SEC STAFF IDENTIFIES SEVERAL PATHS TO "INADVERTENT CUSTODY" UNDER THE ADVISERS ACT CUSTODY RULE

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Investment Management Alert

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Last week, the staff of the Securities and Exchange Commission ("SEC") clarified its views on certain arrangements that can result in investment advisers having "custody" of client assets, as defined in rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940, as amended (the "Advisers Act").

In a no-action letter issued to the Investment Adviser Association ("IAA"), the SEC staff stated that an investment adviser would have "custody" under the Custody Rule if it acts pursuant to a standing letter of instruction or other similar arrangement established between a client and its custodian ("SLOA") that allows the adviser to disburse funds to one or more third parties specifically designated by the client.[1] In taking this position, however, the SEC staff affirmed that it would not recommend enforcement action to the SEC if the adviser acts pursuant to an SLOA, subject to certain conditions (described below), and does not obtain the surprise examination that would otherwise be required under the Custody Rule.

The SEC staff also issued an IM Guidance Update (the "Guidance Update")[2] cautioning advisers that they may inadvertently have custody of client funds or securities due to language in agreements between their clients and their clients' custodians that authorizes the adviser to instruct the custodian to disburse funds or securities, even if the adviser is prohibited from doing so in its advisory agreements with clients.

The IAA Letter and the Guidance Update are discussed in greater detail below.

THE IAA LETTER

Background

In an SLOA as contemplated in the IAA Letter, an adviser's client instructs its custodian to transfer funds to a designated third party upon the future request of the adviser. Specifically, the client instructs the custodian to accept the adviser's direction on the client's behalf to transfer funds to a third party *specifically designated by the client* on the SLOA, and the adviser acts solely as an agent of the client subject to the terms of the SLOA. The limited authority provided under an SLOA can be revoked or changed by the client at any time.

The arrangement is useful for clients that maintain multiple accounts for different purposes at one or more custodians, and seek the assistance of their advisers with respect to investment activities and cash management among those accounts. For example, an SLOA could authorize an adviser to liquidate certain investments in one account, and transfer the proceeds of the sales to another account for purposes of paying tax bills or making disbursements to family members.

Staff Guidance

The *IAA Letter* sets forth the staff's position that an SLOA, as described above, imputes "custody" to an adviser under the Custody Rule. The SEC staff stated that such an SLOA "would constitute an arrangement under which an investment adviser is authorized to withdraw client funds or securities maintained with a qualified custodian upon its instruction to the qualified custodian."[3] The staff recognized that SLOAs may come in different shapes and sizes, and that an SLOA that is structured such that an adviser does not have discretion as to the amount, payee and timing of transfers would not implicate the Custody Rule. However, the staff took the position that an SLOA that authorizes the adviser to make determinations as to the amount and timing of payments, but not the identity of the payee, represents sufficient authority to result in the adviser having "custody" under the rule.

In taking this position, the SEC staff nevertheless agreed that it would not recommend enforcement action against an investment adviser if that adviser does not obtain a surprise examination, as otherwise required under the Custody Rule, if the adviser acts pursuant to an SLOA under the following circumstances:

1. The client provides an instruction to the qualified custodian, in writing, that includes the client's signature, the third party's name, and either the third party's address or the third party's account number at a custodian to which the transfer should be directed.
2. The client authorizes the investment adviser, in writing, either on the qualified custodian's form or separately, to direct transfers to the third party either on a specified schedule or from time to time.
3. The client's qualified custodian performs appropriate verification of the instruction, such as a signature review or other method to verify the client's authorization, and provides a transfer of funds notice to the client promptly after each transfer.
4. The client has the ability to terminate or change the instruction to the client's qualified custodian.
5. The investment adviser has no authority or ability to designate or change the identity of the third party, the address, or any other information about the third party contained in the client's instruction.
6. The investment adviser maintains records showing that the third party is not a related party of the investment adviser or located at the same address as the investment adviser.
7. The client's qualified custodian sends the client, in writing, an initial notice confirming the instruction and an annual notice reconfirming the instruction.

Practical Application for Advisers

The terms of the IAA Letter appear to be limited to disbursements of client funds to third parties, and not applicable to transfers between client accounts.[4] On the same day that it issued the IAA Letter, the SEC staff reaffirmed and clarified its prior interpretation that an adviser's limited authority to transfer a client's assets between the client's accounts maintained at one or more custodians does not confer "custody" on the adviser, provided that the client has authorized the adviser in writing to make such transfers and a copy of that authorization is provided to the custodians, precisely specifying the accounts.[5]

Advisers that have entered into an SLOA should be aware of the SEC staff's position, and ascertain whether the terms of their specific arrangements cause them to have "custody" under the Custody Rule. Even if an adviser complies with the conditions of the IAA Letter, and is therefore exempt from the surprise audit requirement, an adviser that has custody of client assets pursuant to an SLOA still must comply with the client notice and account statement delivery requirements of paragraphs (a)(2) and (3) of the Custody Rule.[6]

The SEC staff stated that it understands that advisers, custodians and their clients will require a reasonable period of time to implement procedures necessary to comply with the relief in the IAA Letter. Although a definite timeline for compliance with the views expressed in the IAA Letter was not provided, the staff did note that an adviser should include client assets that are subject to a SLOA that result in custody in its response to Item 9 of Form ADV Part 1A beginning with its next annual updating amendment after October 1, 2017.[7]

THE GUIDANCE UPDATE

Background

In the Guidance Update, the SEC staff observed that the terms of an agreement between a client and a qualified custodian might authorize the client's adviser to instruct the custodian to disburse client funds or securities. For example, a custody agreement may contain language that grants the adviser the right to "receive money, securities, and property of every kind and dispose of same" or state that the custodian "may rely on the client's adviser's instructions without any direction from the client." The SEC staff explained that an adviser would have custody for purposes of the Custody Rule in these circumstances because the custodial agreement authorizes the adviser to withdraw client funds or securities, and this authority could be exercised notwithstanding a provision in the advisory agreement between the adviser and its client to the contrary.

