



# Investment Adviser Custody and Potential Changes Under the SEC's Proposed Safeguarding Rule

2023 ANNUAL COMPLIANCE CONFERENCE

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# Your Instructor

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▶ Jarrod has spent his entire career (twenty-two years) working with investment advisers as a compliance professional. His current compliance consulting practice focuses on helping SEC and state-registered firms of all business types and models.

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# Course Overview

- ▶ Regulatory Resources
- ▶ Current SEC Custody Rule 206(4)-2
  - ▶ Four Types of Custody Situations
  - ▶ SEC Requirements for Firms with Custody
  - ▶ First-Party v. Third-Party SLOA
  - ▶ Avoiding Inadvertent Custody
- ▶ Key Components of SEC's Proposed Rule 223-1 Safeguarding Client Assets
  - ▶ Expands the scope and definition of custody
  - ▶ Changes to agreements with qualified custodians
  - ▶ Impact on Digital Assets
  - ▶ Impact on Privately Offered Securities
  - ▶ Recordkeeping and Form ADV Reporting

# Regulatory Resources

*Staff Responses to Questions About the Custody Rule:*

[https://www.sec.gov/divisions/investment/custody\\_faq\\_030510](https://www.sec.gov/divisions/investment/custody_faq_030510)

*Interpretive Rule Release: Custody of Funds or Securities of Clients by Investment Advisers (12/30/2009):*

<https://www.sec.gov/files/rules/final/2009/ia-2968.pdf>

*No-Action Letter to Investment Adviser Association Regarding Third-Party Standing Letter of Authorizations (SLOA):*

<https://www.sec.gov/divisions/investment/noaction/2017/investment-adviser-association-022117-206-4.htm>

*Division of Investment Management Guidance Update: Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority*

<https://www.sec.gov/investment/im-guidance-2017-01.pdf>

*Risk Alert: Investment Advisers' Fee Calculations (11/10/2021):*

<https://www.sec.gov/files/exams-risk-alert-fee-calculations.pdf>

# Regulatory Resources

*SEC Proposes Enhanced Safeguarding Rule for Registered Investment Advisers*

<https://www.sec.gov/news/press-release/2023-30>

*SEC Commissioner Caroline Crenshaw Statement on Safeguarding Advisory Client Assets Proposal*

[https://www.sec.gov/news/statement/crenshaw-statement-custody-021523#\\_ftn1](https://www.sec.gov/news/statement/crenshaw-statement-custody-021523#_ftn1)

*SEC Commissioner Hester M. Peirce Statement on Safeguarding Advisory Client Assets Proposal*

<https://www.sec.gov/news/statement/peirce-statement-custody-021523#>

*Ropes & Gray Article*

<https://www.ropesgray.com/en/newsroom/alerts/2023/03/sec-proposes-enhanced-safeguarding-rule-for-registered-investment-advisers>

*Mayer Brown Article*

<https://www.mayerbrown.com/en/perspectives-events/publications/2023/04/indepth-us-sec-proposes-new-safeguarding-rule-for-investment-advisers>

SEC  
Custody  
Rule 206(4)-  
2 – *Types of  
Custody*

Fee Debit Authorization – Don't Report on Form ADV Part 1A, Item 9 and Don't Need Surprise Verification Examination

Third-Party SLOA No-Action Letter – Report on Form ADV Part 1A, Item 9 but Do NOT Need Surprise Verification Exam

# SEC Custody Rule 206(4)-2 – *Types of Custody*

- February 21, 2017 – Third-Party Standing Letter of Authorization No-Action Letter - Seven Safeguards (well, really eight)
  1. The client provides an instruction to the qualified custodian, in writing, that includes the client's signature, the third party'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.
  2. The client authorizes the investment adviser, in writing, either on the qualified custodian's form or separately, to direct transfers to the third party either on a specified schedule or from time to time.
  3. The client's qualified custodian performs appropriate verification of the instruction, such as a signature review or other method to verify the client's authorization, and provides a transfer of funds notice to the client promptly after each transfer.
  4. The client has the ability to terminate or change the instruction to the client's qualified custodian.
  5. The investment adviser has no authority or ability to designate or change the identity of the third party, the address, or any other information about the third party contained in the client's instruction.
  6. The investment adviser maintains records showing that the third party is not a related party of the investment adviser or located at the same address as the investment adviser.
  7. The client's qualified custodian sends the client, in writing, an initial notice confirming the instruction and an annual notice reconfirming the instruction.
  8. In addition, beginning with the next annual updating amendment after October 1, 2017, an investment adviser should include client assets that are subject to a SLOA that result in custody (see note 1 above) in its response to Item 9 of Form ADV.

