

SEC proposes enhanced safeguarding rule for registered investment advisers

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The SEC's proposed amendment would expand the current custody rule to cover a broader array of client assets and advisory activities and impose new custodial protections on client assets held under the Advisers Act.

Introduction:

On February 15, 2023, the Securities and Exchange Commission (SEC) voted to propose new rules and amendments to Rule 206(4)-2 under the Investment Advisers Act of 1940 (Advisers Act). The SEC's proposal is designed to provide enhanced custodial protections for advisory client assets and protect a broader array of asset types and advisory activities. The primary elements of the proposed new rules and amendments include:

- **Expanding the custody rule to cover a broader array of client assets and advisory activities:** The proposed amendments would expand the scope of the custody rule beyond client funds and securities to also include “other positions held in a client’s account” (e.g., crypto assets).
- **Enhancing the custodial protections that client assets receive, including the following changes under the proposed safeguarding rule:**
 - **Qualified custodian:** A qualified custodian would be required to have “possession or control” of advisory client assets.
 - **Foreign Financial Institutions (FFIs):** The proposal would require a more robust set of requirements for an institution to be an FFI that is eligible to serve as a qualified custodian.
 - **Definition of custody:** The proposal would explicitly include an adviser’s discretionary authority to trade client assets within the definition of custody.
 - **Written agreement requirement:** Investment advisers would be required to enter into a written agreement with, and obtain certain reasonable assurances from, qualified custodians, including with respect to proper segregation of client assets from the qualified custodian’s proprietary assets and liabilities.
 - **Exception for certain privately offered securities:** The proposed rule would modify the current custody rule’s exception from the obligation to maintain client assets with a qualified custodian for certain privately offered securities, including expanding the exception to include certain physical assets.
 - **Expand the availability of the audit provision to satisfy surprise examinations by independent public accountants:** The proposal would expand the availability of the custody rule’s audit provision as a means of satisfying the surprise examination requirement.
 - **Amend Form ADV:** The proposal would amend Form ADV to align investment advisers’ reporting obligations with the new requirements under the proposed safeguarding rule.
- **Amending the recordkeeping rule.** The proposed amendment to the recordkeeping rule would 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.

Comment period

The comment period will remain open until 60 days after publication of the proposing release in the Federal Register.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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