Simpson Thacher

Regulatory and Enforcement Alert

The SEC Proposes Significant Changes in a New Safeguarding Rule

February 17, 2023

In a 4-1 vote earlier this week, the SEC proposed a dramatic set of amendments to existing Rule 206(4)-2 (the "**Custody Rule**") under the Investment Adviser's Act of 1940. The proposal, if adopted[1] would re-designate the Custody Rule as new Rule 223-1 and name it the "Safeguarding Rule." The SEC stated that the rationale for issuing the proposal is to enhance investor protection relating to advisory clients assets over which registered investment advisers have custody and to modernize certain aspects of the existing Custody Rule.[2] The SEC proposed a staggered implementation, with a 12 month compliance period for large advisers and 18 months for smaller advisers.

There is widespread consensus that safeguarding client assets is vitally important, and at the heart of the SEC's responsibility for investor protection. Unfortunately, however, the proposal's workability and implementation timeline raise many questions. The proposal introduces challenging new obligations with the potential to disrupt current practices by market participants, including private fund sponsors and other investment advisers and their investors and clients, and any bank, broker-dealer or other intermediary that serves as the client's qualified custodian ("**Qualified Custodian**"). Thoughtful engagement on these important questions, however, will be challenged by the abbreviated comment period (60 days after the proposing release is published in the Federal Register), limited proposed implementation period and the SEC's rapid fire rulemaking pace aimed at investment advisers. Following is a summary of some of the more noteworthy aspects of the proposal.

- ***The proposal would require advisers to enter into new written agreements with each client's Qualified Custodian and obtain several written assurances from that Qualified Custodian.*** Among these are an assurance that the Qualified Custodian will indemnify the client against losses resulting from the Qualified Custodian's negligence, recklessness or willful misconduct and that the existence of any sub-custodial or similar arrangement will not excuse any of the Qualified Custodian's obligations to the client. The Qualified Custodian also would need to assure the adviser that it will exercise due care in accordance with reasonable commercial standards in discharging its duty as custodian and segregate client assets from the Qualified Custodian's proprietary assets and liabilities. The SEC

[1] The SEC published the full text of the proposal: *Safeguarding Advisory Client Assets* as well as a *Proposed Safeguarding Fact Sheet*. At the same meeting, the SEC finalized rules shortening the standard trade settlement date to one day (T+1). *See* *Shortening the Securities Transaction Settlement Cycle*.

[2] Corresponding changes to the Advisers Act books and records rule (Rule 204-2) and Form ADV are designed to align reporting obligations with the proposed rule.

acknowledged that these requirements are a substantial departure from current practice. We doubt the workability or enforceability of this proposed requirement, and expect the commenters to assert that the SEC has conducted an inadequate economic analysis of its impact. We also expect commenters to question the necessity of the SEC seeking to interpose itself in private contractual arrangements and impose indirect regulation on Qualified Custodians through investment advisers; investment advisers are not typically parties to custodial agreements between their clients and Qualified Custodian's, particularly in the case of wealth managers. Furthermore, as a contractual matter, it is unclear how or whether the assurances provided to an investment adviser could be enforced. We expect this aspect of the proposal to generate much comment.

- ***The proposal would add onerous conditions to a key exception under the Custody Rule for private securities.*** The proposal would continue to except certain privately offered securities from the requirement they be held with a Qualified Custodian, but would add two significant new requirements to rely on the exception:
    - First, the adviser must reasonably determine, and document in writing, that such securities cannot be recorded and maintained by a Qualified Custodian. This would be a significant departure from the current exemption. The SEC release does not clarify the extent of the analysis required to justify this reasonable determination, and how impracticable it must be for the Qualified Custodian to maintain the asset.
    - Second, the proposal would require that an independent public accountant verify promptly any purchase, sale or other transfer of any privately offered securities relying on the exception. This will likely be onerous and costly, with questionable end benefits to investors.
- ***The proposed rule would apply to all assets in a client's account.*** The current Custody Rule applies to "funds and securities." The proposal would extend to all other positions held in a client's account and all other assets that investment advisers custody for their clients. As statements from various Commissioners made clear, this aspect of the proposed rule was squarely aimed at investments in crypto assets (although it also would apply to other assets that are not securities, such as real estate). We expect crypto market participants to mount a sustained challenge to the sweeping changes contemplated by the proposal, including its failure to account for the unique attributes of many digital assets.
- ***The proposal would add a new requirement on Qualified Custodians that would require them to have possession and control of assets.*** This requirement must be met for the Qualified Custodian to be viewed as "maintaining" the assets for purposes of meeting the Safeguarding Rule requirements. One challenge with this requirement is how and whether the adviser, which is the only party subject to the rule, can determine whether the Qualified Custodian has such possession and control.

- ***The proposal would broaden the types of advisory activities that could be deemed to confer custody to an adviser.*** These new circumstances include simply the authority to engage in discretionary trading without the ability to otherwise direct assets out of the account.

Conclusion

The proposal does introduce some changes that may be welcomed by the market, as consistent with the SEC's overall investor protection mandate, such as possibly expanding the audit provision under the current Custody Rule to cover entities (rather than just pooled investment vehicles). Overall, however, if adopted in current form, the rule may have significant negative implications, both seen and unforeseen, for investment advisers, advisory clients, Qualified Custodians, and other market participants. Advisers would likely incur significant costs in negotiating agreements with qualified custodians and may have significant difficulty, particularly in the case of smaller advisers, in identifying Qualified Custodians willing to take on these requirements, particularly for novel or esoteric forms of assets and even for privately offered securities (which they may or may not have previously custodied).

While ultimately meant to protect investors, this raises the possibility that the proposed rule could have the effect of making it more expensive to operate, especially for newer or smaller advisers, and cause a reduction in available service providers and further migration to (and entrenchment of) existing Qualified Custodians.

While the SEC has recognized that the proposal may be more difficult in the case of smaller advisers, the current implementation timeframe could be particularly challenging given the scope of changes required of the industry and the negotiations with Qualified Custodians and independent public accountants that would need to take place to meet the proposed rule's requirements. As has been observed with a number of recent SEC proposals, the current 60-day comment period raises additional concerns that the public and relevant industry stakeholders will not have enough time to analyze all aspects of the proposal, particularly amid a flurry of other regulatory changes targeting fund sponsors and alternative asset managers.

For further information regarding this Alert, please contact one of the following members of the Firm's Private Funds – Regulatory Department.

WASHINGTON, D.C.

David W. Blass
+1-202-636-5863
david.blass@stblaw.com

David Nicolardi
+1-202-636-5571
david.nicolardi@stblaw.com

NEW YORK CITY

Michael J. Osnato, Jr.
+1-212-455-3252
michael.osnato@stblaw.com

Meredith J. Abrams
+1-212-455-3095
meredith.abrams@stblaw.com

Manny M. Halberstam
+1-212-455-2388
manny.halberstam@stblaw.com

Jeffrey Caretsky
+1-212-455-7764
jeffrey.caretsky@stblaw.com

William LeBas
+1-212-455-2617
william.lebas@stblaw.com

HOUSTON

Minzala G. Mvula
+1-713-821-5617
minzala.mvula@stblaw.com

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.