SEC Proposes Expansion of Investment Adviser Custody Rule – Digital Assets Would Be Required to Be Held by a "Qualified Custodian"

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On February 15, 2023, by a vote of 4 to 1 with only Commissioner Peirce voting no, the U.S. Securities and Exchange Commission proposed to amend the content of Rule 206(4)-2 under the Investment Advisers Act of 1940 (the "Advisers Act"), known as the Custody Rule, and redesignate it as Rule 223-1 under the Advisers Act, now known as the Safeguarding Rule. If adopted, the proposal would, among other things, expand the coverage of the Advisers Act's custody provisions beyond "client funds and securities" to include any client assets of which an adviser has custody, a change that would bring within the rule's coverage all digital assets, including non-securities such as commodities. Such a change would impose a requirement on many investment advisers that hold client assets to place those assets with a "qualified custodian," despite a current lack of widespread availability of such service providers for many digital assets.

We think the proposal, if adopted, would at minimum make it exceedingly difficult for investment advisers to offer investment advisory services to clients that involve the custody of digital assets.

Background

The Custody Rule requires federally registered investment advisers that have custody of client funds or securities to adopt policies and procedures designed to protect those client assets from being lost, misused, misappropriated, or subject to the adviser's own financial issues. Custody is defined as occurring when an adviser holds client funds or securities or has the authority to obtain possession of them. While it is uncommon for advisers to maintain physical custody of client assets, many advisers, including fund managers, are deemed to have custody under a variety of circumstances, including:

- A fund manager in its capacity as general partner of a limited partner (or a comparable arrangement) has legal ownership or access to client funds or securities; and
- Any arrangement where the adviser is authorized to withdraw client funds or securities maintained by a custodian, including for the payment of investment management fees.

If an adviser has custody of client funds or securities, the adviser must maintain those assets with a "qualified custodian" that must hold the assets either in a separate account under the client's name or in accounts that contain only client funds and securities under the adviser's name as agent or trustee for its clients. Qualified custodians include banks, registered broker-dealers, registered futures commission merchants, and foreign financial institutions that customarily hold financial assets for their customers. The Custody Rule contains an exception from the qualified custodian requirement for certain uncertificated, privately offered securities that are not transferrable without the prior consent of the issuer or holders of the outstanding securities, a category that includes many interests in private funds such as private equity and hedge funds.

With certain important exceptions, advisers with custody of client assets must have custody verified by surprise examination at least annually by an independent public accountant pursuant to a written agreement between the adviser and the accountant. The exceptions to this requirement generally include (1) advisers to pooled investment vehicles that conduct certain annual audits and distribute audited financial reports to investors and (2) advisers that are deemed to have custody of client assets solely because of their ability to deduct fees from client accounts.

Advisers have taken varying positions on whether the Custody Rule applies to crypto assets, with those taking the negative view arguing that such assets do not constitute "client funds or securities." As a result, some advisers

currently do not hold their clients' crypto assets at a qualified custodian. Instead, such advisers will commonly custody client crypto assets with non-qualified crypto-specialized custodians, such as a digital asset exchange, or may even internally develop a custody solution (*i.e.,* self-custody). Advisers that do seek to use qualified custodians for client crypto assets often find it difficult to locate qualified custodians capable of maintaining custody of crypto assets. Virtually no qualified custodians offer custody solutions for any crypto assets beyond the few commonly known and widely traded assets.

Proposed Safeguarding Rule

The proposed amendments would redesignate the existing Custody Rule as the new Rule 223-1 under the Advisers Act, to be known as the "Safeguarding Rule."[1] If adopted, the Safeguarding Rule would change a variety of the provisions of the Custody Rule, including the notable provisions below.

Change in Coverage

The Safeguarding Rule would apply to all client assets in the custody of an adviser instead of only to "client funds and securities" and would therefore apply to all manner of assets, including crypto assets and physical assets.

Investment Discretion Deemed Custody

In a further change, the Safeguarding Rule would deem an adviser that has discretionary trading authority over client assets to have custody of those assets for purposes of the Rule. Under the Custody Rule, discretionary authority is not by itself a dispositive factor in establishing whether an adviser had custody.

Qualified Custodians

The Safeguarding Rule would limit the types of foreign financial institutions that qualify as qualified custodians. The proposal would also further specify the manner in which qualified custodian banks and savings associations must hold client assets, requiring that such institutions hold client assets in an account designed to protect such assets from creditors of the institution in the event of its insolvency or failure. Furthermore, the Safeguarding Rule would require that qualified custodians have "possession or control" of client assets, not merely that they "maintain" those funds or securities as required under the Custody Rule.

Written Agreement with Qualified Custodian

The Safeguarding Rule would require that an adviser enter into a written agreement with and obtain certain reasonable assurances from qualified custodians to ensure clients receive certain standard custodial protections when an adviser has custody of their assets.

Privately Offered Securities

The proposal would expand advisers' obligations to maintain certain privately offered securities at a qualified custodian, narrowing the types of securities that would qualify for the exception. The expansion of the obligation would also extend to certain client physical assets.

Annual Audit Exception

The Safeguarding Rule would retain the Custody Rule's surprise examination requirement but expand the availability of the Custody Rule's annual audit exception to circumstances where the adviser has custody solely because it has discretionary authority or because the adviser is acting according to a standing letter of authorization.

1 Congress expressly vested the SEC with authority to promulgate rules requiring registered advisers to take steps to safeguard client assets over which advisers have custody by adding section 223 to the Advisers Act in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

Recordkeeping

The proposal would also amend the investment adviser recordkeeping rules to require advisers to keep additional, more detailed records of trade and transaction activity and position information for each account over which they have custody.

Form ADV

The proposal would amend Form ADV to align advisers' reporting obligations with the proposed Safeguarding Rule's requirements and to improve the accuracy of the custody-related data available to the SEC, the staff and the public.

Potential Impact on Digital Asset Industry

While the proposal states that most crypto assets are already covered by the existing Custody Rule, in practical terms many industry participants have maintained the position that non-security crypto assets (such as bitcoin) are not subject to the rule. If adopted, the Safeguarding Rule would eliminate any ambiguity with respect to the application of the qualified custodian provisions to digital assets. Advisers that maintain custody with non-qualified custodians, such as digital asset exchanges, or self-custody would be required to find a suitable qualified custodian, and there are serious questions as to whether qualified custodian solutions exist for broad swaths of assets available on crypto markets. The Safeguarding Rule proposal does not provide guidance on how advisers pursuing "DeFi" or "staking" investment strategies could comply with the proposal, as those strategies typically involve sacrificing some elements of possession or control of client digital assets to a non-custodial party or cryptographic protocol, arrangements which do not fit neatly into a traditional asset custody analysis.

What's Next?

Comments on the rule proposal may be submitted using the SEC's internet comment form available here or by sending an email to rule-comments@sec.gov with subject line File Number s7-04-23. The Commission has asked that comments be received on or before the date that is 60 days after the proposal's publication in the Federal Register.

For More Information

If you would like further information concerning the matters discussed in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.