March 20, 2023

SEC Proposes Enhanced Safeguarding Rule for Registered Investment Advisers

On February 15, 2023, the SEC issued a release (the "Release") containing proposed Rule 223-1 under the Advisers Act (the "safeguarding rule") and proposing certain rule and form amendments to address how investment advisers safeguard client assets (the "Proposals"). If adopted as proposed, the Proposals would amend and redesignate Rule 206(4)-2 (the "custody rule") under the Advisers Act and amend certain related recordkeeping and Form ADV amendments.[1]

Executive Summary

The safeguarding rule makes significant changes to the existing custody rule. It would expand the scope and definition of assets, with the definition now including all client assets as opposed to only "funds and securities." The safeguarding rule would also bring within its scope many assets that are currently not able to be held with a qualified custodian. Additionally, the safeguarding rule would expand the types of activities that cause an investment adviser to have custody of client assets, including having discretionary authority to trade client assets, which brings many separately managed account ("SMA") arrangements within the ambit of the safeguarding rule. The Proposals would also have a significant effect on investment advisers that enter into derivatives transactions on behalf of clients, in addition to holding other types of assets that historically have not been subject to the custody rule's requirements, as qualified custodians would be required to have "possession or control" over client assets such that they are involved in any change in the beneficial ownership of those assets.

Further, there are a number of requirements that will be revised or added. Among others, the safeguarding rule would require advisers to enter into written agreements, along with obtaining reasonable assurances, directly with qualified custodians, a departure from current practice through which a fund or entity enters into an agreement with a custodian. Existing custodial agreements would have to be revised or rewritten, as there would be no grandfathering. The safeguarding rule would also require advisers to meet a multi-part test to utilize its exception for assets, including certain "physical assets," that cannot be maintained with a qualified custodian. It would require advisers to segregate client assets from their own assets and ensure that client assets are not subject to any encumbrance in favor of the adviser. Advisers would have to conduct diligence prior to engaging with an accounting firm for a surprise examination and on an ongoing basis.

The Proposals would lead to corresponding changes to the recordkeeping rule and Form ADV. Advisers would have to maintain new categories of records and report new information in connection with the safeguarding rule requirements on Form ADV.

The Proposals are described in detail below. The final section of this Alert includes some observations regarding the Proposals.

The Safeguarding Rule

The Proposals would redesignate the custody rule as the safeguarding rule and, as described below, make a number of amendments. The redesignation as Rule 223-1 brings custody under Section 223 of the Advisers Act, which was added in 2010 by the Dodd-Frank Act to give the SEC authority to promulgate rules requiring registered investment advisers to take steps to safeguard client assets. In contrast, the custody rule was adopted as an antifraud provision under Section 206.

[1] The Proposals would not affect the custody provisions applicable to registered investment companies under Section 17(f) of the 1940 Act and the rules thereunder. Thus, as with the custody rule, investment advisers would not be required to comply with the safeguarding rule with respect to the accounts of registered investment companies.

Expanded Definition of Assets. The safeguarding rule would expand the scope of the custody rule by amending the definition of "assets" and broadening the scope of the activity subject to the safeguarding rule. Specifically, assets would be defined as "funds, securities, or other positions held in a client's account," while the custody rule covers only "funds and securities." Thus, the safeguarding rule would include all other assets, such as all crypto assets, physical commodities, and real estate, even if the assets are neither funds or securities, provided the adviser has custody under the safeguarding rule.

- The addition of the term "other positions" is intended to capture holdings that are not necessarily recorded on a balance sheet as an asset for accounting purposes, including, for example, short positions and written options.

- Assets under the safeguarding 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 are not clearly covered by the custody rule.

Scope of Activity Subject to the Proposed Rule. The safeguarding rule would generally retain the custody rule's three categories of activities within the definition of "custody" to include (i) physical possession, (ii) certain arrangements pursuant to which an investment adviser is authorized or permitted to instruct a client's custodian, and (iii) circumstances in which the investment adviser acts in certain capacities that give the adviser or its supervised persons legal ownership or access to client assets (such as acting as a general partner of a fund organized as a limited partnership).

