Paul | Weiss

CLIENT MEMORANDUM

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SEC Proposes Significant Changes to Custody Rule: Potential Implications for Private Fund Advisers

Executive Summary

On February 15, 2023, the SEC proposed to replace the current "Custody Rule" (Advisers Act Rule 206(4)-2) with a new "Safeguarding Rule" (proposed Advisers Act Rule 223-1) and to make related amendments to the recordkeeping rule and Form ADV (available here) (the "Proposal").

The Proposal is designed to strengthen and clarify existing protections relating to the custody of client assets by SEC-registered investment advisers ("RIAs")[1] and recognize the evolution in products and services RIAs offer to their clients.

The proposed Safeguarding Rule would, among other things:

- expand the scope of client assets covered from "funds and securities" to *any* client assets;
- expand the definition of "custody" to include an RIA's "discretionary authority" to trade client assets regardless of whether or not they are settled on a delivery versus payment ("DVP") basis;
- require qualified custodians ("QCs") to maintain "possession or control" of client assets pursuant to a written agreement between the RIA and the QC that contains specified safeguards that the RIA must reasonably believe have been implemented;
- require RIAs to obtain certain "reasonable assurances" in writing from QCs that the QCs will provide certain enumerated safeguards that the RIA must reasonably believe have been implemented; and
- expand the exception from the QC requirement for "privately offered securities"[2] to include physical assets and add significant conditions for relying on the exception.

Below is a summary of certain aspects of the Proposal, with particular emphasis on its potential implications for private fund advisers.

Expand Scope to Cover All Client Assets

The Safeguarding Rule would expand the types of client assets subject to the safeguarding requirements by defining "assets" as "funds, securities, or other positions held in a client's account," as opposed to the Custody Rule's use of "funds and securities." This expanded definition would explicitly include:

- crypto assets (even in instances where such assets are neither funds nor securities);

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- financial contracts held for investment purposes and collateral posted in connection with a swap contract on behalf of the client;
- other positions that may not be recorded on a balance sheet as an asset for accounting positions (e.g., short positions and written options); and
- physical assets, including artwork, real estate, precious metals or physical commodities (e.g., wheat or lumber).

Expand Definition of Custody to Include Discretionary Trading Authority

The Safeguarding Rule generally would preserve the Custody Rule's definition of "custody," and apply when an RIA "holds, directly or indirectly, client assets, or has any authority to obtain possession of them" (i.e., an RIA has the ability or authority to effect a change in beneficial ownership of a client's assets). In addition, the Safeguarding Rule would explicitly include in the definition of custody an RIA's "discretionary authority" to trade client assets, specifically any arrangement under which the RIA is authorized or permitted to withdraw or transfer beneficial ownership of client assets upon the RIA's instruction.

In this instance, the RIA would be subject to the surprise examination requirement whereby client assets must be verified by an actual examination at least once during each calendar year by an independent public accountant. The Safeguarding Rule, however, would exempt assets for which an RIA has custody from the surprise examination requirement if the RIA's sole basis for being deemed to have custody is discretionary authority that is limited to instructing the client's QC to transact in assets that settle on a DVP basis.[3, 4]

*Separately managed accounts with non-DVP assets (*e.g.*, loans and privately offered securities) would not qualify for this exemption and will be subject to, among other requirements, the surprise examination requirement.*

Overhaul Requirements Relating to Qualified Custodians

The proposed Safeguarding Rule would require that an RIA maintain client assets with a QC that has "possession or control" of those assets. "Possession or control" would mean holding assets such that the QC is required to participate in any change in beneficial ownership of those assets, the QC's participation would effectuate the transaction involved in the change in beneficial ownership, and the QC's involvement is a condition precedent to the change in beneficial ownership. The SEC notes that the requirement for QCs to have "possession or control" of client assets may present unique challenges for digital assets.

The Safeguarding Rule would require an RIA to enter into a written agreement with the QC that includes a long list of new required provisions including provisions that address recordkeeping, client account statements,[5] internal control reports and the RIA's agreed-upon level of authority to effect transactions in the account.

In addition, the Safeguarding Rule would require that an RIA obtain reasonable assurances in writing from the QC relating to certain protections the QC will provide, namely that: the QC will exercise due care in accordance with reasonable commercial standards; the QC will indemnify the client in the event of the QC's negligence, recklessness or willful misconduct; sub-custodial services or similar arrangements will not excuse QC's obligations; the QC will segregate client assets; and the QC will not subject client assets to security interests or liens in favor of QC except as agreed to by the client.

