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Separately Managed Accounts – SEC Provides Guidance on "Inadvertent" Custody and Reliance on Standing Letters of Authorization

The SEC's Division of Investment Management recently published a three-page Guidance Update, *Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority* (the "Guidance"). The purpose of the Guidance is to caution registered investment advisers that, for purposes of Rule 206(4)-2 under the Advisers Act (the "Custody Rule"), an adviser may be deemed to have custody of a client's funds or securities when a custody agreement between a client and a custodian grants an adviser greater access to the client's funds or securities than the adviser's agreement with the client. The Guidance calls this situation "inadvertent custody" and notes that inadvertent custody subjects an adviser to the Custody Rule's surprise examination requirements. Inadvertent custody is most likely to arise with respect to a separately managed account because the custodian of a separately managed account is typically hired by the client.[1]

The Guidance provides a single suggestion as to how an adviser can avoid inadvertent custody. However, the suggestion is likely to be administratively difficult and, perhaps, impossible, for an adviser to complete with reasonable certainty. The Guidance also contains some language that could be read to imply that an adviser has custody of client funds and securities when it initiates transactions that do not traditionally settle on a deliver-versus-payment ("DVP") basis.

The Problem Highlighted by the Guidance

The Guidance states that the SEC staff has observed instances in which the terms of a custody agreement between a client and qualified custodian could be interpreted as permitting the client's adviser to instruct the custodian to transfer funds or securities. The Guidance provides three examples of such custody agreement provisions that may give rise to inadvertent custody:

- A custody agreement that gives the client's adviser the right to "receive money, securities, and property of every kind and dispose of same."
- A custody agreement under which a custodian "may rely on [adviser's] instructions without any direction from you. You hereby ratify and confirm any and all transactions with [the custodian] made by [adviser] for your account."
- A custody agreement that provides authorization for the client's adviser to "instruct us to disburse cash from your cash account for any purpose . . . ."

The Guidance also states that an adviser may have custody if the provisions in a custody agreement conflict with provisions in a related advisory agreement regarding the scope of an adviser's authority to transfer client funds or securities upon instruction to the custodian. As an example, the Guidance states that an adviser has custody if the

[1] The Custody Rule does not apply to the custody accounts of registered investment companies. Section 17(f) of the 1940 Act and rules thereunder contain the custody requirements for such companies. Advisers to private funds are likely to have "custody" of private fund assets in any event.

custody agreement authorizes the adviser to transfer client funds or securities, despite a provision in the related advisory agreement to the contrary. The issue here is that a custodian would be unaware of any provisions in an advisory agreement that limit an adviser's authority, and, therefore, from the perspective of the custodian, an adviser may appear authorized to instruct the custodian to transfer a client's funds and securities.

After describing the ways in which an adviser may have inadvertent custody, the Guidance cautions advisers to take steps to assure the adviser's compliance with the Custody Rule. The Guidance then states:

One way for an adviser to avoid such inadvertent custody would be to draft a letter (or other form of document) addressed to the custodian that limits the adviser's authority to "delivery versus payment," notwithstanding the wording of the custodial agreement, and to have the client and custodian provide written consent to acknowledge the new arrangement.

Discussion

Viability of the Guidance's Solution. According to the Guidance, inadvertent custody is a real problem for investment advisers. The Custody Rule's definition of "custody" includes [1] "having any authority to obtain possession of" client funds or securities and [2] any "arrangement . . . under which [an adviser is] authorized or permitted to withdraw client funds or securities maintained with a custodian upon [the adviser's] instruction to the custodian." However, the proposed remedial action in the Guidance – having every client and custodian acknowledge in a new document a limit on the adviser's authority – fails to take into account that an adviser is likely to have a large number of clients and a significant number of custodians are likely to be involved.

- There is no incentive for a custodian to acknowledge in writing the new documentation because, from a custodian's perspective, inadvertent custody is the adviser's problem. Thus, obtaining the acknowledgements from each custodian is likely to be administratively burdensome and time consuming and may end up incomplete.
- Moreover, there is a disincentive for the custodian to provide an acknowledgement to a requesting adviser. Once the custodian acknowledges the new documentation, which has the effect of amending the custodian's existing agreements, the custodian would be obligated to exercise greater oversight and a higher degree of care with respect to transactions initiated by an adviser. With expanded obligations, the cost to the custodian to satisfy its contractual obligations, as well as its potential liability if it fails to satisfy those obligations, increase. Therefore, acknowledgements from custodians are unlikely to be quickly provided to the adviser and, in some cases, may not be provided.
- Many custodians will not send an adviser the custodian agreement upon request and, therefore, in many cases, an adviser is unlikely to know whether the custody agreement contains any problematic provisions, unless the adviser obtains the custodian agreements from its clients. In addition to raising client-relationship concerns, it is possible that some clients will not respond or not respond in a timely manner.

