FORsights

Expansion of Adviser's Safeguarding & Custody Rules?

On February 15, 2023, the SEC voted four to one to approve a proposal to significantly expand investor protection on advisory client assets. The proposal would:

- **Expand the custody rule's scope to cover additional client assets and add discretionary authority as a custody activity**
- **Enhance the custodial protections for client assets**
- **Add new custody record-keeping and reporting requirements**

If approved, the final rule would have staggered compliance dates depending on an adviser's regulatory assets under management.

Comments are due 60 days after Federal Register publication.

I. Background

Rule 206(4)-2 (Custody Rule) was first adopted in 1962 and last updated in 2009 following the Bernard Madoff Ponzi scheme. The rule is designed to protect client funds and securities from an adviser insolvency or bankruptcy, and prevent client assets from being lost, misused, stolen, or misappropriated. The 1962 rule was designed at a time when securities trading was paper-based and required all investment advisers with custody or physical possession of client funds and securities to deposit client funds in a bank account that was maintained in the adviser's name and contained only client funds. Advisers were required to segregate client securities and hold them in a reasonable, safe place. Investment advisers also were required to engage an independent public accountant to conduct an annual surprise examination to verify client funds and securities. The rules were updated in 2003 with an expanded definition of custody beyond physical possession to include situations when an adviser had any ability to obtain possession of client funds or securities. This included possession of securities (even briefly), authority to withdraw funds or securities from a client's account, and any capacity that gives the adviser legal ownership of—or access to—client funds or securities. The 2003 amendments also required most securities (not just funds) be kept with a custodian and expanded the types of qualified custodians. An exception from the updated Custody Rule was created for privately offered securities. The 2009 amendments extended the rule's scope to an adviser's ability to access client funds or securities through related parties, expanded the circumstances when a surprise examination is necessary, and required advisers to obtain an independent accountant's report evaluating custody internal controls when the adviser or a related party serves as qualified custodian. The 2010 Dodd-Frank Act authorized the SEC to prescribe rules requiring advisers to take steps to safeguard all client assets, not just funds and securities, over which an adviser has custody.

The population and variety of privately offered securities has grown substantially since 2003 and now includes private equity, private debt, real estate, natural resources, and crypto assets. Commonly, custodians will list assets for which they do not accept custodial liability on a client's account statement. For these assets, the custodian does not attest to the investment's holdings or transactions or take steps to ensure that the investments are safeguarded appropriately. This practice is known as accommodation reporting.

Recent crypto bankruptcies have highlighted the lack of regulation on custody of these assets. Crypto assets generally use a distributed ledger or blockchain technology to record ownership and transfer assets. This

technology often makes it difficult or impossible to reverse erroneous or fraudulent transactions and could leave advisory clients without meaningful recourse to reverse erroneous or fraudulent transactions, recover or replace lost crypto assets, or correct errors that result from their adviser having custody of these assets.

II. Scope

Assets

The proposal expands the scope of investments covered by defining assets as "funds, securities, **or other positions held in a client's account,**" as opposed to the current rule's use of "funds and securities." The SEC intends for "other positions" to include holdings that may not necessarily be recorded on the balance sheet as an asset for accounting purposes, *e.g.*, short positions and written options. New assets covered would include:

- Crypto assets that may not be classified as either funds or securities
- Physical assets, including artwork, real estate, precious metals, or physical commodities, *e.g.*, wheat or lumber
- Financial contracts held for investment purposes
- Collateral posted in connection with a swap contract on behalf of the client

Activities

The current custody definition includes three categories that serve as examples of custody: physical possession, certain arrangements when the adviser is authorized or permitted to instruct the client's custodian, and circumstances when the adviser acts in certain capacities. The proposal would amend the custody definition to specifically include discretionary authority.[1] The SEC acknowledges that the participation of a qualified custodian limits the risk of loss, and the proposal creates a limited exception to the **surprise examination rules**. The exception would generally apply to client assets that are maintained with a qualified custodian when the sole basis for the application of the rule is an adviser's discretionary authority that is limited to instructing the client's qualified custodian to transact in assets that settle only on a delivery versus payment (DVP) basis.

III. Expanded Custodial Protections

The proposal would continue to permit an adviser or its related person to serve as a qualified custodian for client assets.

