Statement

Statement on Safeguarding Advisory Client Assets Proposal

Commissioner Caroline A. Crenshaw

Feb. 15, 2023

I am pleased to support today's proposal relating to amendments to the Custody Rule, or the newly minted "Safeguarding Advisory Client Assets" Rule.[1]

The Custody Rule from inception acknowledged that, when clients entrust their funds and securities to their investment advisers, those advisers must hold such assets in safekeeping, so that they are "insulated from and not [] jeopardized by financial reverses, including insolvency, of the investment adviser."[2] In fact, it is considered a fraudulent, deceptive or manipulative practice to do otherwise. That was true at inception and it remains true today.[3] This premise is foundational to the relationship between adviser and client.

When most recently amending the Custody Rule in 2009, the Commission cited to wrongdoing on the part of advisers involving misappropriation or misuse of investor assets.[4] The Custody Rule, however, is also an unsung hero of the frauds that were never perpetrated because of the rule's protections. Those protections are stalwart as the SEC continues to strengthen the rule,[5] enforce its mandates,[6] and rigorously examine adviser compliance.[7] Indeed, the Custody Rule is the rule that, when properly executed, helps *prevent* fraud, *protect* investors against the guiles and vagaries of a misguided or fraudulent adviser, and *promote confidence* in the integrity of the client - adviser relationship.[8]

Today's proposed rule expands and fortifies the safeguards under the existing Custody Rule in a number of important ways. For example:

- Assets. The proposal uses our Dodd-Frank authority to apply the protections of the rule to *all* client assets over which an investment adviser has custody, and not just "funds or securities" as is the language in the current rule.[9] This would potentially capture certain alternative assets, for which advisers provide investment advice but are not considered securities.[10],[11] The expansion of the rule to cover all assets ensures that new or novel assets will get adequate protection as they arise, regardless of whether such assets are funds or securities.[12] An adviser's fiduciary duty applies to the entire relationship with the client, not just with respect to

funds or securities. This proposal would help bring the safeguarding of assets in line with that fiduciary obligation.

- Privately Offered Securities. The proposal would also enhance investor protections under, and circumscribe the availability of,[13] the "privately offered securities" exception, where advisers are not required to custody assets with a qualified custodian.[14] While this exception was intended to be utilized infrequently, the exception appears to be widely relied upon throughout the industry.[15] Today's proposal would mandate that advisers who rely on the privately offered security exception have a reasonable belief that such securities *cannot* be maintained with a qualified custodian; such assets are nonetheless safeguarded and independently verified annually and upon transfer, purchase or sale.

- Safeguards Surrounding Qualified Custodianship. The proposal also improves the gatekeeping function provided by qualified custodians.[16] For example, an adviser would have to enter into a written agreement with the qualified custodian to ensure that certain basic fundamental custodial protections are in place. The qualified custodian would also have to obtain a written internal control report that includes an opinion of an independent public accountant regarding the adequacy of its controls. And, the adviser would have to get certain assurances in writing from the qualified custodian, including assurances that the custodian will not subject client assets to any lien or claim by the custodian or its creditors unless expressly authorized in writing by the client (a prohibition that would also be true of an investment advisor and its creditors under the proposal).[17]

Finally, a word about the application of the rule to cryptocurrencies and digital assets. The proposal lays out how advisers can ensure that crypto assets are adequately custodied. Many in the industry have asked how our rules apply to crypto and this proposal is explicit on that point. Under the current crypto landscape, with a glaring lack of registered offerings, registered participants, transparency and accountability, investors' crypto assets remain particularly vulnerable to misuse, misappropriation and fraud. And restoring or recovering assets that have dissipated presents potentially insurmountable challenges.[18] While the Custody Rule today in fact covers many crypto asset securities, I share the concerns in the release that many of those assets are not in practice properly custodied or safeguarded, and events across the crypto markets have shown the spectacular harm and loss that can befall investors when client assets are not adequately safeguarded.

Today's proposed amendments apply to *all* assets over which an investment adviser has custody. It does not favor or discourage one asset class over another. It allows for innovation and new technologies, but not at the expense of basic, fundamental investor protection. No matter how bold or different the investment landscape may look in the future, the Custody Rule must stand unweathered as the promise that investor assets are safeguarded against misuse and misappropriation. Today's proposal seeks to strengthen that promise. For these reasons, and many more, I'm pleased to support today's proposed rule.

This release, I know, has been a tremendous undertaking for our teams in the Division of Investment Management, Division of Economic and Risk Analysis, the General Counsel's office, the Division of Examinations, the Division of Enforcement, the Office of International Affairs, the Office of the Strategic Hub for Innovation and Financial Technology, and in the offices of the Chair and my fellow Commissioners. Thank you as always for your hard work, rigor and careful consideration.

[1] It will always be the Custody Rule to me. *But see* Safeguarding Advisory Client Assets, IA Rel. No. 6240, (Feb. 15, 2023) ("Safeguarding Proposal").

[2] *See* Custody or Possession of Funds or Securities of Clients, IA Rel. No. 123, 44 FR 2149, 2149 (Mar. 6, 1962) ("1962 Adopting Release").

