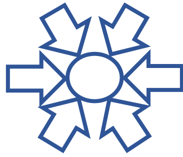

Financial Services Management

Custody Reform

Cite
SEC, Notice of Proposed Rule, Safeguarding Advisory Client Assets

Recommended Distribution:
Custody, Investment Advisers, Digital Finance, Wealth Management, Corporate Planning, Policy, Legal, Government Relations

Website
https://www.sec.gov/rules/proposed/2023/ia-6240.pdf

Impact Assessment

- The SEC is seeking to establish an "evergreen," technology-agnostic approach to custodial services to the benefit of all investors across the full range of asset classes imposing more stringent operational, segregation, indemnification, and transparency requirements. This will determine not only which entities may be deemed qualified custodians, but even which asset classes succeed in the capital and asset-management markets.
- Cryptoassets will be particularly challenged by this construct, as will the ability of cryptoasset trading platforms to continue to provide custodial services. The strategic future of many digital assets and entities could thus be threatened.
- Assets now exempt from mandatory custody – e.g., real estate, privately-issued securities, art – would come into the new, stringent custody construct. This poses numerous operational challenges along with indirectly imposing new AML and sanctions-compliance requirements on these sectors.
- Express standards in matters such as indemnification and due care are intended to better protect retail customers, whom the Commission believes now have little bargaining power over custodial services and thus often receive imperfect or even improper protection.
- Custodians would generally take on greater liability and operational obligations. Nonbank custodians could also come under requirements for a certain level of capitalization or other risk buffers to ensure they can honor indemnification claims, possibly limiting the number of entities willing or able to undertake this role.
- Banks, savings associations, broker-dealers, and FCMs would not automatically be considered eligible custodians and foreign financial institutions would face stringent new requirements. Conversely, transfer agents and insurance companies might be able to enter this arena.
- A reduced number of custodians could raise investor costs and/or risk

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despite the benefits of eliminating unsuitable or fragile custodians.

Overview

Making full use of powers granted in the 2010 Dodd-Frank Act,[1] the SEC is proposing a wholesale rewrite of the rules dictating how investment advisers must place assets in custody and which institutions are considered qualified for this purpose. Although the proposal was sparked first by controversies surrounding custody for cryptoassets and then by significant investment losses, the NPR reaches most assets held in the direct or indirect possession of investment advisers or to which the adviser may gain possession, also redefining qualified custodians to exclude not only most crypto platforms, but also foreign firms and other entities the Commission believes do not ensure sufficient safeguards protecting investor assets in the event of the adviser's malfeasance, insolvency, or operational failure. Many of the proposal's new requirements – e.g., control over beneficial-ownership changes, strict segregation – are already followed by those bank custodians with fiduciary obligations due to their own protocols and regulatory requirements, perhaps giving banks a head-up complying with new standards. However, the new standards may be problematic for at least some custody banks – the SEC wants them to resume fiduciary obligations and does not appear wholly satisfied with bank rules governing qualified custodians.

If the SEC's standards are too onerous and/or bank regulators impose additional requirements reflecting heightened bank risk, then banks could reduce their custody operations. Custody services could then become scarce and/or more costly, a result that would harm the retail investors the SEC believes would benefit the most from its proposal. However, the SEC posits that industry standards have slipped largely because banks have reduced their own controls in order to compete with risky new entrants and that universally tough standards would improve protection as low-end providers exit custodial services. Perhaps anticipating this, the Commission also establishes new fiduciary-like duties for investment advisors even in the absence of mandatory custody.

Impact

The impetus for this rulemaking is clearly the rapid expansion of the cryptocurrency market, the establishment of new state-chartered trust companies that provide custody services, and the collapse of several major cryptoasset companies at considerable cost to investors. However, the Commission also notes growth in financial products (e.g., privately-issued securities and certain commodities instruments) that are largely outside the scope of current custodians and thus may put investors at risk.

The proposal also takes this opportunity bring more traditional assets – e.g., real estate, art, and even wine – into the mandatory-custody construct, raising significant operational issues given the physical nature and complex documentation associated with these assets. Once all of these assets – crypto, new securities, and the rest – come into the ambit of qualified custodians, banks

[1] See **CUSTODY3**, *Financial Services Management,* January 29, 2010.

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and any other approved providers would need to know beneficial owners and approve transactions in ways sure not only to enhance investor protection as the Commission expressly intends, but also to force far greater transparency in asset classes of considerable concern regarding money laundering and sanctions evasion.