The Safeguarding Rule would fundamentally change the traditional relationship among clients, RIAs and QCs. Implementing these contractual requirements would require significant effort and expense on the part of RIAs and QCs.

Limit Exception for Privately Offered Securities

The Custody Rule provides an exception from an RIA's obligation to maintain client assets with a QC for any security that meets the exception's definition of "privately offered securities." The proposal would expand the exception to include "physical assets"

(including artwork, real estate, precious metals and physical commodities). However, the proposal would only allow an RIA to rely on the exception if:

- the RIA reasonably determines that ownership cannot be recorded and maintained by a QC;
- the RIA reasonably safeguards the assets;
- an independent public account, pursuant to a written agreement with the RIA, verifies the purchase, sale or other transfer of beneficial ownership of such assets promptly upon receiving notice from the RIA and notifies the SEC upon the findings of any material discrepancies;
- the RIA notifies the independent public account engaged to perform the verification of any purchase, sale or other transfer of beneficial ownership of such assets within one business day; and
- the existence and ownership of the assets are verified during an annual independent verification or as part of a financial statement audit by the independent public accountant.[6]

The release indicates that the SEC believes that digital assets issued on public, permissionless blockchains would not satisfy the definition of "privately offered securities," and RIAs with custody of such assets would be required to maintain them with a QC.

This would add significant compliance burdens on RIAs who want to continue to rely on the exception.

The SEC's emphasis on digital assets would increase the pressure on QCs to enhance their capabilities related to digital assets.

Add Recordkeeping and Reporting Obligations

The SEC's proposal would also amend the "Books and Records Rule" (Advisers Act Rule 204-2) to require RIAs 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 RIAs' reporting obligations with the Safeguarding Rule's requirements and to improve the accuracy of custody-related data available to the SEC, its staff and the public.

Next Steps

The public comment period will remain open until the date that is 60 days after the publication of the Safeguarding Rule in the *Federal Register*. If adopted, the SEC is proposing a staggered transition period for RIAs to come into compliance with the Safeguarding Rule, with a 12-month transition period for RIAs with more than $1 billion in regulatory assets under management ("RAUM") and an 18-month transition period for RIAs with up to $1 billion in RAUM.

The proposed implementation of 12 months for large RIAs would not leave much time to come into compliance with the significant obligations of the Safeguarding Rule, many of which are not consistent with current industry practice.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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1 The Safeguarding Rule would apply to investment advisers registered, or required to be registered, with the SEC. The Safeguarding Rule would not apply to "exempt reporting advisers" and the accounts of non-U.S. clients (including funds) of registered offshore investment advisers.

2 The Safeguarding Rule would define "privately offered securities" as securities: (1) acquired from the issuer in a transaction or chain of transactions not involving any public offering; (2) that are uncertificated and the ownership of which can only be recorded on the nonpublic books of the issuer or its transfer agent in the name of the client as it appears in the records you are required to keep under Rule 204-2; and (3) that are transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.

3 In DVP transactions, QCs are generally under instructions to transfer assets out of a client's account only upon corresponding transfer of assets into the account. If an RIA has custody solely because the RIA has discretionary authority that is limited to instructing the custodian to transact in assets that settle on a DVP basis, the risk that an RIA could withdraw or misappropriate the assets in its client's custodial account is minimized; whereas, on a non-DVP basis, the seller of an asset could deliver the asset but not receive payment or the buyer of an asset could make payment but not receive delivery of the asset.

4 Similarly, under the Safeguarding Rule, an RIA would not be required to have an annual surprise examination if the RIA is deemed to have custody of client assets solely as a consequence of its authority to withdraw funds from client accounts to pay its advisory fees.

5 In circumstances where an investor is itself a pooled vehicle that is controlling, controlled by, or under common control with the adviser or its related persons, the contract with the QC must require the quarterly account statement to be delivered by the QC to all of the investors in each pooled investment vehicle client, which includes investors in the underlying pools by looking through that pooled vehicle (and any pools in a control relationship with the adviser or its related persons, such as in a master-feeder fund structure).

6 Like the Custody Rule, the Safeguarding Rule would require RIAs relying on the privately offered securities exception to undergo an annual surprise examination or rely on the audit provision.