Qualified Custodians

The safeguarding rule would continue to allow banks or savings associations, registered broker-dealers, registered futures commission merchants, and certain foreign financial institutions (each, an "FFI") to act as qualified custodians.

- In its definition of qualified custodian, the custody rule includes certain qualifying banks. The safeguarding rule would largely retain the definition of qualified custodian relating to banks and savings associations. However, the safeguarding rule would require that a qualifying bank or savings association hold client assets in an account that is 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.

- The safeguarding rule also would modify the conditions that an FFI would need to fulfill before it could be deemed a qualified custodian. The safeguarding rule would require an FFI to satisfy seven new conditions to serve as a qualified custodian for client assets, including (i) being required by law to comply with anti-money laundering requirements and related provisions similar to those of the U.S. Bank Secrecy Act and regulations thereunder, and (ii) requiring the FFI to be subject to the ability of the investment adviser and the SEC to enforce judgments, including civil monetary penalties, against the FFI.

Possession or Control. In a change from the custody rule, these entities could serve as qualified custodians only if they have "possession or control" of client assets (pursuant to a written agreement between the qualified custodian and the investment adviser, as described below).

The safeguarding rule would define "possession or control" to mean "[i] holding assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets, [ii] the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership, and [iii] the qualified custodian's involvement is a condition precedent to the change in beneficial ownership."

The Release notes that the safeguarding rule's proposed definition of "possession or control" "is designed to be consistent with the laws, rules, or regulations administered by the qualified custodian's functional or primary financial

regulator for purposes of its custodial activities." In addition, the Release states that "under their existing regulatory regimes, qualified custodians are generally considered to have 'possession or control' of assets that are in their exclusive or physical possession or control." Accordingly, the Release asserts that the proposed definition of possession or control (*i.e.*, being required to participate in any change of beneficial ownership) "is consistent with how the concept of possession or control is understood currently by most qualified custodians and does not conflict with the requirements of qualified custodians' respective regulatory regimes."

- The Release notes that proving exclusive control of a crypto asset may be more challenging than doing so for assets such as stocks and bonds. In particular, while it is possible for a custodian to implement processes that seek to create exclusive possession or control of crypto assets (*e.g.*, private key creation, maintenance, etc.), it may be difficult to actually demonstrate exclusive possession or control of crypto assets due to their specific characteristics (*e.g.*, being transferable by anyone in possession of a private key).

- Separately, the Release observes that an adviser with custody of client crypto assets would generally need to ensure that those assets are maintained with a qualified custodian that has possession or control of the assets at all times in which the adviser has custody. This may prove to be difficult in light of current crypto asset trading practices.

Written Agreement. The safeguarding rule would generally require an investment adviser maintain client assets with a qualified custodian pursuant to a written agreement between the qualified custodian and the investment adviser (or between the investment adviser and client if the adviser is also the qualified custodian). The written agreement pursuant to which the qualified custodian maintains possession or control of an investment adviser clients' assets would be required to contain certain provisions that the adviser must reasonably believe to have been implemented. There is no grandfathering of existing agreements under the safeguarding rule such that all existing custodial agreements would need to be rewritten or amended to come into compliance. Consequently, these agreements would be required to contain the following provisions:

- The qualified custodian will promptly, upon request, provide records relating to the clients' assets held in the account at the qualified custodian to the SEC[2] or to an independent public accountant for purposes of complying with the safeguarding rule;

- The qualified custodian will send account statements, at least quarterly, to the client (or its independent representative) and to the investment adviser identifying the amount of each client asset in the account at the end of the period and setting forth all transactions in the account during that period, including investment advisory fees;[3]

- The qualified custodian will obtain, at least annually, and provide the investment adviser a written internal control report that includes an opinion of an independent public accountant as to whether controls have been placed in operation as of a specific date, are suitably designed, and are operating effectively to meet control objectives relating to custodial services (including the safeguarding of the client assets held by that qualified custodian during the year);

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[2] All custodians, including foreign custodians, are required to provide records of custody and use of the securities, deposits, and credits related to an investment adviser's client to representatives of the SEC upon request. *See* Advisers Act § 204(d)(1).