Practical Application for Advisers

The Guidance Update highlights that certain custodial arrangements could result in an adviser having "custody" under the Custody Rule, notwithstanding that the adviser did not intend to have custody, and may not even be aware that it has been granted the authority that resulted in it having custody. Although an adviser may contractually limit its authority to withdraw client funds in its agreement with a client, the custodian would not necessarily be aware of such limitations; consequently, an adviser could attempt to withdraw funds from a client account and the custodian may view such withdrawal as properly authorized under the terms of the custody arrangement with the client.

The SEC staff suggested in the Guidance Update that one way for an adviser to avoid having inadvertent custody of client assets is to draft a document addressed to the custodian that limits the adviser's authority to "delivery versus payment," notwithstanding any language in the custody agreement to the contrary.[8]

THE GUIDANCE IN CONTEXT AND NEXT STEPS FOR INVESTMENT ADVISERS

The Advisers Act, the rules thereunder, and SEC staff guidance relating to the Custody Rule are complicated and not always intuitive. Although the SEC staff has historically and consistently taken an expansive view of arrangements that result in "custody" under the Custody Rule, advisers may find that the positions of the staff discussed herein conflict with positions previously taken by industry participants in good faith in the absence of such guidance.

In our view, the IAA Letter and the Guidance Update should be viewed in the context of other recent actions from the SEC and its staff related to the Custody Rule, particularly the National Exam Program Risk Alert ("Risk Alert")[9] from the Office of Compliance Inspections and Examinations ("OCIE") and the SEC's recent consent order against Morgan Stanley Smith Barney, LLC.[10] As the SEC staff continues to focus on issues relating to custody in examinations, advisers should review their practices related to custody of client assets and related compliance policies.[11] In light of the IAA Letter, the Guidance Update, and concerns stated in the Risk Alert that recently examined advisers did not recognize that they had custody for a variety of reasons; counsel and compliance officers should pay particular attention to arrangements that may impute custody inadvertently.

If you have any questions regarding these matters, please contact any of the authors listed below, or one of the K&L Gates attorneys with whom you work.

Notes:

[1] *See* Investment Adviser Association, No-Action Letter (February 21, 2017) (the "IAA Letter"), available at https://www.sec.gov/divisions/investment/noaction/2017/investment-adviser-association-022117-206-4.htm.

[2] *See* IM Guidance Update "Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority" (February 2017), available at https://www.sec.gov/investment/im-guidance-2017-01.pdf.

[3] Under the terms of the Custody Rule, this would confer "custody" to the adviser of the client's funds or securities. *See* Rule 206(4)-2(d)(2)(ii).

[4] The IAA Letter states that "an investment adviser with power to dispose of client funds or securities for any purpose *other than authorized trading* has access to the client's assets" (emphasis added). While the IAA Letter and the Guidance Update appear to contemplate traditional delivery-versus-payment or "DvP" trading, many advisers direct the transfer of funds to counterparties, futures commission merchants, and others in connection with the trading of futures, swaps, bank loans, and other instruments. These transfers by their nature are not made on a "DvP" basis. Whether this activity would constitute "authorized trading" is not expressly addressed in the recent guidance.

[5] *See* "Staff Responses to Questions About the Custody Rule", Question II.4 (modified February 21, 2017), available at https://www.sec.gov/divisions/investment/custody_faq_030510.htm.

[6] Specifically, Rule 206(4)-2(a)(2) requires an adviser that opens an account with a custodian on a client's behalf, either under the client's name or under the adviser's name as agent, to notify the client in writing of the custodian's name, address, and the manner in which the funds or securities are maintained, promptly when the account is opened and following any changes to this information. In addition, if the adviser sends account statements to such a client, the adviser must urge the client, in the initial notice and in any subsequent account statements, to compare the account statements from the custodian with those from the adviser. Section 206(4)-2(a)(3) requires an adviser to have a reasonable basis, after due inquiry, for believing that the custodian sends an account statement, at least quarterly, to each of the adviser's clients for which it maintains funds or securities, identifying the amount of funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period.

[7] This timing corresponds with the compliance date applicable to the recent changes to Form ADV that require, among other things, additional reporting on separately managed accounts and "umbrella registration" used by private fund advisers. *See* "SEC Adopts Rules for Reporting Separately Managed Accounts on Form ADV and

Revised Recordkeeping Rules" by Beth Clark, Christopher J. Martini and Cary J. Meer (October 17, 2016), available at http://www.klgates.com/files/Publication/ab6578df-aa26-4537-81b5-3c22d698b637/Presentation/PublicationAttachment/8f6692d0-690a-45a0-b139-3ded57f066d5/IM_Alert2_10172016.pdf.

[8] Such document, which may be in the form of a letter, must be coupled with written consent of the client and acknowledgement by the custodian.

[9] *See* "The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers" (February 7, 2017), available at https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf.

[10] *See* In the Matter of Morgan Stanley Smith Barney, LLC, IA-Release 4609 (January 13, 2017), available at https://www.sec.gov/litigation/admin/2017/34-79794.pdf.

[11] Several Divisions at the SEC have recently focused on the Custody Rule. For example, the IAA Letter and the Guidance Update were issued by the SEC's Division of Investment Management; the Risk Alert was issued by OCIE; and the Morgan Stanley Smith Barney, LLC action, which resulted from an OCIE examination, was brought by the SEC's Division of Enforcement.