Prior SEC Guidance – Custody and Authorized Trading. Separately, the Guidance contains language that could be read to eliminate the "authorized trading" exemption to the Custody Rule with respect to securities that do not trade on a DVP basis (such as swaps and bank loans). While the Guidance is unclear on this point, such a reading would require an adviser to treat a separately managed account as subject to the Custody Rule if the account holds such non-DVP assets, regardless of the terms of the custody agreement or advisory agreement.

The Guidance's Endnote 2 states:

An adviser's authority to issue instructions to a broker-dealer or a custodian to effect or to settle trades does not constitute "custody." Clients' custodians are generally under instructions to transfer funds (or securities) out of a client's account only upon corresponding transfer of securities (or funds) into the account. **This "delivery versus payment" arrangement minimizes the risk that an adviser could withdraw or misappropriate the funds or**

securities in its client's custodial account. This guidance update contemplates custody arising from authority that goes beyond such arrangements. (Emphasis added).

Action Items. We are aware of several trade organizations that are likely to seek guidance from the SEC staff on the two issues described above. However, the timing of such clarification, if any, is uncertain. In the meantime, advisers should consider whether the Guidance applies to them and, if so, the steps they will take in response.

Separately, on February 21, 2017, the SEC staff issued a no-action letter (the "Letter") in which the staff concluded that a registered investment adviser has custody of a client's assets if the adviser acts pursuant to a standing letter of instruction or other similar asset transfer authorization arrangement that a client has established with a qualified custodian (a "SLOA"). However, the Letter provided requested no-action assurance with respect to the Custody Rule's surprise examination requirements, provided certain conditions are satisfied.

Rule 206(4)-2 under the Advisers Act (the "Custody Rule") provides that an adviser has "custody" of client assets when it "holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them" in connection with the advisory services it provides to its clients. Custody by an adviser also includes "[a]ny arrangement (including a general power of attorney) under which [the adviser is] authorized or permitted to withdraw client funds or securities maintained with a custodian upon [the adviser's] instruction to the custodian."

The Letter noted that it is a common practice for an adviser's client to grant the adviser limited authority in a SLOA to disburse the client's funds to one or more third parties, as specifically designated by the client. In connection with the SLOA, a client gives written instructions to its custodian to accept the adviser's directions to transfer funds to the accounts of the third parties designated in the SLOA.

In the underlying incoming letter, the applicant asserted that an investment adviser that follows a client's instructions to transfer assets pursuant to the limited authority provided by a SLOA, and the adviser's related directions to the custodian, does not result in an investment adviser "holding" client funds, give the adviser "authority to obtain possession" of the client's funds, or authorize the adviser to "withdraw client funds" for any purpose, as contemplated by the Custody Rule. The Letter expressly rejected these arguments.

The Letter stated that "[a]n 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." For this reason, a SLOA is an arrangement under which an investment adviser is authorized to transfer client funds from a custodian upon the adviser's instruction, and falls within the definition of "custody." Therefore, an investment adviser that enters into a SLOA is required to comply with the requirements of the Custody Rule. Nonetheless, the Letter stated that the staff would not recommend enforcement action against an investment adviser if the adviser does not obtain a surprise examination, as the Custody Rule would otherwise require, where the adviser acts pursuant to an arrangement that satisfies the following conditions:

1. The client provides written instruction to the custodian that includes the client's signature, the third party's name, and either the third party's address or account number at a custodian to which the transfer should be directed.

2. The client gives written authorization to the investment adviser, either on the 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 custodian performs appropriate verification of the instruction (e.g., signature review or other method to verify the client's authorization) and promptly provides a transfer of funds notice to the client after each transfer.

4. The client has the ability to terminate or change the instruction to the client's custodian.

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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, or located at the same address, as the investment adviser.

7. The client's custodian sends the client an initial written notice confirming the instruction and an annual notice reconfirming the instruction.

Separately, the Letter noted that, with respect to an investment adviser's next annual updating amendment after October 1, 2017, the adviser should include client assets that are subject to a SLOA resulting in custody in its response to Form ADV Item 9.

Discussion. To put an arrangement in place that satisfies the Letter's conditions will require the agreement of the client's custodian (in particular, conditions 3 and 7), including providing evidence to the adviser that the custody arrangement with the client now satisfies those conditions. Therefore, difficulties similar to those that are likely to arise in implementing the Guidance (as described above) may arise in satisfying the Letter's conditions.

If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney.

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