[3] These account statements are not required to identify assets for which the qualified custodian lacks possession or control, unless requested by the client, in which case, the qualified custodian would be required to clearly identify any such assets on the account statement.

  - If the investment adviser is the qualified custodian, or if the qualified custodian is a related person of the adviser, the independent public accountant that prepares the internal control report must verify that client assets are reconciled to a custodian other than the adviser or its related person and be registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (the "PCAOB"); and

- A specification of the investment adviser's agreed-upon level of authority to effect transactions in each account, as well as any applicable terms or limitations, and a means for the adviser and the client to reduce that authority.

Reasonable Assurances. In addition to the written agreement requirement, the safeguarding rule would require investment advisers to obtain reasonable assurances in writing from the qualified custodian[4] that the qualified custodian will comply with the following five requirements, and the adviser would be required to maintain an ongoing reasonable belief that the qualified custodian is complying with these five requirements:

- The qualified custodian will exercise due care in accordance with reasonable commercial standards in discharging its duty as custodian and will implement appropriate measures to safeguard client assets from theft, misuse, misappropriation, or other similar types of loss;

- The qualified custodian will indemnify the client (and will have insurance arrangements in place that will adequately protect the client) against the risk of loss of the client's assets maintained with the qualified custodian in the event of loss due to the qualified custodian's own negligence, recklessness, or willful misconduct;

- The existence of any sub-custodial, securities depository, or other similar arrangements with regard to the client's assets will not excuse any of the qualified custodian's obligations to the client;

- The qualified custodian will clearly identify the client's assets as such, hold them in a custodial account, and will segregate all client assets from the qualified custodian's proprietary assets and liabilities; and

- The qualified custodian will not subject client assets to any right, charge, security interest, lien, or claim in favor of the qualified custodian or its related persons or creditors, except to the extent agreed to or authorized by the client in writing.

Segregation of Client Assets

Although investment advisers must obtain reasonable assurance of the segregation of client assets at a qualified custodian, the safeguarding rule would further require advisers to segregate client assets from the adviser's assets and its related persons' assets in circumstances in which the adviser has custody. Specifically, the safeguarding rule would require that client assets over which an adviser has custody (i) be titled or registered in the client's name or otherwise held for the benefit of that client, (ii) not be commingled with the adviser's assets or its related persons' assets, and (iii) 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 by the client in writing.[5]

[4] If the investment adviser is also the qualified custodian, the required written agreement between the adviser and the client would be required to provide that the adviser will comply with these five requirements.

[5] This is a change from the custody rule, which requires a qualified custodian to maintain client assets either (i) in a separate account for each client under that client's name, or (ii) in accounts that contain only the clients' funds and securities under the adviser's name as agent or trustee for the clients.

- The Release states that this prohibition on commingling is not intended to preclude traditional operational practices in which client assets are held together with other clients' assets.[6]

- The proposed exception in item (iii) regarding security interests and liens in which a client agrees to or authorizes such arrangements in writing is intended to permit clients to authorize certain types of arrangements (*e.g.*, securities lending arrangements, margin accounts, and the deduction of fees directly from client assets for the payment for services rendered by the investment adviser or its related persons).

Investment Adviser Delivery of Notice to Clients

The safeguarding rule would retain the custody rule's requirement that an investment adviser promptly notify each client in writing upon the opening of an account with a qualified custodian on the client's behalf. The required notice would continue to include the qualified custodian's name, address, and the manner in which the investments are maintained. In addition, the safeguarding rule would expressly require that the notice include the custodial account number to improve the utility of the notice.

