Securities Regulation Daily Wrap Up, INVESTMENT ADVISERS—SEC proposes expanding Advisers Act client asset safekeeping rule, (Feb. 15, 2023)

Securities Regulation Daily Wrap Up

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The new rule would enhance the old one by capitalizing on qualified custodians and capturing cryptocurrencies.

The SEC held an open meeting on February 15 on proposed new Rule 223-1 pertaining to investment adviser safekeeping of client assets. The proposal would expand the investor-client protections contained in the 1962 original Rule 206(4)-2 and subsequent 2009 rule amendments in order to cover financial instruments such as cryptocurrencies that were nonexistent in 2009 but came to present substantial risks to client assets. The Commission's authority to expand the safekeeping protections was carved from the 2010 Dodd-Frank Act following both the 2008 financial crisis and the Bernard Madoff fraud on retail and other investors. The client asset protection discussion followed a discussion and vote on a final rule to shorten the clearance and settlement time-period. The safekeeping proposal was approved by a 4 to 1 vote, with Commissioner Peirce dissenting (*Safeguarding Advisory Client Assets*, Release No. IA-6240, February 15, 2023).

Primary rule expansions. Rule 223-1 improves upon Rule 206(4)-2 and the 2009 amendments by:

1. ***Expanding the current custody rule to protect a broader array of client assets and advisory activities.*** The current regime safeguards client funds and assets the investment adviser holds or possesses. The new rule, however, would broaden the coverage to include any client asset over which an adviser has custody. By authority under Dodd-Frank to develop and enhance client asset protections, the Commission now defines "assets" as "funds, securities, or other positions held in a client's account." And extrapolating from this definition, protecting cryptocurrencies whether securities or not, and any future securitized instruments comprising client assets, would also be fair game for Rule 223-1 regulation.
2. ***Cover discretionary authority together with custody.*** Proposed Rule 223-1 would also extend client asset safekeeping protections to specifically include an investment adviser's discretionary authority to trade client assets.
3. ***Amend recordkeeping and Form ADV.*** To reflect the above two proposed provisions, the Commission's investment adviser recordkeeping rule, along with Form ADV, would necessitate some rewrites. Specifically, the recordkeeping rule would be amended to require advisers to keep additional, more detailed records of trade and transaction activity and position information for each client account over which the adviser has custody. As for Form ADV, its proposed amendments would align investment adviser reporting requirements with the proposed safeguarding rule's requirements in order to improve the accuracy of custody-related data.
4. ***Qualified custodian usage.*** The final proposed prong of Rule 223-1—and the most talked-about at the meeting (aside from cryptocurrency assets)—concerned the need to safeguard client assets with a qualified custodian. Like current Rule 206(4)-2 and the 2009 amendments, the proposed rule would require investment advisers having custody of client assets to maintain the assets with a qualified custodian, with very limited exceptions.

While the qualified custodian can be a federal or state-chartered bank or savings institution, as well as certain trust companies, a registered broker-dealer, a registered futures commission merchant, or particular foreign financial institutions (FFIs), the proposal would require the qualified custodian to have "possession or control" of

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client assets. Furthermore, the proposal would: (1) mandate a more robust set of requirements for an FFI to be a qualified custodian; and (2) specify the way that qualified custodian banks and savings institutions must hold client assets.

Moreover, the proposed rule would require investment advisers to enter into a written agreement with, and obtain a set of assurances from, the qualified custodian to ensure clients receive standard custodial protections when the adviser has custody of their assets. These assurances are particularly designed to ensure the client assets are segregated in separate client accounts to protect them should a qualified custodian later declare bankruptcy or otherwise become insolvent.

Chair Gensler's and Commissioner Crenshaw's and Lizárraga's overall remarks supporting the proposal. Chair Gensler, supporting proposed Rule 223-1, declared the ripeness for safeguarding *all* custodial client assets following Dodd-Frank's granting SEC authority to do so because of the current tens of trillions of dollars in assets under management now held by investment advisers which may include extremely volatile cryptocurrencies. And he emphasized the proposal's detailed qualified custodian provision, including the stringent application requirements for FFIs to act as qualified custodians and the mandate to preserve client assets in segregated accounts to prevent them from becoming assets a client would have to fight for in bankruptcy court following the qualified custodian's insolvency.

Commissioner Lizárraga stated the proposal is timely to capture in the new rule the escalating number of enforcement actions the SEC has had to initiate against investment advisers over their misappropriation of custodial client assets since the 2009 Rule 206(4)-2 amendments. Commissioner Crenshaw reiterated Chair Gensler's comments, also praising the proposed rule's explicit detail for protecting cryptocurrency assets.

Commissioner Uyeda. While voting for the proposal, Commissioner Uyeda proclaimed Rule 223-1 "deceptively simple." He precisely referred to the FFI and cryptocurrency provisions. Pertaining to FFI, he believes that, in reality, it will be a lot harder than the proposal suggests to properly vet a foreign financial institution to become a qualified custodian. Also, there is already a separate SEC proposal on outsourcing the qualified custodian role to an FFI, which may run counter to the eventual outcome of this proposal. He suggested that both proposals be joined in some way and discussed together to avoid inconsistent results down the road. As for cryptocurrency, Uyeda remarked upon how cryptocurrencies are often traded on online platforms, thereby making it more difficult for a qualified custodian to take custody of the assets. Moreover, the trading on these platforms already violates the rule because the platforms, themselves, are not qualified custodians.

Commissioner Peirce dissents. While not supporting the current proposal, Commissioner Peirce declared she could support the rule when it nears adoption if her concerns are addressed during and beyond the public comment period, leading to further amendments before adoption. Peirce identified the proposal's most pronounced flaws as:

- The proposal is too large in scope to be sufficiently fleshed out in a 60-day public comment or 18-month after-comment period;
- Complying with current proposed rule requirements will be unworkable and too costly for smaller investment advisers;
- The proposal would push the Commission to attempt regulating types of assets (e.g., certain cryptocurrencies and future securitized instruments) it does not typically regulate or have jurisdiction over;
- Approving FFIs as qualified custodians would be conditioned on proof that they are not money launderers, among other qualifications, which may be difficult for the Commissioner to determine;
- And if the Commission does not have jurisdiction over particular assets or a particular FFI or other qualified custodian or does not properly vet them before approving their qualified custodian role, who's accountable if the qualified custodian loses or otherwise misappropriates a client's assets?

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