

CLIENT ALERT

SEC Proposes a New Crypto Asset Self-Custody Rule and Other Amendments to Modernize Custody Rules for Advisers and Investment Companies

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On October 1, 2026, the U.S. Securities and Exchange Commission (“SEC” or “Commission”) proposed to amend the custody rule under the Investment Advisers Act of 1940 (“Advisers Act”) and proposed new and amended custody rules under the Investment Company Act of 1940 (the “1940 Act”) (the “Proposal”).¹ The Proposal is wide-ranging and has three principal components. First, the Proposal includes provisions specifically intended to address the holding of crypto assets on behalf of advisory clients and registered funds, including a new framework under which advisers could hold client crypto assets in self-custody when no qualified custodian is available, and amendments that would permit state trust companies to serve as custodians of crypto assets. Second, the Proposal includes a number of additional amendments to the Advisers Act custody rule that are not crypto-specific, including new exceptions for discretionary trading authority, standing letters of authorization and inadvertent custody,

¹ See Adviser and Regulated Fund Custody Rules; Crypto Custody Rules, Advisers Act Release No. 7023 (Oct. 1, 2026) [91 FR 63870] (Oct. 6, 2026) (“Proposing Release”).

modernization of the rule's audit provision for pooled investment vehicles, elimination of the requirement that accountants performing services under the rule be registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB"), and redesignation of the rule as new Rule 223-1. Third, the Proposal would modernize the 1940 Act custody rules, including through a wholesale overhaul of Rule 17f-1, which would replace that rule's numerous enumerated conditions for broker-dealer custody with a single condition tied to the Securities Exchange Act of 1934 customer protection rule and expand eligible broker-dealer custodians to all registered broker-dealers, as well as a new proposed Rule 17f-9, which would permit regulated funds to hold crypto assets in self-custody through their advisers, subject to board oversight. In addition, the SEC proposed amendments to certain recordkeeping, reporting and disclosure requirements relating to crypto assets and custody for registered investment advisers and registered investment companies and business development companies ("BDCs," and together with registered investment companies, "regulated funds"). The Proposal is open for public comment until December 7, 2026.

1. New Crypto Asset Self-Custody Provisions

The Proposal provides a framework for the custody of crypto assets for registered investment advisers and regulated funds, continuing the flurry of regulatory activity related to digital assets² and a marked focus by the executive branch on the development of a crypto regulatory framework.³ In 2025, the President's Working Group on Digital Asset Markets recommended that the SEC consider using its regulatory and exemptive authority under the Advisers Act and the 1940 Act to "[p]rovide clarity on the custody of digital assets that are securities" for advisers and regulated funds.⁴ As the SEC notes in the Proposing Release, advisers and regulated funds face challenges in complying with the current custody rules, which predate the growth of the crypto industry over the last decade,⁵ including difficulty identifying financial institutions that are eligible to serve as custodians under the current rules.⁶ While the SEC's Division of Investment Management issued no-action relief in September 2025 in the context of state trust companies as crypto asset custodians,⁷ other rulemaking and guidance has been limited. As a result, many traditional custodians have not historically offered custodial services for crypto assets. The Proposal aims to

² See, e.g., Comstock et al., *Crypto Coordination Takes Shape: An In-Depth Review of the Landmark SEC and CFTC Joint Release on Digital Asset Classification Alongside New Memorandum of Understanding* (May 14, 2026), available at: <https://www.willkie.com/-/media/files/publications/2026/05/crypto-coordination-takes-shape-an-in-depth-review-of-the-landmark-sec-and-cftc-joint-release.pdf>.

³ See Exec. Order No. 14178, *Strengthening American Leadership in Digital Financial Technology* (Jan. 23, 2025) [90 FR 8647] (Jan. 31, 2025).

⁴ Digital Assets PWG, *Strengthening American Leadership in Digital Financial Technology* (July 30, 2025), available at <https://www.whitehouse.gov/wp-content/uploads/2025/07/Digital-Assets-Report-EO14178.pdf>.

⁵ *Custody of Funds or Securities of Clients by Investment Advisers*, Advisers Act Release No. 2968 (Dec. 30, 2009) 75 FR 1456 (Jan. 11, 2010).

⁶ See Advisers Act Rule 206(4)-2(d)(6) (providing that a "qualified custodian" may be a bank or savings association, broker-dealer, futures commission merchant, or certain foreign financial institutions); 1940 Act Section 17(f) and Rules 17f-1 through 17f-7 (providing that securities and similar investments must be maintained with certain specific custodians that include banks, broker-dealers that are members of a national securities exchange, and securities depositories, among others).

⁷ See SEC Staff No-Act. Letter (pub. avail. Sept. 30, 2025), available at <https://www.sec.gov/rules-regulations/no-action-interpretive-exemptive-letters/division-investmentmanagement-staff-no-action-interpretive-letters/simpsonthacherbartlett093025>.

provide more clarity to the industry on regulatory expectations regarding crypto custody, particularly with respect to the heightened risks inherent to holding such assets.⁸

A. Scope

The Proposal defines “crypto asset” as “any digital representation of value that is recorded on a cryptographically secured distributed ledger.”⁹ The Proposal notes that this definition is generally consistent with the proposed definition of “digital asset” in the GENIUS Act¹⁰ and that crypto assets may or may not meet the definition of “security” under the federal securities laws.¹¹

B. Adviser Self-Custody

The Proposal would amend Rule 206(4)-2¹² under the Advisers Act (the “Advisers Act custody rule”) to add a new provision (the “adviser self-custody rule”) that would permit advisers to hold advisory clients’ crypto assets for which they provide investment advice in self-custody, including crypto assets of advisory clients that are registered funds.¹³ For purposes of the Proposal, self-custody includes the adviser holding any portion of the private key necessary to access and effectuate transactions in the crypto asset.¹⁴ Self-custody by any adviser would be permissible only when the following conditions are met:

- The adviser determines that a permitted custodian is not available to maintain the crypto asset prior to taking self-custody of the crypto asset and on a quarterly basis thereafter;
- The adviser has expertise regarding the safeguarding of each crypto asset (and documents the basis of its determination that it has the safeguarding expertise); adopts, implements, and maintains the systems to safeguard each crypto asset against loss, theft, misuse, and misappropriation; and reviews its safeguarding systems and the effectiveness of their implementation no less frequently than annually. The adviser’s

⁸ See Proposing Release at 25.

