

SEC Proposes Enhanced Safeguarding (Custody) Rule for Registered Investment Advisers

Alert

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On February 15, 2023, the U.S. Securities and Exchange Commission (SEC) proposed to exercise its authority by amending and re-designating [Rule 206\(4\)-2](#) under the Investment Advisers Act of 1940 (the Custody Rule). The proposed new “Safeguarding Client Assets” rule (Proposed Rule), would, among other changes:

1. Expand protections to a broader array of client assets, including assets like crypto and artwork
2. Expand definition of custody to include discretionary authority
3. Enhance required custodial protections
4. Expand and otherwise revise the “privately offered securities” exception
5. Update related recordkeeping and reporting requirements, and amend Form ADV

According to the SEC, the Proposed Rule “would help ensure that advisers don’t inappropriately use, lose, or abuse investors’ assets.”

EXPANDED SCOPE

The Proposed Rule would expand the scope of assets and activities covered by the Custody Rule. Currently, the Custody Rule applies to client “funds and securities.” The Proposed Rule would extend coverage beyond client “funds and securities” so as to include additional assets, whether or not such assets are securities, held in a client’s account. This includes crypto assets, 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 covered by the Custody Rule. Additionally, physical assets, including artwork, real estate,

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precious metals or physical commodities (e.g., wheat or lumber), are within the scope of the Proposed Rule.

The Proposed Rule would also expand the definition of “custody,” notably to now include mere discretionary authority vested in the registered investment adviser. Under the Proposed Rule, an adviser has custody if it or a related person holds (directly or indirectly) client assets, or has any authority to obtain possession of them in connection with advisory services. Such custody would include: (1) possession of client assets (but not of checks drawn by clients and made payable to third parties) unless the adviser receives them inadvertently and returns them to the sender promptly but in any case within three business days of receiving them; (2) any arrangement (including, but not limited to a general power of attorney or discretionary authority) under which the adviser is authorized or permitted to withdraw or transfer beneficial ownership of client assets upon its instruction; and (3) any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives the adviser or its supervised person legal ownership of or access to client assets. The Proposed Rule does provide an exemption from the surprise examination requirement where “custody” is based solely on discretionary authority.

QUALIFIED CUSTODIANS

The Proposed Rule also requires that a “qualified custodian” hold such assets and, like the Custody Rule, defines qualified custodian to mean a bank or savings association, registered broker-dealer, registered futures commission merchant (FCM), or certain types of foreign financial institutions.

In a change from the Custody Rule, the Proposed Rule would require that an investment adviser maintain client assets with a qualified custodian that has “possession or control” of those assets. “Possession or control” would be defined to mean holding assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets, the qualified custodian’s participation would effectuate the transaction involved in the change in beneficial ownership, and the qualified custodian’s involvement is a condition precedent to the change in beneficial ownership. The Proposed Rule also requires a written agreement between a qualified custodian and the investment adviser with a new list of minimum investor protection elements for advisory clients, including that the adviser obtain certain related contractual “reasonable assurances” from the custodian in writing.

EXCEPTIONS

The Proposed Rule provides for an exception from the obligation to maintain client assets with a qualified custodian for certain physical assets such as real estate or physical commodities (e.g., wheat or lumber) where ownership cannot otherwise be recorded and maintained with a qualified custodian and other requirements are met. The Custody Rule currently offers an exception for certain “privately offered

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securities;" the Proposed Rule expands that exception but adds compliance obligations to rely upon the exception.

RECORDKEEPING AND REPORTING OBLIGATIONS

The Proposed Rule would also amend advisers' recordkeeping requirements and Form ADV in an effort to improve the level of detail and accuracy of custody-related information available to the SEC and the public. The recordkeeping would require more detailed records of transaction activity and position information for each client account of which it has custody.

COMMENT PERIOD

The comment period will remain open until 60 days after publication of the proposing release in the *Federal Register*.

CONTACT

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