Qualified Custodian Definition

The proposed rule would continue to allow banks or savings associations, registered broker-dealers, registered futures commission merchants (FCMs), and certain foreign financial institutions (FFIs) to act as qualified custodians, but only if they have possession or control of client assets pursuant to a **written agreement** between the qualified custodian and the investment adviser. For a qualified custodian that is the adviser, the proposal would

[1] 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.

require that the written agreement be between the adviser and the client. The amendments would modify the FFI definition and requirements for banks and savings associations.

Banks & Saving Associations

To be designated as a qualified custodian, a bank or savings association must 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 financial institution's insolvency or failure, *i.e.*, an account in which client assets are easily identifiable and clearly segregated from the bank's assets. This change aligns criteria with those required for broker-dealers, FCMs, and FFIs acting as qualified custodians.

Possession or Control

Possession or control means holding assets such that the qualified custodian is required to participate in any change in an asset's beneficial ownership, 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. Participation by a qualified custodian requires the qualified custodian to participate in a way that it is willing to attest to the transaction on an account statement and for which it customarily takes custodial liability. Accommodation reporting would not constitute participation.

The Wall Street Journal notes that cryptocurrencies are often transferable by anyone who holds a private key. Because of these unique features, it might be more difficult for a custodian to demonstrate that it is has exclusive control of a crypto asset.

Written Agreements

An investment adviser that maintains client assets with a qualified custodian must have a written agreement between the qualified custodian and the investment adviser (or between the adviser and client if the adviser also is the qualified custodian). The written agreement should be entered into with the adviser's reasonable belief that the qualified custodian is capable of—and intends to—comply with the contractual provisions. Advisers also should have a reasonable belief that the qualified custodian is complying with the agreement's contractual obligations and continuing to provide the protections to client assets for which the adviser obtained reasonable assurances from the qualified custodian. The written agreement must contain the following terms:

- **Provision of records**. A qualified custodian must provide promptly, upon request, records relating to clients' assets held in the account at the qualified custodian to the SEC or an independent public accountant engaged to comply with the safeguarding rule.
- **Adviser's level of authority**. The written agreement must specify the adviser's agreed-upon level of authority to effect transactions in the account as well as any applicable terms or limitations.
- **Account statements**. The qualified custodian must send account statements (unless the client is an entity whose investors will receive audited financial statements as part of the financial statement audit process), at least quarterly, to the client and the investment adviser, identifying the amount of each client asset in the custodial account at period-end and all transactions during the period, including advisory fees. The account statements also could be delivered to the client's independent representative. The current rule requires that advisers have only a reasonable basis for believing statements are delivered. The written agreement must contain a provision prohibiting the qualified custodian from identifying assets on account statements for which the qualified custodian lacks possession or control, unless requested by the client.

- **Internal control report**. The qualified custodian, at least annually, must obtain and provide to 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). The adviser should review the report for control exceptions and take appropriate action where necessary.

The proposal would expand the internal control report requirement to *all qualified custodians* from the current rule's application to an adviser or its related person.

Reasonable Assurance

An adviser must obtain reasonable assurances—in writing—from the custodian covering certain protections for the safeguarding of client assets. Currently, advisers are rarely parties to the custodial agreement, which is generally between the client and a qualified custodian. Reasonable assurances include:

- **Due Care**. Exercise due care in accordance with reasonable commercial standards in discharging its duty as custodian and implement appropriate measures to safeguard client assets from theft, misuse, misappropriation, or other similar type of loss. For example, the exercise of due care may require that a bearer instrument, such as a physical coupon bond, a physical security certificate, or a commodity such as gold, be kept in a vault. Likewise, an investment that is evidenced in electronic book-entry form, such as an exchange-traded note, could be maintained in line with robust cybersecurity standards.
- I**ndemnification**. Indemnify the client against losses caused by the qualified custodian's negligence, recklessness, or willful misconduct.
- **Sub-custodian arrangements**. Not be excused from its obligations to the client as a result of any sub-custodial or other similar arrangements.
- **Segregation**. Clearly identify and segregate client assets from the custodian's assets and liabilities.
- **Liens**. 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 in writing by the client.