⁹ See proposed Rule 223-1(d)(3).

¹⁰ See Section 2(6) of the Guiding and Establishing National Innovation for U.S. Stablecoins Act (“GENIUS Act”), Pub. L. No. 119-27, § 17, 139 Stat. 419 (2025) (defining “digital asset” as “any digital representation of value that is recorded on a cryptographically secured distributed ledger”).

¹¹ U.S. SEC. & EXCH. COMM’N, *Application of the Federal Securities Laws to Certain Types of Crypto Assets and Certain Transactions Involving Crypto Assets*, Release Nos. 33-11412; 34-105020 (Mar. 17, 2026), <https://www.sec.gov/files/rules/interp/2026/33-11412.pdf>. Consistent with the current scope of assets subject to the Advisers Act and the 1940 Act custody rules, the Proposal would only apply with respect to crypto assets that are “funds or securities” (or, with respect to a regulated fund client, a “security or similar investment”), and the proposed 1940 Act custody rules would only apply with respect to crypto assets that are “securities or similar investments.” Examples of “funds” in this context include cash, bank accounts, payment stablecoins issued by stablecoin issuers that are permitted payment stablecoin issuers under the GENIUS Act or foreign payment stablecoin issuers registered pursuant to section 18 of the GENIUS Act, and tokenized deposits. See Proposing Release at 52-53.

¹² The Proposal proposes to redesignate the Advisers Act custody rule as 17 CFR § 275.223-1.

¹³ Advisers Act proposed Rule 223-1(b)(7); 1940 Act proposed Rule 17f-9.

¹⁴ See Advisers Act proposed Rule 223-1(d)(16). Access to crypto assets is controlled by a private cryptographic key that allows the holder to transfer the asset or participate in certain rights of ownership. See Proposing Release at 26.

safeguarding systems would be required to address private key management and joint authorization of any crypto asset transactions by at least two people;

- The adviser maintains each client's crypto assets in one or more crypto asset addresses on the crypto network storing only such client's crypto assets;
- The adviser mitigates cybersecurity risks associated with safeguarding clients' crypto assets held in self-custody and, at a minimum, annually reviews its cybersecurity controls and the effectiveness of their implementation;
- Within six months of taking self-custody of crypto assets and on an annual basis thereafter, the adviser obtains internal control reports from an independent public accountant concerning its control objectives relating to custodial services, including the safeguarding of crypto assets;
- Account statements are sent at least quarterly to each of the adviser's clients for whom the adviser is self-custodying crypto assets (this requirement would not apply to the account of a regulated fund, or of a pooled investment vehicle that undergoes an annual financial statement audit, because investors in those vehicles instead receive audited financial statements); and
- The adviser and the client agree, in writing, to treat each crypto asset that is in the adviser's self-custody as a "financial asset" under state law implementing the Uniform Commercial Code to provide additional protections.¹⁵ Because the adviser self-custody rule would apply to an adviser that self-custodies crypto assets for a regulated fund, this written agreement would also be required between the adviser and a registered fund client.

Registered funds. Although advisers are currently excepted from the Advisers Act custody rule with respect to the accounts of registered investment companies, the adviser self-custody rule would apply to an adviser that self-custodies crypto assets for a regulated fund; the adviser would otherwise remain excepted from the Advisers Act custody rule with respect to that fund's account. A regulated fund therefore could rely on the adviser self-custody rule to hold its crypto assets with its adviser, but only if certain additional conditions are satisfied, including that the adviser's qualified custodian determination be made by reference to the custodians permitted under Section 17(f) of the 1940 Act, that access to the fund's key materials be limited to supervised persons designated by resolution of the fund's board, and that the fund's board oversee the arrangement as required by new Rule 17f-9 under the 1940 Act. These additional conditions are discussed in detail in Section 2.B.iv below.

¹⁵ Proposed Rule 223-1(b)(7)(viii). State law governs the written contractual treatment of an asset as a financial asset and a party to the written agreement as a securities intermediary, pursuant to the applicable State's enacted version of Article 8 of the Uniform Commercial Code. A financial asset election, accompanied by crediting of the financial asset to a person's securities account by the securities intermediary in its records, allows a person to acquire a security entitlement (*i.e.*, rights and property interest) and to become an entitlement holder, with respect to the financial asset in that securities account. Among other things, Article 8 provides that the financial asset is not the property of the securities intermediary and is generally not subject to claims of creditors of the securities intermediary. See Proposing Release at 160-62.

