ownership of each of the client's privately offered securities (or physical assets) that is not maintained with a qualified custodian during the annual surprise examination or as part of a financial statement audit.[20]

The SEC would continue (per its prior 2013 Guidance) to view a security not 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 without issuer or shareholder consent.

Nonetheless, if adopted, the new requirements would mark a significant compliance burden for many private funds. Furthermore, the SEC explicitly considers that this exception might be phased out over time if it becomes

17 The SEC makes clear that it does not believe that privately offered securities would include crypto assets securities issued on public, permissionless blockchains.

18 The exception is currently set forth in Rule 206(4)-2(b)(2), which would be replaced by a new definition of "privately offered security" in proposed Rule 223-1(d)(9) and a new exception set forth in proposed Rule 223-1(b)(2)

19 Proposed Rule 223-1(d)(9).

20 Proposed Rule 223-1(b)(2).

increasingly possible for qualified custodians to provide custody services for privately offered securities (pursuant to the new RIA determination requirement).[21]

Other changes

The new safeguarding rule would make additional changes to the existing custody rule, highlights of which are described below.

Segregation of assets

The new safeguarding rule also proposes a new segregation requirement, such that a client's assets must:

- be titled or registered in the client's name or otherwise held for the benefit of that client;
- not be commingled with the adviser's assets or its related person's 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.[22]

Audit provision

As with the current custody rule, RIAs that obtain an annual audit for certain pooled vehicles will be exempt from the surprise examination requirement and the need to comply with the client notice requirement.[23] The new provision is set forth slightly differently in the new rule, however, and would be available not only to limited partnerships, LLCs and pooled investment vehicles, but any entity (including, for example, pension plans, retirement plans or college savings plans). In addition, the new audit provision would require that financial statements of non-U.S. clients contain information substantially similar to statements prepared in accordance with U.S. GAAP and any material differences with U.S. GAAP to be reconciled. Finally, the audit provision would include a requirement that the RIA or entity enter into a written agreement with the auditor, requiring such auditor to notify the SEC upon the auditor's termination or issuance of a modified opinion.

Books and records rule and Form ADV

The proposal would make corresponding changes to Rule 204-2, which currently lists the books and records required of all RIAs. Proposed amendments would add new recordkeeping requirements with respect to custody of client assets and custodial arrangements.

The proposal would also make corresponding change to Form ADV and, in particular, Part 1A, with respect to custody of client assets.

Conclusion

The new safeguarding rule represents nothing less than a full transformation of the existing custody rule. Though the most notable change – expanding the rule's scope to all assets, not just client funds and securities – will impact advisers of clients with crypto assets in particular. Most notably, the safeguarding rule would require all RIAs, including private fund sponsors, to bolster the protections afforded by qualified custodians through written agreement and additional written safeguards. The rule would also require new compliance measures to take advantage of the exemption for privately offered securities that currently do not require a qualified custodian. Moreover, revisions to the audit provision, books and records rule and Form ADV will affect RIAs that advise private funds.

The proposal comes on the heels of over a half-dozen proposals in 2022, including potential rules on cybersecurity practices, new restrictions and regulations on private funds, and a new framework for disclosures on environmental, social and governance (ESG) standards, as well as the formal transition for RIAs to the new marketing rule in November 2022. We continue to monitor ongoing SEC rulemaking, and we will provide

21 In the proposal, the SEC notes that "while today it may be reasonable under appropriate circumstances for an adviser to determine that a qualified custodian cannot maintain possession or control of a particular privately offered security, we believe that determination may be more difficult to support as the custodial industry continues to evolve."

22 Proposed Rule 223-1(a)(3).

23 Rule 206(4)-2(b)(4), as modified in proposed Rule 223-1(b)(4).

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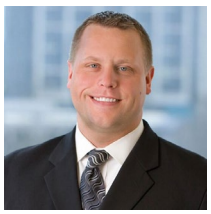

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