The nature of these requirements is likely to prove particularly challenging for digital assets and especially for cryptoassets due to the immediacy and finality that characterize virtually all of these transactions and the requirement under current rules that custodians have “exclusive” control of assets (a requirement tightened in the proposal to make it still more stringent). Crypto’s features provide significant benefits in several respects, but they also complicate the extent to which assets can be housed in third parties with the firewalls essential for safeguarding assets without at the same time slowing transaction speed and ensuring remediation for false or flawed execution.

This does not appear to trouble the Commission, with the proposal also suggesting that “atomic” crypto settlement is so problematic that it should be strictly limited. The SEC also notes that its proposal may in fact prove so problematic for cryptoassets as to threaten the viability of some or even all cryptoassets. This is a prospect that the Commission appears to view with equanimity in this release because of risks recently evident in the marketplace. It is, however, strongly opposed by Republican commissioners, who note that cryptoassets are legal and thus should not be indirectly barred for purposes of ensuring sound custodial services. In its defense, the NPR also notes that investment advisers may become more willing to support digital assets with these rules in place because reliable custodial services would be more readily available, a change that might further at least some instruments (e.g., tokenized fiat obligations) in this market.

The NPR’s preamble also emphasizes that any cryptoasset that is or is deemed likely to be deemed a fund or security by the SEC comes under the requirements in current rule requiring a qualified custodian. The SEC also takes advantage of this rulemaking to advise institutions that are now holding digital assets without the benefit of a qualified custodian that they are acting in contravention of current rules because the Commission believes most digital assets are either funds or securities – a controversial call, but one the SEC has established in recent months via numerous and often costly enforcement orders. When the proposal was announced, at least one crypto platform which currently provides custody services for assets that it also settles indicated that it complies with the proposal, but the Commission’s discussion in the NPR may not only make this problematic, but also pose challenges to the extent to which current operations are deemed to comply with the existing rule.

As discussed below, the proposal retains the automatic eligibility of U.S. banks and savings associations as qualified custodians. However, the Commission does not seem assured that bank regulation fully suffices to ensure that a custodian can perform the duties it would now specify. This is in part because the SEC does not believe that the banking agencies have updated

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custody standards to ensure they are robust, especially when it comes to digital assets. The OCC attempted to do so in 2019 via an advance notice of proposed rulemaking that would in fact have significantly liberalized bank custody powers for cryptoassets,[2] but it instead decided in 2021 to roll this back by reiterating the importance of safety and soundness along with prior approval for new crypto activities.[3] The OCC did not, however, roll back previous approvals nor have the cautionary policies in recent months from the FRB[4] and other banking agencies done so in general or with specific regard to custodial services.

The interplay of SEC standards and bank regulation is made still more complex by an SEC staff bulletin released last year setting accounting standards related to segregated custodial assets. Staff bulletins of this sort do not set binding policy and the new rule would generally override those related to custody and specifically to the crypto assets targeted in this release. Many interpreted it as requiring custodial banks to segregate cryptoassets so significantly as to make them de facto bank assets then subject to regulatory-capital requirements. The proposal's numerous indemnification and related requirements override aspects of the staff bulletin and could be read to do so completely, but to the extent standards are read expressly to force capitalization remain, bank custodians would likely not enter the cryptoasset arena even if the SEC's standards do not otherwise make custodial activities problematic.

Notably, banks are not the only custodians that could fall under stringent capital requirements. The SEC seeks comment on whether all qualified custodians would need to demonstrate sufficient capital and/or insurance in order to meet the standard requiring them also to indemnify clients in the event of loss due to negligence or other causes germane to custodial activity. Nonbanks, broker-dealers, FCMs, and foreign entities may find this challenging even if other impediments do not bar eligibility.

The SEC says that it has also observed a general shift in custody practices in which investors with the least market power – i.e., lower-balance retail customers – receive the least protection, the result in part of the diminished willingness of bank custodians to act in a fiduciary capacity. The Commission premises its rules on expectations that bank custodians will regain market share and thus resume prior standards now heightened by express requirements, but it is possible that banks will instead exit this arena, sharply increase the cost of offering custodial services, or limit services to institutional investors – a business-strategy choice the Commission cannot overrule.