These proposed conditions go beyond the requirements related to qualified custodians under the current Advisers Act custody rule and in many cases would require subjective determinations by the adviser. The Proposal provides considerations for making these determinations, including, for example, how an adviser might determine whether he or she has the required knowledge and expertise to self-custody, which may include an evaluation of each crypto asset's crypto network and other technical considerations.¹⁶ The Proposal also discusses the use of service providers¹⁷ and states that advisers are not precluded from leveraging service providers; however, advisers remain responsible for their obligations under the rules. The SEC acknowledged the extensiveness of these conditions, maintaining that they are justified given the heightened risks of crypto assets. The SEC specifically emphasized that the loss or theft of a private key can result in the irreversible loss of crypto assets, and that such a loss or theft would occur without the protections for reversals of erroneous or fraudulent transactions that may be more commonly available for traditional assets.¹⁸

C. State Trust Company Custody

The SEC proposed to amend the custody rules to permit custody of advisory client and regulated fund crypto assets by state trust companies, subject to the following conditions:

- Prior to engaging a state trust company as a permitted custodian and annually thereafter, the adviser or regulated fund must have a reasonable basis, after due inquiry, for believing that the state trust company is authorized by the relevant state banking authority to provide crypto asset custody;
- Prior to engaging a state trust company as a permitted custodian and annually thereafter, the adviser or regulated fund must have a reasonable basis, after due inquiry, for believing that the state trust company maintains and implements written policies and procedures reasonably designed to safeguard crypto assets and related cash and/or cash equivalents from the risk of theft, loss, misuse, or misappropriation;
- The adviser or regulated fund would be required to receive and review the state trust company's most recent annual audited financial statements and most recent internal control report as an initial matter and on an annual basis thereafter; and
- All advisory client and regulated fund crypto assets would be required to be segregated from the state trust company's proprietary assets, and funds would be required to enter into a custodial services agreement with the state trust company that provides for this asset segregation.¹⁹

¹⁶ See Proposing Release at 91.

¹⁷ See *id.* at 60.

¹⁸ *Id.* at 41.

¹⁹ See Proposing Release at 179-81.

2. Modernization of the Advisers Act and 1940 Act Custody Rules

The Commission proposed a number of amendments intended to modernize the custody rules under the Advisers Act and the 1940 Act, and to address current industry practices and feedback received from industry participants.

A. Other Amendments to the Advisers Act Custody Rule

By way of background, the current Advisers Act custody rule applies to an adviser that has “custody” of client funds or securities, which the rule defines to include holding client funds or securities, directly or indirectly, or having any authority to obtain possession of them. Such an adviser generally must (1) maintain client funds and securities with a “qualified custodian” (a bank or savings association, registered broker-dealer, registered futures commission merchant or certain foreign financial institutions) (Rule 206(4)-2(a)(1)); (2) notify the client in writing when it opens an account with a qualified custodian on the client’s behalf (Rule 206(4)-2(a)(2)); (3) have a reasonable basis, after due inquiry, for believing that the qualified custodian sends account statements directly to the client at least quarterly (Rule 206(4)-2(a)(3)); and (4) have the client funds and securities verified by actual examination at least once each calendar year by an independent public accountant at a time chosen by the accountant without prior notice (a “surprise examination”) (Rule 206(4)-2(a)(4)). The current rule contains a limited number of exceptions, including the “audit provision” (Rule 206(4)-2(b)(4)), under which an adviser to a pooled investment vehicle is excepted from the notice and account statement requirements, and is deemed to satisfy the surprise examination requirement, if the vehicle is audited annually and its audited financial statements are distributed to investors, and an exception for the accounts of registered investment companies (Rule 206(4)-2(b)(5)). The Proposal would add three new exceptions to this framework and modify several existing requirements, as described below.

i. Exceptions

The Commission proposed three new exceptions from parts or all of the Advisers Act custody rule, none of which has a counterpart in the current rule. These exceptions apply to discretionary trading authority, standing letters of authorization, and inadvertent custody.

a. Discretionary Trading Authority

The current Advisers Act custody rule does not expressly address discretionary trading. Because the current definition of custody includes any authority to obtain possession of client funds or securities, the breadth of that definition has raised industry concerns about whether discretionary trading authority, particularly for trades that do not settle on a delivery-versus-payment basis, gives an adviser custody. The SEC proposed a new exception from all of the requirements of the Advisers Act custody rule (proposed Rule 223-1(b)(9)) for funds and securities over which an investment adviser has custody because it has authority to trade at its discretion.²⁰ No existing conditions would be removed; rather, the following new conditions would have to be met:

²⁰ See *id.* at 268.

- the adviser only has authority to execute trades for designated client accounts in the client's name or the transfer is recorded in the client's name by the issuer;
- the adviser has no authority to transfer client funds or securities from the designated client account to itself or to any account that is not the client's unless directed by the client. The adviser has no authority to have the transfer recorded by the issuer in its own name or that of a related person; and
- the adviser complies with proposed Rule 223-1, including other applicable exceptions, if it has custody of such funds or securities for any reason other than its discretionary trading authority.²¹