# SEC Custody Rule 206(4)-2 – *Types of Custody*

- Full Power of Attorney (including Trustee and other similar legal authority, check writing privileges, 3<sup>rd</sup> Party SLOA not in compliance with SLOA) – Report on Form ADV Part 1A and MUST attain surprise verification examination
- General Partner to Limited Partnership and other similar structures for private funds and pooled investment vehicles

## SEC Custody Rule 206(4)-2 – *Requirements*

Must maintain client funds and securities with qualified custodian (QC) at all times

Client must know who the QC is and IA must inform client of changes to QC

QC must deliver account statements directly to client and IA must form reasonable belief, upon due inquiry, that client is receiving account statements

# SEC Custody Rule 206(4)-2 – Requirements

## What is a “qualified custodian”?

Qualified custodian means:

- (i) A **bank** as defined in section 202(a)(2) of the Advisers Act (15 U.S.C. 80b–2(a)(2)) or a **savings association** as defined in section 3(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(b)(1)) that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act (12 U.S.C. 1811);
- (ii) A **broker-dealer** registered under section 15(b)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(b)(1)), holding the client assets in customer accounts;
- (iii) A **futures commission merchant** registered under section 4f(a) of the Commodity Exchange Act (7 U.S.C. 6f(a)), holding the client assets in customer accounts, but only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; and
- (iv) A **foreign financial institution** that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets.

\*The rule currently excepts advisers from complying with the requirement to maintain **mutual fund shares** with a qualified custodian, provided they are maintained with a **transfer agent**. Per the May 16, 2005 no-action letter to American Skandia Life Assurance Corporation, SEC staff indicated it would not recommend enforcement action when an **insurance company** served a particular role with respect to **variable annuity contracts** similar to the role of a transfer agent with respect to mutual fund shares.



# SEC Custody Rule 206(4)-2 – *Requirements*

- Surprise Verification Exam. Must be performed within 6 months of first attaining custody and then performed annually thereafter (every 12 months).
  - Independent 3<sup>rd</sup> Party Accounting Firm
  - Requires Agreement that Complies with Custody Rule
  - Submit on Form ADV-E
  - Discrepancies Must be Reported to SEC Immediately
- IA prepared statements/reports must include disclaimer urging client to compare the statement/report against the qualified custodian's account statements.
- Private Funds and Pooled Investment Vehicles can rely on audit approach. Financial statement audit and result of audit delivered to fund investors with 120 days of end of fund's FY. Accountant must be PCAOB registered and inspected.

# SEC Custody Rule 206(4)-2 – Avoiding Custody

## First-Party Transfers is NOT Custody so long as in compliance with SEC FAQ

- ▶ **Q:** Does an adviser have custody if it has authority to transfer client funds or securities between two or more of a client's accounts maintained with the same qualified custodian or different qualified custodians?
- ▶ **A:** Under rule 206(4)-2(d)(2)(ii), an adviser has custody if it has the authority to withdraw client assets maintained with a qualified custodian upon the adviser's instruction to the custodian. We do not interpret the authority to withdraw assets to include the limited authority to transfer a client's assets between the client's accounts maintained at one or more qualified custodians if the client has authorized the adviser in writing to make such transfers and a copy of that authorization is provided to the qualified custodians, specifying the client accounts maintained with qualified custodians. In the staff's view, "specifying" would mean that the written authorization signed by the client and provided to the sending custodian states with particularity the name and account numbers on sending and receiving accounts (including the ABA routing number(s) or name(s) of the receiving custodian) such that the sending custodian has a record that the client has identified the accounts for which the transfer is being effected as belonging to the client. That authorization does not need to be provided to the receiving custodian. Moreover, in the staff's view, an adviser's authority to transfer client assets between the client's accounts at the same qualified custodian or between affiliated qualified custodians that both have access to the sending and receiving account numbers and client account name (e.g., to make first-party journal entries) does not constitute custody and does not require further specification of client accounts in the authorization. (Modified February 21, 2017.)