- If the client is a pooled investment vehicle, the notice must be sent to all of the investors in the pool. If an investor is a pooled investment vehicle that is in a control relationship with the adviser or the adviser's related persons, the sender must look through that pool (and any pools in a control relationship with the adviser or its related persons) in order to send the notice to the investors in those pools.

- The notice provision would require advisers to send account opening notices only to clients for which it has opened new client accounts with a qualified custodian following the safeguarding rule's compliance date.

Assets that are Unable to be Maintained with a Qualified Custodian

In General. The custody rule already contains a "privately offered securities" exception from its qualified custodian requirement. The safeguarding rule would modify this exception and would expand the exception to include certain "physical assets."

The safeguarding rule would provide an exception to the requirement to maintain client assets with a qualified custodian if an adviser has custody of privately offered securities or physical assets, provided it meets the following conditions:

- The investment adviser reasonably determines and documents in writing that ownership cannot be recorded and maintained (book-entry, digital, or otherwise) in a manner in which a qualified custodian can maintain possession or control transfers of the beneficial ownership of such assets;

- The investment adviser reasonably safeguards the assets from loss, theft, misuse, misappropriation, or the adviser's financial reverses, including the adviser's insolvency;

- An independent public accountant, pursuant to a written agreement between the adviser and the accountant:

    - Verifies any purchase, sale, or other transfer of beneficial ownership of such assets promptly upon receiving notice from the adviser of any purchase, sale, or other transfer of beneficial ownership of such assets; and

[6] The Release states that "[w]e recognize that some advisers and custodians regularly service assets in a manner where such assets are reasonably identifiable from other clients' assets and not subject to increased risk of loss from adviser misuse or in the case of adviser insolvency."

  - Notifies the SEC's Division of Examinations within one business day upon finding any material discrepancies during the course of performing its procedures;

- The adviser notifies 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

- 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.

Definitions of Privately Offered Security and Physical Assets. Subject to one exception noted below, the safeguarding rule's definition of "privately offered securities" would retain the elements from the custody rule's description, which already requires the securities to be acquired from the issuer in a transaction or chain of transactions not involving any public offering and to be transferable only with the prior consent of the issuer or holders of other outstanding securities of the issuer.

- Like the custody rule, the safeguarding rule would also require the securities to be uncertificated and would require ownership to be recorded only on the books of the issuer or its transfer agent in the name of the client.

- However, the safeguarding rule would also require that the securities be capable of only 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 that the adviser is required to keep under the recordkeeping rule (Rule 204-2).

  - The Release states that the SEC would not deem a security to be certificated if 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.

The safeguarding rule would not define "physical asset." The SEC stated that what constitutes a "physical asset" is often self-evident, particularly when compared to other assets that are certificated, maintained digitally, or maintained in book-entry form. This would include real estate and physical commodities, among other types of assets.

Adviser's Reasonable Determinations. To rely on the exception for privately offered securities and physical assets, the safeguarding rule would require an investment adviser to "reasonably determine" and document in writing that ownership cannot be recorded and maintained (book-entry, digital, or otherwise) in a manner in which a qualified custodian can maintain possession or control of such assets. The Release states that such a determination "necessarily depends on the facts and circumstances in issue" and would "generally involve an analysis of the asset and the available custodial market." The Release observes that:

- The safeguarding rule does not mandate the frequency with which an investment adviser must make this determination;

- An investment adviser's reasonable determination generally would not require the identification of every conceivable qualified custodian or an evaluation of its custodial services; and

- The adviser's written documentation of its determination would generally contain material facts concerning its understanding of the custodial marketplace and a description of the client asset in issue.

Adviser Reasonably Safeguards Assets. In addition, to rely on the exception for privately offered securities and physical assets, the safeguarding rule would require an investment adviser to reasonably safeguard any privately offered securities

or physical assets that are not maintained with a qualified custodian from loss, theft, misuse, misappropriation, or the adviser's financial reverses, including the adviser's insolvency. While the specific procedures implemented to safeguard assets may vary depending on the asset, the Release states that "advisers must satisfy their fiduciary duty in safeguarding any particular asset."