The Commission indicated that this proposal is intended to respond to industry concerns over the applicability of the custody rule to discretionary trading, particularly with respect to non-DVP (delivery-versus-payment) trading, in light of certain past Commission and staff guidance, which may be rescinded if the exception is adopted.²²

b. Inadvertent Custody

The current Advisers Act custody rule contains no exception for custody that an adviser obtains inadvertently, so an adviser may have custody under the current rule solely because a client's custody agreement grants it broader authority over the client's account than intended. Under the Proposal (proposed Rule 223-1(b)(10)), an investment adviser would not be required to comply with proposed Rule 223-1 with respect to funds and securities over which the adviser has custody inadvertently as a result of a client's custodial agreement.²³ The Proposing Release stated that in certain cases, a client's custodial agreement may give the adviser broader access to client funds and securities than is contemplated by the adviser's own agreement with the client, and the adviser may be unaware of such provisions and have a limited ability to have the custody agreement changed. The proposed exception would be available only if the adviser did not recommend, request, or require the client to select the qualified custodian, and the adviser has neither a copy of the client's custodial agreement nor actual knowledge or reason to know that the agreement causes it to have custody. If the adviser does know or have reason to know that the agreement causes it to have custody, the adviser must promptly notify the client and qualified custodian in writing of such unwanted authority, repudiate such authority, and request in writing that such authority be removed from the custodial agreement or superseded by a new agreement that does not confer custody on the adviser.²⁴

c. Standing Letters of Authorization

Under the current Advisers Act custody rule, an adviser with custody of client funds and securities generally must undergo an annual surprise examination, and the current rule contains no exception for an adviser whose custody arises from a standing letter of authorization. A standing letter of authorization is an arrangement among the adviser, the client, and the client's qualified custodian authorizing the adviser to direct the qualified custodian to transfer

²¹ See proposed Rule 223-1(b)(9).

²² See Custody of Investment Company Assets with a Securities Depository, Investment Company Act Release No. 25934 (Feb. 13, 2003); 68 FR 8437 (Feb. 20, 2003); Proposing Release at 271.

²³ See *Proposing Release* at 313-4.

²⁴ See proposed Rule 223-1(b)(10).

funds and securities to a third-party recipient periodically.²⁵ Advisers have instead relied on a 2017 SEC staff no-action letter, under which the staff stated that it would not recommend enforcement action if an adviser does not obtain a surprise examination for such arrangements, provided that specified conditions are met. The Proposal would codify an exception from the surprise examination requirement only (current Rule 206(4)-2(a)(4), to be redesignated as Rule 223-1(a)(4)), such that an investment adviser would not be required to obtain an independent verification of client assets if the adviser has custody of client assets solely due to a standing letter of authorization.²⁶ The other requirements of the Rule, including the qualified custodian, notice and account statement requirements, would continue to apply. The exception is subject to certain new conditions, including that:

- the qualified custodian cannot be the adviser or a related person of the adviser (defined as any person, directly or indirectly, controlling or controlled by the adviser, and any person that is under common control with the adviser),
- the client's authorization must contain certain specified information, and
- the adviser must not have any ability or authority to designate or change any information about the third-party recipient.²⁷

The SEC stated that in these circumstances the qualified custodian would be best positioned to ensure that the required authorizations and instructions are properly and verifiably issued by the client and that requiring an independent verification would not add meaningful protection.²⁸

ii. Other Amendments

The Proposal, if adopted, would also modify the following existing requirements of the Advisers Act custody rule:

- *PCAOB registration.* Currently, three provisions of the rule require the independent public accountant to be registered with, and subject to regular inspection by, the PCAOB: (1) under the audit provision (Rule 206(4)-2(b)(4)), the accountant that audits a pooled investment vehicle's financial statements; and, (2) where the adviser or a related person maintains client assets as a qualified custodian, the accountant that prepares the required annual internal control report (Rule 206(4)-2(a)(6)); and (3) the accountant that performs the surprise examination. The Proposal would remove this condition in each case.²⁹ No new condition would replace it; the accountant would continue to be required to be an "independent public accountant," meaning one that meets the independence standards of Rules 2-01(b) and (c) of Regulation S-X. The Proposal also would make conforming changes to the description of the internal control report opinion to align it with current attestation standards, which the SEC stated are not intended to change the substance of that requirement. In support of this action, the Commission concluded that PCAOB

²⁵ See proposed Rule 223-1(d)(17).

²⁶ See proposed Rule 223-1(b)(8).

²⁷ See *id.*

²⁸ See Proposing Release at 306.

²⁹ See *id.* at 285.

registration status does not provide assurance of the quality of the audit and examination services required under the custody rule, and that removing the requirement may increase the number of independent public accountants that can perform the required services under the rule and possibly lead to lower costs to advisers of complying with the rule.³⁰

- *U.S. GAAP.* The current audit provision (Rule 206(4)-2(b)(4)) requires a pooled investment vehicle's audited financial statements to be prepared in accordance with "generally accepted accounting principles" but does not specify U.S. GAAP, although the Commission has long taken the view that, except in limited circumstances, U.S. GAAP is required. The Proposal would add an express condition that the financial statements be prepared in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP).³¹ For pooled investment vehicles organized under non-U.S. law or that have a general partner or other manager with a principal place of business outside the United States, the Proposal would permit accounting principles other than U.S. GAAP, subject to new conditions that the financial statements contain information substantially similar to that in financial statements prepared in accordance with U.S. GAAP, including a reconciliation to U.S. GAAP for material differences, and that the reconciliation be delivered to the vehicle's U.S. investors along with the audited financial statements.
- *Funds of funds and independent representatives.* Currently, the audit provision requires a pooled investment vehicle's annual audited financial statements to be distributed to all limited partners, members or other beneficial owners within 120 days after the end of its fiscal year. The Proposal would relax this condition by extending the deadline to 180 days in the case of a fund of funds (a pooled investment vehicle that invests in other investment funds), and 260 days for a fund of funds of funds (a multilayered investment vehicle that invests in a portfolio of funds of funds).³² The Proposal also would permit the audited financial statements to be distributed to an investor's designated independent representative, consistent with the current rule's treatment of client notices and account statements.
- *Newly formed pooled investment vehicles.* The current audit provision contains no accommodation for newly formed vehicles, so even a pooled investment vehicle formed shortly before its fiscal year-end must distribute audited financial statements for that first fiscal year within 120 days after year-end. Under the Proposal, a pooled investment vehicle formed within the last 90 days of its fiscal year could satisfy the audit provision by delivering financial statements (which may be unaudited) covering the last 90 days of its first fiscal year within 90 days of the end of that first fiscal year, provided that it delivers audited financial statements covering both the partial first fiscal year and the entire second fiscal year within 120 days after the end of the second fiscal year.³³

³⁰ See *id.* at 289.