[3] *See id.* Despite today's re-designation of the Custody Rule as Rule 223-1, the statutory authority continues to include not only Section 223 of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-18b, but also Sections 206(4) and 211(a). 15 U.S.C. §§ 80b-6(4), 80b-11(a); *see also* Safeguarding Proposal at Section V.B, p. 397. The provision continues, therefore, to derive its statutory basis from the antifraud provisions of the Advisers Act. *See* Safeguarding Proposal at n.32 and accompanying text.

[4] *See, e.g.,* Custody of Funds or Securities of Clients by Investment Advisers, IA Rel. No. 2968 (Dec. 30, 2009), 75 FR 1455 (Jan. 11, 2010) ("2009 Adopting Release"), at n.1; Safeguarding Release at n.11 and accompanying text.

[5] 1962 Adopting Release; Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2176 (Sept. 25, 2003), 68 FR 56692 (Oct. 1, 2003) ("2003 Adopting Release"); 2009 Adopting Release; Safeguarding Proposal.

[6] *See*, *e.g.,* SEC Charges Two Advisory Firms for Custody Rule Violations, One for Form ADV Violations, and Six for Both (Sept. 9, 2022) (press release collecting cases); *Matter of Arcadia Wealth Management, Inc*., IA Rel. No. 6137 (Sept. 19, 2022); *Matter of Charles Pratt & Co*., LLC, IA Rel. No. 6107 (Sept. 8, 2022); *Matter of Spruce Investment Advisors, LLC*, Rel. No. 5987 (Mar. 30, 2022); *SEC v. Boveda Asset Management*, 21-cv-5321, Dkt. 1 (Complaint) (Dec. 29, 2021); *Matter of Redwood Wealth Management, LLC*, IA Rel. No. 5880 (Sept. 20, 2021); *Matter of Soteira Capital*, IA Rel. No. 5877 (Sept. 28, 2021).

[7] *See, e.g.,* Safeguarding Release at n.391 ("In FY 2022, EXAMS verified over 2.1 million investor accounts, totaling over $2 trillion."); U.S. Securities & Exchange Commission Division of Examinations, 2023 Examination Priorities (Feb. 7, 2023) at 10 (noting the custody rule as a "significant focus area" in connection with RIAs to private funds); Division of Examinations Risk Alert, The Division of Examinations' Continued Focus on Digital Asset Securities (Feb. 26, 2021) at 3-5; OCIE Risk Alert, Observations from OCIE's Examinations of Investment Advisers: Supervision, Compliance and Multiple Branch Offices (Nov. 9, 2020) at 2-3; National Examination Program Risk Alert, The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers (Feb. 7, 2017) at 3-4.

[8] Custody protections are of heightened importance in the less-regulated private markets. *See* John C. Coffee, Jr., "Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and the Need for Reform," Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, 111th Congress, 1st session ("Testimony of John C. Coffee, Jr.") at 7, 9-10 (noting that, amid the increased frequency of Ponzi schemes generally, no mutual fund registered under the Investment Company Act of 1940 had ever collapsed or been exposed as a Ponzi scheme).

[9] Safeguarding Proposal at § 275.223-1(a).

[10] *See* Safeguarding Proposal at 19 ("The proposal is designed to recognize the evolution in products and services investment advisers offer to their clients and to strengthen and clarify existing

custody protections . . . ."). The proposal notes that "other positions," which would be considered assets under the proposal, might also include short positions, written options, financial contracts, collateral posted in connection with a swap contract, artwork, real estate, precious metals, physical commodities, among other potential assets. *Id.* at 27-9. *See generally* Prequin, "Alternatives in 2022," (Jan. 19, 2023) at 10 (projecting assets under management invested in alternative asset classes to grow from $13.32 trillion at the end of 2021 to approximately $23.21 trillion by 2026).

[11] Many have been calling for this change for years. *See, e.g.,* Testimony of James Chanos, "Regulating Hedge Funds and Other Private Investment Pools," Testimony before the Subcommittee on Securities, Insurance, and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs, 111th Congress (Jul. 15, 2019) at 50, n.19 ("[P]rivately issued uncertificated securities, bank deposits, real estate assets, swaps, and interests in other private investment funds, as well as shares of mutual funds, . . . under current law, can simply be titled in the name of the private investment fund care of the manager, and the evidence of ownership held in a file drawer at the manager of the private investment fund. . . . This gaping hole in current Advisers Act custody requirements can allow SEC-registered advisers easily to abscond with money or other assets and falsify documentation of ownership of certain categories of assets, and makes it difficult for auditors, investors and counterparties to verify the financial condition of advisory accounts and private investment funds."); Testimony of John C. Coffee, Jr., at 13 ("The most important reform is to require an external and independent custodian for all collective investment vehicles.").

[12] Safeguarding Proposal at 20.

[13] Safeguarding Proposal at 24 ("The modifications are designed to limit availability of the exception to circumstances that truly warrant it because we believe the bulk of advisory client assets are able to be maintained by qualified custodians and should be safeguarded in the manner contemplated under the safeguarding rule.").

[14] Safeguarding Proposal § 275.223-1(b)(2).

[15] Safeguarding Proposal at 14-15.

[16] Safeguarding Proposal § 275.223-1(a)(1).

[17] Safeguarding Proposal § 275.223-1(a)(3)(iii).

[18] Safeguarding Proposal at 17 (noting that the requirement of public and private cryptographic key pairings often results in the inability to restore or recover crypto assets in the event that such assets are misappropriated and that distributed ledgers make it difficult or impossible to reverse fraudulent transactions).