- With respect to privately offered securities, the Release states that an investment adviser might reasonably safeguard an asset by looking to reasonable commercial standards, which presently may draw from a variety of protections (*e.g.*, enhanced recordkeeping, additional change-of-control terms in governance agreements, or the designation of an agent required to be involved in transfers of beneficial ownership).

- With respect to physical assets, the Release again states that an investment adviser might reasonably safeguard such assets by looking to reasonable commercial standards, which may include, among other options, storage in a secure facility or vault that adheres to exchange, clearinghouse, or other licensing requirements.

Surprise Examination or Audit. Like the custody rule, the safeguarding rule would require investment advisers that rely on the exception to undergo an annual surprise examination or rely on the audit provision. However, in another change from the custody rule, the safeguarding rule would require the existence and ownership of each of a client's privately offered securities or physical assets that are not maintained with a qualified custodian to be verified either during an annual independent surprise examination or as part of a financial statement audit (in the case of a pooled investment vehicle such as a private fund).

Amendments to the Surprise Examination Requirements

The safeguarding rule would make changes to the custody rule's surprise examination requirements. Under the custody rule, investment advisers with custody, subject to certain exceptions, must undergo an annual surprise verification by an independent public accountant. If the investment adviser (or any related person) maintains the adviser's client assets under the safeguarding rule as a qualified custodian, the safeguarding rule would newly require that the independent public accountant must be registered with, and subject to regular inspection by, the PCAOB.

The custody rule's surprise examination requirement already mandates a written agreement between the adviser and the accountant, but it does not expressly require an investment adviser to have a reasonable belief about the implementation of the written agreement between the adviser and the accountant. In a change from the custody rule, the safeguarding rule would require that an adviser "must reasonably believe" that the written agreement has been implemented.

- According to the Release, this means that investment 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."

- For example, the Release states that after securing a written agreement for the engagement, "the adviser generally should ensure that the accountant is able to access the [SEC] filing system so that it can perform its Form ADV-E filing functions properly."

Exceptions from the Surprise Examination

In General. The safeguarding rule would modify the custody rule's audit provision to expand the availability of its use. In addition, the safeguarding rule would provide exceptions to the surprise examination requirement in instances in which the investment adviser's sole reason for having custody is due to it having discretionary authority or because the adviser is acting according to a standing letter of authorization (each, an "SLOA"), each subject to certain conditions.

Entities Subject to Audit. Similar to the custody rule, an investment adviser that obtains an audit at least annually (and upon an entity's liquidation) under the safeguarding rule would be deemed to have complied with the surprise

examination requirement and would eliminate the need for an adviser to comply with the client notice requirements (*i.e.*, client notices required upon opening a client account with a qualified custodian). Advisers would, however, still need to comply with the other requirements of the safeguarding rule. Additional differences and similarities between the safeguarding rule and the custody rule would be as follows:

- The custody rule's audit provisions would be expanded by the safeguarding rule from "pooled investment vehicles" to be available to any "any entity" that undergoes a financial statement audit as stated in the safeguarding rule at least annually and upon liquidation (*e.g.*, certain SMAs, pension plans, and retirement plans).

- Consistent with the custody rule's FAQs, the financial statements of entities organized under non-U.S. law or that have a general partner or other manager with a principal place of business outside of the United States must contain information substantially similar to statements prepared in accordance with U.S. GAAP, and any material differences with U.S. GAAP must be reconciled.

- Under the custody rule, an investment adviser must distribute its audited financial statements, including any reconciliations to U.S. GAAP or supplementary U.S. GAAP disclosures, annually within 120 days of the end of its fiscal year and promptly upon completion of the audit in the final year of liquidation. The safeguarding rule would generally retain this approach, but would extend the delivery deadline to 180 days in the case of a fund of funds or 260 days in the case of a fund of funds of funds of the entity's fiscal year end.