³¹ See *id.* at 293.

³² See *id.* at 297. The Commission also stated in the Proposing Release that in its view, a failure to distribute audited financial statements by the applicable deadline due to reasonably unforeseeable circumstances generally would not be considered a violation of the audit provision, provided that the audited financial statements are promptly delivered upon resolution of the reasonably unforeseeable circumstances. See *id.*

³³ See *id.* at 301.

- *Notice of material discrepancies.* Currently, the surprise examination provision (Rule 206(4)-2(a)(4)) requires the written agreement between the adviser and the accountant to provide that, upon finding any material discrepancies during an independent verification, the accountant will notify the SEC by facsimile transmission or electronic mail, followed by first-class mail, directed to the Director of the Office of Compliance Inspections and Examinations. The Proposal would instead require the accountant to send the notice by electronic means to the Division of Examinations.³⁴
- *BDCs.* Currently, Rule 206(4)-2(b)(5) provides that an adviser is not required to comply with the Advisers Act custody rule with respect to the account of a registered investment company, but does not mention BDCs. The Proposal would expressly extend this exception to the accounts of BDCs.³⁵ The SEC noted that market participants currently treat BDCs as registered closed-end investment companies for purposes of the Advisers Act custody rule.³⁶ As amended, the exception would not extend to crypto assets that the adviser holds in self-custody for a registered investment company or BDC, as to which the adviser would be required to comply with the adviser self-custody rule.
- *Account number in client notice.* Currently, Rule 206(4)-2(a)(2) requires an adviser that opens an account with a qualified custodian on a client's behalf to notify the client in writing of the qualified custodian's name, address, and the manner in which the funds or securities are maintained, promptly upon opening the account and following any changes to this information. The Proposal would add a new condition that the adviser include the client's account number at the custodian in the notice, which the SEC intends to help clients in overseeing their accounts.³⁷

iii. Redesignating the Rule

In 2010, the Dodd-Frank Act added Section 223 to the Advisers Act, which specifically authorizes the SEC to adopt rules relating to the safeguarding of client assets by investment advisers that have custody of such assets.³⁸ In light of that authority, the SEC proposed to redesignate the custody rule as Rule 223-1 and to rename it "Safeguarding client assets."³⁹ The proposed rule removes the reference to Section 206(4) of the Advisers Act from paragraph (a) of the current custody rule, but the Proposing Release notes that the safeguarding of client funds and securities remains subject to an investment adviser's fiduciary duties.⁴⁰

iv. Future Guidance

In addition to the proposed amendments to the custody rule, discussed above, the SEC indicated that it plans to provide guidance regarding asset segregation, accommodation reporting and accountants.

³⁴ See *id.* at 312-3.

³⁵ See *id.* at 310.

³⁶ See *id.*

³⁷ See Proposing Release at 311-2.

³⁸ See Section 223 of the Advisers Act, 15 U.S.C. 80b-18b.

³⁹ See Proposing Release at 267.

⁴⁰ See *id.* at 268 n.525.

a. Segregation from Adviser and Qualified Custodian Proprietary Assets

The SEC stated that it will provide its views regarding how the Advisers Act custody rule's asset segregation requirement applies to the segregation of client funds and securities from both the proprietary assets of the adviser, and those of the qualified custodian. The SEC stated that it believes that asset segregation is a fundamental protection of the Advisers Act custody rule and that segregation from the proprietary assets of the adviser (and its related persons), as well as the qualified custodian, remains important for investor protection.⁴¹ The SEC further stated that the Advisers Act custody rule does not preclude qualified custodian banks from maintaining funds such that cash balances are held as general deposits and reflected on the custody bank's balance sheet as a liability to the client, and not segregated from the bank's own cash.⁴²

b. Segregation and Certain Escrow Accounts

The Commission indicated that it expects to provide its views on the use of certain escrow accounts in connection with the sale of portfolio companies owned by one or more pooled investment vehicle clients. As described in the Proposing Release, when pooled investment vehicle clients such as private equity funds and other non-clients sell a portfolio company that they jointly own, they typically hold a portion of sale proceeds in a seller escrow account following the closing of the sale or merger.⁴³ The escrow account holds a percentage of the sale proceeds in case an indemnification or an adjustment to the sale price of a portfolio company is needed.

The SEC indicated that an adviser would be permitted to maintain client funds in a seller escrow account commingled with other client and non-client funds if the following conditions are met:

- the client is a pooled investment vehicle for which the adviser relies on the audit provision and the portion of the seller escrow account attributable to the pooled investment vehicle is included in its financial statements;
- the seller escrow account is in connection with the sale or merger of a portfolio company owned by the client (*i.e.*, for indemnification or to adjust the purchase price);
- the seller escrow account contains an amount of money that is agreed upon as part of a bona fide negotiation between the buyer and the sellers;
- the seller escrow account exists for a period of time that is agreed upon as part of a bona fide negotiation between the buyer and the sellers;
- the seller escrow account is maintained at a qualified custodian;⁴⁴ and

⁴¹ See *id.* at 320-1.

⁴² See *id.* at 321-2.

⁴³ See *id.* at 322-3.