As discussed below, the scope of this rule would require extensive retooling, auditing, internal controls, disclosures, and legal accountability. Stringent segregation standards could be particularly problematic if the Commission decides, as proposed, to end commingling or the other ways in which bank custodians now generally hold retail or complex customer assets. In addition, current custody practices would also be revised in areas such as "accommodation" statements that show client assets in the adviser's possession

[2] See **CUSTODY4**, *Financial Services Management,* May 9, 2019.

[3] See **CRYPTO22**, *Financial Services Management*, December 1, 2021.

[4] See **CRYPTO31**, *Financial Services Management*, August 22, 2022.

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not held in custody; the Commission believes that these create the misimpression that assets are in safekeeping even though this is not the case.

What's Next

The SEC approved this proposal on February 15 by a 4-1 vote. Comment is due sixty days after *Federal Register* publication, with implementation required of large entities within one year of the final rule.

Analysis

These standards would continue to apply only to advisers with a U.S. principal office and place of business governing U.S. and foreign clients. For purposes of this analysis, the term digital assets subsumes cryptoassets just as it does in the NPR. The NPR is extensive and very detailed. Key strategic considerations are noted below. The NPR also asks for comment on hundreds of questions; the analysis below highlights those on topics germane to strategic considerations where a change in the final rule from the proposal would significantly affect likely outcomes.

A. Scope

1. Key Terms

Under the new rule, a custodial relationship does not exist if the custodian lacks possession or control of related assets, with this criterion defined to mean that the custodian must be involved in any change of an asset's beneficial ownership. Limited exemptions apply if a custodian inadvertently receives certain client assets.

2. Covered Assets

Assets covered by the qualified-custodian requirement would be expanded from funds and securities to "client assets" to cover a wide range of current and prospective assets including collateral, commodities, real estate, and many others as well as client liabilities (e.g., negative cash). Exceptions to this rule would be limited only to assets where there is no reasonable ability to secure the asset by a qualified custodian and the adviser itself complies with an array of restrictions and third-party audits. Numerous questions about who should conduct these audits and what they must review are provided.

The proposal notes that the possession-and-control standards are operationally complex to implement for certain assets (e.g., privately-offered securities, real estate, precious metals), but expects that specialized qualified custodians will emerge for these assets if current entities are unable to handle them. Custodial fiduciary duties would also apply to all covered assets. Comment is sought on these issues, with particular regard to whether other

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assets should be covered and art or similar physical assets should remain excluded and the extent to which different custodial rules are needed for specific asset types.

3. Investment-Advisor Activities

Advisers with discretionary trading authority would now also be required to established qualified-custodial arrangements.

4. Qualified Custodians

The NPR would continue to allow banks or savings associations, registered broker-dealers, registered futures commission merchants, and certain foreign financial institutions to act as qualified custodians. However, in a change from the current rule, only if they have "possession or control" of client assets pursuant to a written agreement between the qualified custodian and investment adviser or, if the investment adviser is also the custodian, then between the adviser and client (see below). Not all entities within these categories would necessarily qualify, as entities must also be regularly supervised and otherwise demonstrably able to perform custodial duties, with banks and thrifts also required to hold custodial assets in accounts safeguarded from loss in the event of the bank or thrift's failure. The NPR appears to mean here that accounts are clearly segregated and identifiable as the client's, not the bank's, but the text could be read to require holding funds in insured deposits. This would be problematic given the $250,000 limit on FDIC coverage. The SEC also seeks comment on additional restrictions for eligible banks and thrifts (e.g., that they be subject to federal regulation, with the NPR confusing how this is done for state member and non-member banks).

Foreign financial institutions allowed to be qualified custodians could also come under new conditions that subject these firms to an express "safeguarding" rule in addition to the safekeeping standards discussed below. The SEC also seeks comment on whether eligible foreign financial institutions would also have to be banks or, conversely, could be expanded to include certain foreign clearing or securities facilities. The SEC is also seeking views on qualified foreign firms would need to serve as custodians under U.S. standards and AML rules even though the proposal would already require eligible foreign firms to be subject to U.S. rule of law, with the proposal also exploring whether entities in AML high-risk jurisdictions should be flatly barred. Advisers would also take on new duties to ensure that a foreign custodian meets all applicable conditions.

New standards and an array of questions are included with regard to reliance on sub-custodians.

5. Segregation

The rule would define how custodians are to ensure asset segregation (i.e., separate registration in the client's name, no commingling). However, many

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questions are asked about omnibus accounts and other techniques now used for administrative convenience to hold customer assets, with the Commission seeking to determine if these alternatives provide sufficient protection against custodian malfeasance or insolvency. Comment is sought also on the extent to which express contractual provisions should ensure segregation and if the proposal would discourage financial institutions from serving as qualified custodians.