- The Release notes that if an adviser is unable to deliver audited financial statements in the time frame required under the safeguarding rule due to reasonably unforeseeable circumstances, this would not provide a basis for enforcement action so long as the adviser reasonably believed that the audited financial statements would be distributed by the applicable deadline. This is consistent with the FAQs to the custody rule.

- The safeguarding rule would require a written agreement between the independent public accountant and the adviser (or the entity) pursuant to which the independent public accountant that completes the audit must notify the SEC's Division of Examination electronically (i) within one business day of issuing an audit report to the entity that contains a modified opinion, and (ii) within four days upon its resignation from, or termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed.

With respect to pooled vehicles, the safeguarding rule would also require that financial statements must be sent to all of the investors in each pooled investment vehicle client, provided that if an investor is a pooled investment vehicle that is controlling, controlled by, or under common control with an adviser or its related person, the sender of the financial statement must look through that pool to send it to the investors in those pools.

The Release also discusses investment advisers' use of special purpose vehicles (each, an "SPV") to purchase one or more investments. Similar to the operation of the custody rule, under the safeguarding rule, an investment adviser could either treat an SPV as a separate client (in which case, the adviser would have custody of the SPV's assets) or treat the SPV's assets as the assets of the pooled investment vehicles of which it has custody indirectly under the safeguarding rule.

- If the adviser treats the SPV as a separate client and relies on the audit provision, the safeguarding rule would require that the adviser comply separately with the safeguarding rule's audited financial statement distribution requirements like the custody rule. That is, the adviser would be required to distribute the SPV's audited financial statements to the pooled investment vehicle's beneficial owners.

- Alternatively, if the adviser relies on the audit provision and treats the SPV's assets as the pooled investment vehicle's assets of which it has custody indirectly, the SPV's assets would be required to be considered within the scope of the pooled investment vehicle's financial statement audit.

- Moreover, an SPV held by a fund in which unaffiliated investors hold interests would be treated as a separate client and have to be separately audited. This would be a significant departure from current practice regarding the use of SPVs in part to facilitate co-investments.

Discretionary Authority. The safeguarding rule also would contain an exception from the surprise examination requirement for client assets when an investment adviser's sole basis for having custody is discretionary authority with respect to those assets, provided that this exception applies only to (i) client assets that are maintained with a qualified custodian in accordance with the safeguarding rule, and (ii) accounts for which the adviser's discretionary authority is limited to instructing its client's qualified custodian to transact in assets that settle exclusively on a delivery versus payment ("DVP") basis.

- In 2017, the SEC staff acknowledged that limiting an adviser's authority to DVP transactions that settle at a qualified custodian allows the adviser to avoid inadvertent custody.[7] The Release reiterated the staff's 2017 guidance that an adviser "could draft a letter (or other form of document) addressed to the custodian that limits the adviser's authority" to DVP payment, notwithstanding the wording of any applicable custodial agreement, "and have the client and custodian provide written consent to acknowledge the new arrangement."

- The safeguarding rule would limit this exception to instances in which this is the adviser's sole basis for custody. Accordingly, if an adviser also has custody of the client's assets for additional reasons, the adviser cannot rely on this exception. However, the safeguarding rule would permit an adviser that has custody of the client's assets for reasons that are also subject to similar exceptions under the safeguarding rule (*e.g.*, the sole basis is fee deduction, the sole basis is related-person custody) to rely on the exception.

Standing Letters of Authorization. Consistent with an SEC staff no-action letter,[8] the safeguarding rule contains an exception from the surprise examination requirement for client assets of which an investment adviser has custody solely because of an SLOA. The safeguarding rule would define an SLOA as an arrangement among the adviser, the client, and the client's qualified custodian in which the adviser is authorized, in writing, to direct the qualified custodian to transfer assets to a third-party recipient on a specified schedule or from time to time. The authorization must include the client's signature, the third-party recipient's name, and either the third-party's address or the third-party's account number at a custodian to which the transfer should be directed, neither of which may be changed by the adviser.