⁴⁴ When the sellers include both clients and non-clients, the seller escrow account necessarily will commingle the funds of the selling client with the funds of others.

- the sellers' representative is contractually obligated to promptly distribute the funds remaining in the seller escrow account at the end of the escrow period on a predetermined formula to the sellers, including the pooled investment vehicle client.⁴⁵

c. Accommodation Reporting

Custodians engage in “accommodation reporting” when they list funds or securities on a client’s account statement but do not accept custodial liability for them (*i.e.*, the assets are reported on an “accommodation basis”). In such cases, the custodian does not attest to the holdings of or transactions in those funds or securities or take steps to ensure that they are appropriately safeguarded; instead, the custodian simply identifies the holdings or transactions as reported to it by the adviser. The Proposing Release notes that advisers may request accommodation reporting for a variety of reasons, including to facilitate a client’s monitoring of its assets or because custodians are unwilling or unable to take custody of certain private investments, and that in some instances advisers have requested it in an attempt to demonstrate that the assets are “held” with a qualified custodian in compliance with the custody rule.

The Commission stated that it would provide its view on the disclosure that should accompany a client account statement that covers funds or securities on an accommodation basis. The SEC said that an adviser that requests accommodation reporting for a client account statement should generally ensure that such statement clearly discloses that the custodian does not hold or have authority to obtain such funds or securities, among other disclosures.⁴⁶ The SEC asserted that to satisfy the account statement delivery requirement, an adviser should have a reasonable basis for believing that the account statement is generally clear and accurate, including disclosure that the custodian does not hold or have authority to obtain any funds or securities included on an accommodation basis.⁴⁷ The SEC also discussed a number of specific disclosures that advisers should consider including.⁴⁸

d. Guidance for Accountants and Qualified Custodians

The Commission stated that it expects to revise certain aspects of the guidance it provided to accountants in 2009⁴⁹ to address auditing and attestation standards for crypto assets and other industry developments since its publication. The 2009 guidance describes the Commission’s position on several control objectives that should be included in an independent public accountant’s assessment of an investment adviser’s (or its related person’s) internal controls in relation to its acting as a qualified custodian under the Advisers Act custody rule.

⁴⁵ See *id.* at 323-4. A sellers’ representative, which may be the investment adviser or an affiliate, may be appointed to act on behalf of the sellers and the escrow typically would be held in the name of the seller’s representative.

⁴⁶ See *id.* at 326.

⁴⁷ See *id.* at 326.

⁴⁸ See *id.* at 326-7.

⁴⁹ See Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940, Advisers Act Release No. 2969 (Dec. 30, 2009), 75 FR 1492 (Jan. 11, 2010).

B. Investment Company Custody Rules Modernization

The Proposal includes numerous amendments to the custody rules applicable to investment companies registered or regulated under the 1940 Act, including (i) adding BDCs to the custody rules⁵⁰ under the 1940 Act, (ii) overhauling Rule 17f-1 to permit regulated funds to custody assets at a broker or dealer registered under Section 15(b)(1) of the Securities Exchange Act of 1934 (the “Exchange Act”) where the broker-dealer’s custody of assets is subject to Rule 15c3-3 or another rule determined by the SEC to provide similar customer protections, (iii) rescinding Rule 17f-3, (iv) making technical amendments to Rules 17f-4 and 17f-7,⁵¹ and (v) adopting new Rule 17f-9, which would permit regulated funds to maintain crypto assets in self-custody with their advisers subject to board oversight.

i. Extension of Investment Company Custody Rules to BDCs

Section 17(f) under the 1940 Act currently applies to BDCs via incorporation into 15 U.S.C. § 80a-58 such that Section 17(f) applies to BDCs to the same extent as if they were registered closed-end investment companies. Accordingly, BDCs are required to place and maintain their securities and similar investments in the custody of a permitted custodian.⁵² Although industry practice has been to interpret the application of Section 17(f) to allow BDCs to rely on the 1940 Act custody rules as if they were registered closed-end investment companies, none of such custody rules mentions BDCs.⁵³ Accordingly, the Proposal would add references to BDCs to the custody rules and notes the SEC’s position that it does not see a reason to restrict BDCs from relying on the custody rules.⁵⁴

ii. Amending Rule 17f-1 to Remove Certain Conditions With Respect to Broker-Dealers

Currently, Rule 17f-1 permits regulated funds to custody their assets with a broker-dealer that is a member of a national securities exchange, subject to certain conditions that must be in a written contract ratified by the board of directors (the “Board”) of the regulated fund, including: (i) physical segregation of the fund’s assets and clear identification of the assets as the fund’s property, (ii) the inability of the broker-dealer to dispose of the assets except pursuant to the fund’s direction and only for the account of the fund, (iii) the fund’s assets shall not be subject to any lien or charge in favor of the custodian or any persons claiming through the custodian, (iv) each fiscal year, the fund’s assets shall be verified by an independent public accountant at the end of the annual period, the semiannual period, and at least one other time chosen by the accountant, (v) the fund’s assets shall be subject to inspection by the SEC at all times, and (vi) conditions (i) through (iii) shall not apply to assets bought for or sold to the fund by the custodian until such assets are in the possession of the custodian, provided that the custodian shall take possession of the assets at the earliest practicable time.

In light of the expansion of the regulatory framework applicable to broker-dealers since Rule 17f-1 was adopted in 1940, the SEC has concluded that the enumerated conditions in Rule 17f-1 are antiquated, duplicative or otherwise

⁵⁰ Rules 17f-1 through 17f-7.

⁵¹ Proposing Release at 216-217.

⁵² 15 U.S.C. § 80a-17(f).