Assets Unable to Be Maintained with a Qualified Custodian

While most advisory client assets can be maintained by qualified custodians, this option is not readily available for certain physical assets and privately offered securities. Some qualified custodians may refuse to custody such assets because the item's physical characteristics increase maintenance and safekeeping expenses. Some assets by their nature or size may not easily be subject to theft or loss, which may reduce the need for safeguarding.

The current rule exempts privately offered securities from custody requirements. The current exemption includes securities acquired from the issuer in a transaction or chain of transactions not involving any public offering; uncertificated, with ownership recorded only on the issuer's books or in client name by the transfer agent; and transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer. For an adviser to rely on this exception, the adviser also must comply with the custody rule's **audit provision**. Updates to the privately offered security exception's eligibility conditions include:

- The 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 beneficial ownership—of such assets. An adviser's reasonable determination generally would not require the identification of every conceivable qualified custodian and an

evaluation of its custodial services. The adviser's written documentation of its determination should contain material facts concerning its understanding of the custodial marketplace and a description of the client asset.

- The adviser reasonably safeguards the assets from loss, theft, misuse, misappropriation, or the adviser's financial reverses, including insolvency. For physical assets, reasonable safeguards may include storage in a secure facility or vault that adheres to exchange, clearing house, or other licensing requirements for participation in certain commodities markets; dual control procedures for access to assets in safekeeping; maintenance of records to evidence movement or transfer of assets (including details on depositor, beneficiary, and/or the legal owner); periodic reconciliation of records with assets held, *e.g.*, vault counts; separation of duties for movement or transfer of assets, record-keeping, and reconciliation; periodic audits; smoke detection and fire suppression systems; and insurance coverage for any custody-related losses incurred by its clients.
- An independent public accountant, pursuant to a written agreement between the adviser and the accountant must:
    - Verify 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
    - Notify the SEC within one business day upon finding any material discrepancies during the course of performing its procedures.
- The adviser notifies the engaged independent public accountant of any purchase, sale, or other transfer of beneficial ownership of such assets within one business day.
- 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.

In a change from the current rule, the proposal would require each privately offered security or physical asset not maintained with a qualified custodian to be verified.

Segregation of Client Assets

While advisers must attain reasonable assurance of segregation of client assets at a qualified custodian, advisers also would be required to segregate client assets from the adviser's assets and its related persons' assets when the adviser has custody. Advisers with custody of client assets must segregate those assets by:

- Titling or registering the assets in the client's name or otherwise holding the assets for the client's benefit
- Not commingling the assets with the adviser's or any of its related persons' assets
- Not subjecting the assets to any right, charge, security interest, lien, or claim of any kind in favor of the investment adviser or its related persons or creditors, except to the extent agreed to or authorized in writing by the client, *e.g.*, an authorization that allows assets to be subject to a securities lending arrangement authorized by the client

Surprise Examinations

The proposal retains the current rule's requirement for an adviser to undergo an annual surprise examination by an independent public accountant to verify client assets but expands the availability of the rule's **audit provision** to satisfy the surprise examination requirement.

Under the proposal, an adviser must reasonably believe that a written agreement has been implemented, *i.e.*, that the accountant will perform the surprise examination pursuant to the agreement and comply with the section's ADV-E filing and notification requirements when required. Entering into the contract with the accountant alone would not satisfy the rule. Advisers generally should enter into a written agreement with the accountant based upon a reasonable belief that the accountant is capable of complying—and intends to comply—with the agreement and the obligations the accountant is responsible for under the surprise examination requirements. For example, after securing the engagement's written agreement, the adviser generally should ensure that the accountant is able to access the SEC's filing system to perform the Form ADV-E filing functions. Any material discrepancies must be sent electronically to the Division of Examinations.