Form ADV Amendments

The Release would affect Form ADV by:

- Revising Item 9.A.(1) to require advisers to indicate, in a single place, if they directly, or indirectly through a related person, have custody of client assets, including if custody is solely due to an adviser's ability to deduct fees from client accounts or because the adviser has discretionary authority;

- Revising Item 9.A.(2) to require advisers to report information currently reported by advisers in Item 9 about the amount of client assets and number of clients falling into each category of custody (*i.e.*, direct or indirect) and to require advisers to report similar information about client assets over which they have custody resulting from (i)

[7] *See* "Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority," Division of Investment Management Guidance Update No. 2017-01 (Feb. 2017).
[8] *See* Investment Adviser Association, SEC No-Action Letter (pub. avail. Feb. 21, 2017).

having the ability to deduct advisory fees, (ii) having discretionary trading authority, (iii) serving as a general partner, managing member, or trustee (or the equivalent) for clients that are private funds, (iv) serving as a general partner, managing member, or trustee (or the equivalent) for clients that are not private funds, (v) having a general power of attorney over client assets or check-writing authority, (vi) having an SLOA, (vii) having physical possession of client assets, (viii) acting as a qualified custodian, (ix) being a related person with custody that is operationally independent, and (x) any other reason;

- Adding new Item 9.B. requiring an adviser to indicate whether it is relying on any of the exceptions from the safeguarding rule and, if so, to indicate upon which exception(s) the adviser is relying;

- Requiring new disclosure in Item 9.C.(1) regarding whether the client assets over which they or a related person have custody are maintained at a qualified custodian and the number of clients and the approximate amount of client assets maintained with each qualified custodian. Advisers also would be required to report certain identifying and detailed information about the qualified custodians that are maintaining client assets;

- Revisions to Item 9.C.(3) that would require advisers to report information about the accountants completing surprise examinations, financial statement audits, or the verification of client assets under the safeguarding rule; and

- Requiring an adviser to file promptly an other-than-annual amendment to Form ADV if certain of the adviser's responses become inaccurate, including those related to whether the adviser or its related person has custody, if the adviser is relying on certain exceptions to the safeguarding rule, if client assets are/are not maintained with a qualified custodian, if the adviser or a related person serves as a qualified custodian, if the adviser is required to obtain a surprise examination, or if the adviser is relying on audit provisions.

Related Recordkeeping Rule Amendments

The Release would amend the recordkeeping rule to require an investment adviser that has custody of client assets to make and keep true, accurate, and current records of required client notifications and independent public accountant engagements under the safeguarding rule, as well as the books and records related to specific types of client account information, custodian information, transaction and position information, and SLOAs.

- The proposed amendments would add new recordkeeping requirements that include (i) retaining copies of required client notices, (ii) creating and retaining records documenting client-account-identifying information, including copies of all account opening records and whether the adviser has discretionary authority, (iii) creating and retaining records of custodian-identifying information, including copies of required qualified custodian agreements, copies of all records received from the qualified custodian relating to client assets, a record of required reasonable assurances that the adviser obtains from the qualified custodian and, if applicable, a copy of the adviser's written reasonable determination that ownership of certain specified client assets cannot be recorded and maintained (book-entry, digital, or otherwise) in a manner in which a qualified custodian can maintain possession or control of such assets, (iv) creating and retaining a record that indicates the basis of the adviser's custody of client assets, (v) retaining copies of all account statements, and (vi) retaining copies of any SLOAs.

- The Release would add new recordkeeping requirements to address independent public accountant engagements, including (i) all audited financial statements prepared under the safeguarding rule, (ii) a copy of each internal control report received by the investment adviser, and (iii) a copy of any written agreement between the independent public accountant and the adviser or the client, as applicable, required under the safeguarding rule.