⁵³ Proposing Release at 217-218.

⁵⁴ *Id.* at 218.

addressed by the regulatory regime.⁵⁵ Accordingly, the Proposal would remove all of the enumerated conditions described above (segregation, rehypothecation, lien, examination, inspection and possession), as well as the requirements that the conditions be set forth in a written contract ratified by the Board and transmitted to the SEC, and would rescind Form N-17f-1. In their place, the amended rule would contain a single condition: a regulated fund could place or maintain its securities and similar investments with any broker-dealer registered under Section 15(b)(1) of the Exchange Act (not only a member of a national securities exchange), where the broker-dealer's custody of those assets is subject to the Customer Protection Rule, Rule 15c3-3, or another rule determined by the SEC to provide similar customer protections.⁵⁶ The SEC explained that the protections underlying the removed conditions, including the restriction on rehypothecation, are now addressed by Rule 15c3-3's possession or control and customer reserve requirements, the broker-dealer hypothecation rules (Exchange Act Rules 8c-1 and 15c2-1), and the protections of the Securities Investor Protection Act. The SEC also noted that it anticipates regulated funds will continue to maintain written custodial contracts as a matter of standard business practice. Such change, if adopted, will expand the number of broker-dealers that may custody the assets of regulated funds and remove the burden on regulated funds' boards with respect to approving custody agreements with broker-dealers.

iii. Recission of Rule 17f-3 and Other Amendments

Rule 17f-3 currently provides that, if a regulated fund has a bank custodian, the fund may maintain a free cash account, in an amount not to exceed \$500, only upon a resolution of the fund's Board. Such free cash account must also be maintained under the "imprest system," meaning the account maintains a fixed amount of money for small, routine expenses that is replenished following withdrawals, and subject to adequate controls over disbursements and reimbursements approved by the Board.

The Proposal states that the SEC understands regulated funds do not currently use Rule 17f-3 and that technological advances in banking and payment processing have made obsolete the need to maintain free cash accounts (*i.e.*, petty cash accounts).⁵⁷ Accordingly, the SEC has proposed to rescind Rule 17f-3. The SEC also proposed amendments to Rules 17f-4 and 17f-7 to clarify certain references and terms.

iv. New Rule 17f-9: Regulated Fund Self-Custody of Crypto Assets

Proposed Rule 17f-9 would permit a regulated fund (a registered management investment company or BDC) to place and maintain its crypto assets that are securities or similar investments with its investment adviser, without the involvement of a permitted custodian, if (1) the adviser complies with the adviser self-custody rule described in Section 1.B above, and (2) the fund's board of directors oversees the custody arrangement as required by the rule.⁵⁸ The SEC stated that board oversight is appropriate given the heightened risk of misappropriation of fund assets where the adviser also acts as custodian, and noted that the approach is similar to the board involvement required under existing Rule 17f-2, the 1940 Act self-custody rule for traditional assets. Rule 17f-9 would apply in

⁵⁵ *Id.* at 233-239.

⁵⁶ *Id.* at 233.

⁵⁷ *Id.* at 242-243.

⁵⁸ See proposed Rule 17f-9 under the 1940 Act.

lieu of Rule 17f-2 to fund crypto assets maintained with the adviser itself, while Rule 17f-2 would continue to apply to fund crypto assets maintained at a custodian affiliated with the adviser. Unit investment trusts and face-amount certificate companies would not be able to rely on Rule 17f-9.

Board requirements. Under Rule 17f-9, the fund's board, including a majority of directors who are not interested persons of the fund, would be required to:

- prior to the adviser maintaining custody of the crypto asset and quarterly thereafter, review the adviser's written report documenting the basis for its determination that no qualified custodian will maintain the crypto asset;
- prior to the adviser maintaining custody of the crypto asset and annually thereafter, determine that the crypto asset will be subject to reasonable care if maintained with the adviser, after considering the factors relevant to the safekeeping of the crypto asset, and evaluate the information furnished by the adviser for this purpose; and
- designate, by resolution, the supervised persons of the adviser who may have access to the fund's key materials (defined in the Proposal as "the cryptographic private keys or any part thereof that is necessary to access and effectuate transactions in the corresponding crypto asset").⁵⁹

The SEC noted that the board's initial review would allow it to prevent the adviser's self-custody of the fund's crypto asset if the board determines that the adviser's qualified custodian determination is not based on adequate due inquiry, is not supported by the facts in the written report, or is inconsistent with the fund's best interests, and that the board may request further information from the adviser. Other factors the board may consider in making its reasonable care determination include the availability of insurance or other arrangements to reimburse the fund for a loss of its crypto asset, and how the adviser intends to use third-party service providers and manage the related risks.

Adviser requirements. In addition to satisfying each condition of the adviser self-custody rule (and remaining responsible for those obligations notwithstanding the board's oversight), the adviser to a regulated fund would be required to:

- make its initial and quarterly qualified custodian determinations by reference to the banks and other persons authorized to hold assets for the fund under Section 17(f) of the 1940 Act and the rules thereunder, rather than the qualified custodians listed in the Advisers Act custody rule;
- limit access to the fund's key materials to the supervised persons designated by resolution of the fund's board;

⁵⁹ Proposing Release at 737.