# SEC Custody Rule 206(4)-2 – *Avoiding Custody*

Discretion and Trading is NOT Custody

Avoid Inadvertent Custody  
Due to written qualified  
custodian and similar  
agreements (IM Guidance  
Update - *Inadvertent Custody:  
Advisory Contract Versus  
Custodial Contract Authority*)

Key  
Components  
of SEC's  
Proposed  
Rule 223-1  
Safeguarding  
Advisory  
Client Assets

Proposed on  
February 15, 2023

Still in Proposal and  
Comment Phase

Key Components  
of SEC's Proposed  
Rule 223-1  
Safeguarding  
Advisory Client  
Assets – *Include  
“Assets” and Other  
Positions*

- ▶ Broadens the definition to include “assets”. The current rule covers “funds and securities”. Under proposed rule, will include “assets” in order to include all investments in a client’s account for the practical effect of covering all “positions”.
- ▶ The SEC stated: “We believe, in the advisory account context, that the entirety of a client account’s positions, holdings, or investments should receive the protections of the proposed rule regardless of how they may be treated for accounting purposes.”
- ▶ Specifically, will include **crypto assets** even in the instances where such assets are neither funds nor securities.

Key Components  
of SEC's Proposed  
Rule 223-1  
Safeguarding  
Advisory Client  
Assets – *Include*  
*“Assets” and Other*  
*Positions*

Key examples of “assets” and other positions:

1. Crypto
2. Financial Contracts held for Investment Purposes
3. Collateral Posted in Connection with a Swap Contract on Behalf of a Client
4. Other Assets that may NOT be clearly funds or securities covered by the current rule.
5. Physical assets including artwork, real estate, precious metals or physical commodities (e.g., wheat or lumber).
6. Would encompass investment that would be accounted for in the liabilities column of a balance sheet or represented as a financial obligation of the client including negative cash, which the SEC believes would be consistent with the purposes of the Investment Advisers Act of 1940 and the longstanding policy goal of the rule to prevent potential fraud, misuse, or misappropriation.

# Key Components of SEC's Proposed Rule 223-1 Safeguarding Advisory Client Assets - *Discretion*

Current rule does NOT include “trading authority”. Proposed rule will include “discretion” with the intent to capture more firms.

- a. SEC stated their intention to provide specificity of the “arrangement” category of the custody definition to state explicitly that discretionary trading authority is an arrangement that triggers the rule.
- b. Specifically, the amended custody definition would include 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 the adviser’s instruction.
- c. In addition, the proposed discretionary authority definition is consistent with the definition in Form ADV and is the authority to decide which assets to purchase and sell for the client.
- d. However, discretionary authority will **not** trigger the surprise verification requirement so long as the discretionary authority limited to instructing the client’s qualified custodian to transact in assets that settle only on a delivery versus payment (“DVP”) basis.

# Key Components of SEC's Proposed Rule 223-1 Safeguarding Advisory Client Assets – *Qualified Custodian (QC)*

## Qualified Custodians (QC):

- a. Still required to maintain all client assets with a qualified custodian at all times.
  - i. Same Definition of Qualified Custodian.
  - ii. Banks and savings associations would be required to 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.
  - iii. Would require seven new conditions that foreign qualified custodians must attain to meet the definition of QC.



## Key Components of SEC's Proposed Rule 223-1 Safeguarding Advisory Client Assets – *Qualified Custodian (QC)*

“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.