- The Release also would add new requirements regarding transaction and position information in client accounts, including the expansion of trade activity to include other transaction activity in client accounts. In addition, the current recordkeeping rule's requirement that advisers keep copies of confirmations of all transactions would be modified to require that advisers keep trade confirmations that show the date and price of each trade as well as any instruction received by the adviser concerning transacting in the assets.

Transition Period

The SEC proposed a one-year transition period, with a longer 18-month period for advisers with no more than $1 billion in regulatory assets under management following the Proposals' effective date (if adopted) to provide time for advisers to come into compliance. The SEC is proposing that upon adoption, any adviser that elects to rely on the effective safeguarding rule prior to the compliance date must also comply with, as applicable, the amended recordkeeping rules and the amendments to Form ADV at the same time.

Comment Period

Comments on the Proposals must be received no later than 60 days after the publication of the Release in the *Federal Register*, which occurred on March 9, 2023. Accordingly, comments should be received by the SEC no later than May 8, 2023.

Observations

Expanded Scope. The safeguarding rule would expand the scope of the custody rule to include all client assets. Many of the assets that would be brought within the scope of the rule cannot currently be held with a qualified custodian due to regulatory restrictions applicable to such custodians or the commercial unwillingness of financial institutions to provide custodial services with respect to those assets. Moreover, the modified requirements, such as the requirement for independent public accountant verification, for assets that are unable to be maintained with a qualified custodian would add increased compliance and operational burdens.

SMAs. The safeguarding rule would expand the definition of custody to expressly include the discretionary authority to trade client assets (*i.e.*, authority to decide which assets to purchase and sell for the client) as an arrangement that constitutes custody. Consequently, the safeguarding rule would cover many SMAs that are not covered by the custody rule.

- The safeguarding rule contains a limited exception to the surprise examination requirement that would generally be available with respect to client assets that are maintained with a qualified custodian, provided the sole basis for the application of the rule is an adviser's discretionary authority, which is limited to instructing the client's qualified custodian to transact in assets that settle only on a DVP basis.

- Alternatively, an SMA that does not transact only in assets that settle on a DVP basis may be able to rely on the safeguarding rule's audit provisions – assuming it is audited in a manner that satisfies the safeguarding rule's audit provisions – to avoid the rule's surprise examination requirements.

- Nonetheless, SMA advisers will have new burdens imposed on them (*e.g.*, qualified custodian/written agreement(s), a requirement to keep copies of, and records relating to, any SLOAs, and notice requirements).

Custody of Swap Contracts and Related Collateral. If the safeguarding rule is adopted as proposed, we anticipate that clients of investment advisers may need to post collateral (including variation margin) into a segregated account with the client's qualified custodian, pledge the assets in the segregated account to the swap counterparty, and enter into an account control agreement among the client, the qualified custodian, and the swap counterparty to perfect the swap counterparty's security interest in the collateral. Alternatively, investment advisers would need to treat each swap

counterparty as a custodian of the client, which would require investment advisers to follow all of the requirements of the safeguarding rule with respect to each swap counterparty. These arrangements would represent significant departures from current market practice.

Additionally, the safeguarding rule would require investment advisers to maintain financial contracts, including swap contracts, with a qualified custodian. The qualified custodian would need to maintain possession or control over the swap contracts, including participating in any change of beneficial ownership. It is not clear how this would work in practice for over-the-counter derivatives, where the client's asset is a contractual right.

Documentation. We expect that investment advisers and other industry participants would encounter logistical and timing challenges and complexities in amending existing contractual arrangements with custodians and broker-dealers to comply with the safeguarding rule's requirements. Similar documentation challenges and complexities are foreseeable in putting new agreements in place with new qualified custodians.

FFIs. The new conditions that an FFI would need to fulfill before it could be deemed a qualified custodian may create significant burdens for FFIs, including those arising from tensions created with non-U.S. custodial practices and regulatory requirements.

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If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney contacts.