- enter into the written financial asset agreement with the fund described in Section 1.B above (although the quarterly account statement requirement would not apply to the account of a regulated fund, because regulated fund investors receive audited financial statements);
- furnish to the board such information as may reasonably be necessary for the board to evaluate the fund's custody arrangement, including, at a minimum: (1) the written report documenting the basis for its qualified custodian determination; (2) a written report documenting the basis for its determination that it has expertise regarding the safeguarding of the crypto asset and the systems, including the appropriate technology, software, hardware, and other associated systems and processes, necessary to safeguard the crypto asset against loss, theft, misuse, and misappropriation; (3) its most recent written annual review of its safeguarding systems and cybersecurity controls, including the effectiveness of their implementation; and (4) its most recent written internal control report;
- if the annual review or internal control report is not available at the time of the board's determination, furnish it by the next regularly scheduled board meeting after it becomes available (and, in the case of an internal control report where the adviser has not held crypto assets in self-custody for any client for at least six months, by the first regularly scheduled board meeting following the end of that six-month period); and
- promptly notify the board of serious safeguarding matters, such as any loss, theft, misuse or misappropriation of the fund's crypto assets maintained by the adviser, significant cybersecurity events that materially raise the risk of harm to the fund, or an internal control report on which the auditor will not issue an unmodified opinion, rather than waiting until the next board meeting.

Distributed crypto assets and recordkeeping. Rule 17f-9 would provide that a fund's receipt of a distributed (*i.e.*, airdropped) crypto asset will be deemed not to violate Section 17(f) of the 1940 Act, provided that the fund, as soon as reasonably practicable, places and maintains the asset with its adviser in compliance with Rule 17f-9 or with a permitted custodian. Regulated funds also would be required to preserve, for at least six years (the first two years in an easily accessible place), any report or other information provided to the board under Rule 17f-9, and to preserve permanently the board resolutions designating the persons with access to key materials.

3. Recordkeeping

The SEC proposed a number of crypto asset-related and other amendments to the recordkeeping rules under the Advisers Act and the 1940 Act. Notably, the Proposal would provide that records related to crypto assets that are required to be maintained and preserved under the applicable recordkeeping rule may be maintained and preserved on a crypto network.⁶⁰ Such records would be required to be provided in a human-readable and reasonably usable electronic format promptly upon request by the Commission (including its examiners and other representatives) and continue to provide access for the same period that other books and records are required to be maintained and preserved. The SEC stated that the adviser or fund may be required to maintain supplemental backup onchain or

⁶⁰ See *id.* at 347.

offchain records to ensure that records maintained on the crypto network remain accessible during the entire applicable retention period.⁶¹

4. Disclosure and Reporting

The Proposal would make Form ADV amendments to collect additional information regarding the custody of crypto assets and tokenized fund shares. In particular, the SEC proposed to amend Form ADV to:

- (1) Add new questions in Part 1A and Schedule D related to the advisers' crypto asset self-custody practices;
- (2) Add new questions to Item 9 that address an adviser's reliance on certain exceptions under the Advisers Act custody rule as well as an adviser's use of state trust companies as qualified custodians, and make other amendments to Item 9 to promote more consistent reporting of an adviser's and a related person's custody;
- (3) Add new questions to Schedule D of Form ADV regarding tokenized private funds; and
- (4) Make certain conforming amendments to reflect the proposed amendments to the Advisers Act custody rule.⁶²

For registered funds, the Commission is proposing amendments to Form N-CEN to require reporting of:

- (1) The use of self-custody or a state trust company to custody a regulated fund's crypto assets; and
- (2) Whether the regulated fund (or series or class thereof) is a tokenized fund.⁶³

Further, the SEC discussed its views as to the disclosures that regulated funds and advisers should consider making to clients and investors relating to investments in and custody of crypto assets, including self-custody risks, cybersecurity risk, and risks associated with decentralized finance activities and the use of state trust companies for custody.⁶⁴

5. Decentralized Finance

The Commission noted that commenters writing to the Crypto Task Force have offered opinions on the compatibility of participating in Decentralized Finance ("DeFi") activity with the Custody Rule requirements. The Commission asked commenters to address a number of questions relating to the application of the Custody Rule to DeFi, staking, and crypto lending activities by regulated funds and advisers.⁶⁵

⁶¹ See *id.* at 348.

⁶² See *id.* at 362, 744.

⁶³ See *id.* at 384.

⁶⁴ See *id.* at 387-93.

⁶⁵ See *id.* at 204-211

6. Staff No-Action Letters and Guidance

The Commission noted that, if the Proposal is adopted, the Commission's views on such topics would control and any inconsistent staff views would be superseded. The Proposing Release includes a list of no-action letters and staff statements dealing with topics addressed in the proposed rule.⁶⁶

7. Compliance Dates

Regulated funds and advisers would be permitted to rely on the proposed amendments to Forms ADV, ADV-E, and N-CEN when updates to the forms are available. The SEC staff will issue a notice when the updated forms are available for use.⁶⁷ Compliance with all other amendments to the 1940 Act and Advisers Act custody and recordkeeping rules would be required as of the effective date of those rules, and regulated funds and advisers would be able to rely on their respective rules regarding self-custody of crypto assets or the use of state trust company custodians as of the effective date of those rules.⁶⁸

Conclusion

While the Proposal is pending, advisers and regulated funds must continue to rely on existing SEC and staff guidance regarding their crypto custody arrangements and disclosures. If the Commission adopts the amendments proposed, advisers should assess their existing practices and determine what steps they will need to take to conform to the amended rules and forms. Willkie is available to assist advisers in assessing the Proposal, submitting comments to the Commission and preparing for any changes that may follow final Commission action.

⁶⁶ See *id.* at 397-8.

⁶⁷ See *id.*

⁶⁸ See *id.* at 398-9.

SEC Proposes a New Crypto Asset Self-Custody Rule and Other Amendments to Modernize Custody Rules for Advisers and Investment Companies

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