Even in the absence of a custodian, advisers could not make use of client assets except under strict conditions executed via written agreements with the clients. Nothing in the new segregation requirements bars securities financing transactions related to assets in the custodial account, reimbursement for unpaid fees, or other forms of account access authorized in the written agreement.

6. *Surprise Audits*

The rule would expand requirements for surprise audits by independent third-party auditors.

B. *Restrictions and Records*

1. *Written Agreements*

Advisers would need to enter into written agreements providing certain assurances related to due care (i.e., cyber and physical protection) and other specified matters from a qualified custodian – i.e., that custodians promptly provide client asset records to the SEC or an independent public accountant engaged in an examination and that advisers detail their authority over an account. The written agreement would also need to require the custodian to provide written statements to clients and the adviser (versus current rules requiring the adviser only to have a reasonable basis to expect that this was done).

Advisers are to monitor custodian performance under these written agreements and address violations in a number of ways described in the NPR. Additional provisions are required in written agreements when the adviser provides custody services, including granting the custodian contractual rights to provide records to third-party auditors conducting examinations as well as to the SEC.

2. *Assurances*

In addition to these written agreements, advisers would have to obtain assurances from qualified custodians that they are exercising due care to protect customer assets, indemnifying the client against losses resulting from the custodian's negligence or similar misconduct, making clear they are not

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absolved of liability due to the activities of a sub-custodian, executing effective asset segregation, and insulating customer assets from claims against the custodian except as authorized in writing by the customer.

The Commission believes that current custodians provide many of these protections, but that these vary significantly across the sector; comment is solicited on how these protections would work in practice, with the Commission noting that indemnification will require custodians to be well enough capitalized and/or ensured to make clients whole in the event of losses due to their negligence, willful default, or other actions or that of a sub-custodian. Comment is sought on whether these capital or insurance requirements should be expressly set in the SEC's standards for qualified custodians. It seems likely that some current custodians (e.g., crypto trading platforms) will find these standards complex and costly, perhaps narrowing the field to entities subject to express regulation and supervision as the Commission generally prefers. As noted, banks could also find regulatory requirements related to indemnification more costly.

The SEC clearly anticipates these concerns, asking for comment on whether custodians would exit this sector if these assurances are required and how this would then affect investor protection. Comment is also sought on whether a simple disclosure that clients could lose assets held by a custodian would suffice in light of the challenges retail customers would have renegotiating custody agreements with an investment adviser. Numerous questions are also asked about how assurances for segregation could best be structured.

3. Account Statements

The proposal includes detailed requirements on what these would need to include. As noted, "accommodation" account balances would not be allowed. Numerous questions are posed on these requirements.

4. Internal Control Reports

The written agreements noted above would need to require custodians to provide reports to investment advisers on internal controls on at least an annual basis. This report would need to include a report from an independent accountant on the extent and effectiveness of relevant controls. Comment is sought on many issues, including whether the accountant should be required to notify the SEC of material discrepancies or other concerns.

5. Cryptoassets

As noted, the SEC's standards would apply to crypto and other digital assets even if they are not funds or securities and thus already subject to custody regulation. The preamble to the proposal makes it clear that most forms of custodial arrangements related to crypto platforms are unlikely now to comply with current standards because the platforms are not eligible qualified custodians under the current rule; compliance would be still more challenging under the proposal due to the expansion of the requirement now for "exclusive control" to a "possession and control" requirement in which only the custodian

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may alter an asset's beneficial ownership.

C. Crypto Activities

The SEC also seeks views on matters including:

- the extent to which banking-agency standards for custodial banks suffice for consumer protection;
- circumstances in which custodial banks that have other relationships with a customer would be in violation of or covered by exemptions to the rule;
- the need for additional exemptions and clarifications;
- if transfer agents should be deemed eligible custodians given that they serve this purpose for mutual funds;
- if insurance companies should be allowed to serve as eligible custodians;
- if the proposed approach essentially nullifies custodial services for cryptoassets;
- whether separate possession-and-control standards should apply to cryptoassets and how the proposal would affect trading platforms;
- whether the current, "atomic" approach to crypto settlement is adverse to investors and, if so, what should be done about it in general and with regard to custody; and
- if qualified custodians now accept liability when they participate in beneficial-ownership changes.

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