Key Components  
of SEC's Proposed  
Rule 223-1  
Safeguarding  
Advisory Client  
Assets – *Qualified  
Custodian (QC)*

Maintains the same general definition of qualified custodian. However, in a change from current rule, only if they have “possession or control” of client assets pursuant to a **written agreement** between the QC and the investment adviser. If the adviser is the QC, the agreement must be between the adviser and the client and the adviser must reasonably believe have been implemented. The agreement would need to address the following:

- i. Recordkeeping
- ii. Client Account Statements
- iii. Internal Control Reports
- iv. The Adviser's Agreed-Upon Level of Authority to Effect Transactions in the Account

# Key Components of SEC's Proposed Rule 223-1 Safeguarding Advisory Client Assets – *Qualified Custodian (QC)*

Adviser will Need to Obtain Reasonable Assurances from the QC, in Writing, Relating to Certain Protections the QC will Provide to the Client, including:

- ▶ the QCs standard of care to the client,
- ▶ indemnification,
- ▶ limitation of liability for sub-custodial services,
- ▶ segregation of client assets, and
- ▶ attachment of liens to client assets.

Key  
Components of  
SEC's Proposed  
Rule 223-1  
Safeguarding  
Advisory Client  
Assets – *Physical  
and Privately  
Offered Assets*

The proposed rule would modify the current custody rule's exception from the obligation to maintain client assets with a qualified custodian for certain privately offered securities, including expanding the exception to include certain physical assets.

The SEC believes the bulk of advisory client assets are able to be maintained by qualified custodians; however, they understand that is not universally the case, particularly for two types of assets: certain **physical assets** and certain **privately offered securities**.

# Key Components of SEC's Proposed Rule 223-1 Safeguarding Advisory Client Assets – *Physical and Privately Offered Assets*

- a. The safeguarding rule would provide an exception to the requirement to maintain client assets with a qualified custodian where an adviser has custody of privately offered securities or physical assets, provided it meets the following conditions:
  - i. The adviser reasonably determines and documents in writing 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 beneficial ownership, of such assets;
  - ii. The adviser reasonably safeguards the assets from loss, theft, misuse, misappropriation, or the adviser's financial reverses, including the adviser's insolvency;
  - iii. An independent public accountant, pursuant to a written agreement between the adviser and the accountant,
    - 1. 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
    - 2. Notifies the Commission within one business day upon finding any material discrepancies during the course of performing its procedures;
  - iv. 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
  - v. The existence and ownership of each of the client's privately offered securities or physical assets that is not maintained with a qualified custodian are verified during the annual surprise examination or as part of a financial statement audit.



## Key Components of SEC's Proposed Rule 223-1 Safeguarding Advisory Client Assets – *Surprise Examinations*

Retain the current custody rule's requirement for an adviser to undergo a surprise examination by an independent public accountant to verify client assets, but expand the availability of the current custody rule's audit provision as a means of satisfying the surprise examination requirement.

Key  
Components of  
SEC's Proposed  
Rule 223-1  
Safeguarding  
Advisory Client  
Assets – *Surprise  
Examinations*

**NOT Required IF:**

- a. Fee Deduction** *is only form of custody.*
- b. Audit Provision** for private funds and similar type investments.
- c. Discretionary Authority** *is only form of custody.* Only available where discretion is limited to transactions that settle exclusively on a DVP basis.

# Key Components of SEC's Proposed Rule 223-1 Safeguarding Advisory Client Assets – *Surprise Examinations*

- a. **Standing Letters of Authorization** *is only form of custody and that meets the following conditions.*
  - i. 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, provided:
    1. The client's qualified custodian is not a related person of the adviser
    2. The client's authorization includes the client's signature, the third-party recipient's name, and either its address or account number at a custodian to which the transfer should be directed; and
    3. The adviser has no ability or authority to designate or change any information about the third-party recipient, including name, address, and account number.





## Key Components of SEC's Proposed Rule 223-1 Safeguarding Advisory Client Assets - *Recordkeeping*

The proposed rule would amend the investment adviser recordkeeping rule to require advisers to keep additional, more detailed records of trade and transaction activity and position information for each client account of which it has custody.



## Key Components of SEC's Proposed Rule 223-1 Safeguarding Advisory Client Assets – *Form ADV Updates*

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

# Questions

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Thank You