Exceptions from the Surprise Examination

Audit Provision

Under the proposal, an adviser that obtains an audit at least annually and upon an entity's liquidation would be deemed to have complied with both the surprise examination requirement and the client statement requirement. Currently, for an adviser to qualify for the audit provision, its client must be a limited partnership, limited liability company, or another type of pooled investment vehicle. The proposal would expand availability to any advisory client entity whose financial statements are able to be audited in compliance with the rule. The proposed audit conditions are largely unchanged from the current provisions:

- The audit must be performed by an independent public accountant that is registered with—and subject to regular inspection—by the PCAOB.
- Audited financial statements must be prepared in accordance with U.S. GAAP.
- Within 120 days (or 180 days in the case of a fund of funds or 260 days in the case of a fund of funds of funds) of an entity's fiscal year-end, the entity's audited financial statements, including any reconciliations to U.S. GAAP or supplementary U.S. GAAP disclosures, as applicable, are distributed.
- Pursuant to a written agreement between the auditor and the adviser or the entity, the auditor notifies the SEC upon certain events.

Discretionary Authority

The proposal contains an exception from the surprise examination requirement if the adviser's sole basis for having custody is discretionary authority with respect to those assets, provided this exception applies only for client assets that are maintained with a qualified custodian and for accounts where the adviser's discretionary authority is limited to instructing its client's qualified custodian to transact in assets that settle exclusively on a DVP[2] basis.

[2] In DVP transactions, clients' custodians are generally under instructions to transfer assets out of a client's account only upon corresponding transfer of assets into the account.

Standing Letters of Authorization (SLOA)

The proposal contains an exception from the surprise examination requirement for client assets if the adviser has custody of those assets solely because of a SLOA, which is defined 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. In such an arrangement, the client's qualified custodian could not be an adviser's related person. Such an 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. The authorization also must provide that the investment adviser has no ability or authority to designate or change any information about the recipient, including name, address, and account number.

IV. Record-Keeping & Reporting Requirements

The proposal would amend the investment adviser record-keeping rule (Rule 204-2) 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, notably:

- Retaining copies of required client notices
- Creating and retaining records documenting client account identifying information, including copies of all account opening records and whether the adviser has discretionary authority
- 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
- Creating and retaining a record that indicates the basis of the adviser's custody of client assets
- Retaining copies of all account statements and SLOAs
- Retaining copies of documents relating to independent account engagements, including all audited financial statements prepared under the safeguarding rule, a copy of each internal control report received by the investment adviser, and a copy of any written agreement between the independent public accountant and the adviser or the client

The proposal would amend Form ADV to align advisers' reporting obligations with the proposed safeguarding rule's requirements and improve the accuracy of custody-related data available to the SEC, its staff, and the public. Advisers would be required to report the following information for all qualified custodians maintaining client assets:

- Full legal name of the qualified custodian
- Location of the qualified custodian's office responsible for the services provided
- Contact information for an individual to receive regulatory inquiries
- Type of entity
- Legal Entity Identifier
- Number of clients and approximate amount of client assets (rounded to the nearest $1,000) maintained by the qualified custodian
- Whether the qualified custodian is a related person, and if so, the identifying information for the independent public accountant engaged to prepare the proposed internal control report and verification required under the proposed safeguarding rule

An adviser would be required to file promptly an other-than-annual amendment to Form ADV if any of an adviser's responses regarding the following becomes inaccurate in any way:

- Whether the adviser has custody of client assets either directly or because a related person has custody of client assets in connection with advisory services that the adviser provides to the client
- Whether the adviser is relying on certain exceptions to the proposed rule
- Whether client assets are maintained with a qualified custodian
- Whether the adviser or a related person serves as a qualified custodian under the proposed rule
- Whether client assets are not maintained by a qualified custodian
- Whether the adviser is required to obtain a surprise examination by an independent public accountant under the proposed rule
- Whether the adviser is relying on the audit provision

Conclusion

The asset management team at Forvis Mazars has more than 50 years of experience providing accounting, tax, and consulting services to various types of investment holdings, including conventional debt and equity investments, loans, businesses, alternative investments, and other unique assets. As of August 2022, Convergence Optimal Performance ranked Forvis Mazars as a top 25 accounting and audit firm to registered investment advisors. Forvis Mazars also was ranked in the top 20 by assets under management. We have experience providing services to fund complexes with net assets ranging from a couple million to several billion dollars. Our experience allows us to provide tailored services to help meet your unique needs. For more information, visit forvismazars.us.

Contributors

Brian Matlock
Partner
brian.matlock@us.forvismazars.com

Debbie Scanlon
Partner
debbie.scanlon@us.forvismazars.com

Anne Coughlan
Director
anne.coughlan@us.forvismazars.com