June 13, 2018

Separately Managed Accounts – SEC Resolves One "Inadvertent Custody" Ambiguity

On June 5, 2018, the SEC's Division of Investment Management supplemented its Staff Responses to Questions About the Custody Rule to respond to a significant ambiguity in its prior custody guidance for investment advisers to separately managed accounts (each an "SMA"). Specifically, in its response to new Question II.11 (the "Response"), the SEC staff clarified that, when an adviser does not have a copy of a client's custody agreement and does not know, or have reason to know, whether the agreement would give the adviser inadvertent custody, the Division would not recommend enforcement under Rule 206(4)-2 of the Advisers Act (the "Custody Rule"), provided the adviser did not recommend, request or require a client engage the client's custodian.

The source of the ambiguity in the SEC staff's prior guidance, as well as how the Response eliminates virtually all of that ambiguity, are described below.

The Response does not address the questions raised in the SEC staff's prior guidance concerning whether all investments must settle on a "delivery versus payment" ("DVP") basis in order to rely on the "authorized trading" exemption from the Custody Rule (the "AT Exemption"). This remaining problem is also described below.

Background

In February 2017, the SEC's Division of Investment Management published a three-page Guidance Update, *Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority* (the "Guidance"). The purpose of the Guidance was to caution registered investment advisers that, for purposes of 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 called this situation "inadvertent custody" and noted that inadvertent custody subjects an adviser to the Custody Rule's surprise examination requirements. Inadvertent custody is most likely to arise with respect to an SMA because the custodian of an SMA is typically hired by the client.[1]

The Guidance stated that the SEC staff had observed instances of inadvertent custody when the terms of a custody agreement between a client and custodian could be interpreted as permitting the client's adviser to instruct the custodian to transfer funds or securities. The Guidance also stated 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.

Separately, the Guidance contained language that could be read to eliminate the AT Exemption to the Custody Rule with respect to securities that do not trade on a DVP basis (such as swaps and bank loans). The Guidance's Endnote 2 stated:

[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; as a result, the SEC's guidance is unlikely to affect the custody analysis for private fund managers.

> 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).

The Guidance recommended a remedial procedure that, if followed by advisers, would avoid inadvertent custody. The Guidance recommended that an adviser "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."

Soon after the Guidance was published, representatives of industry trade groups met with members of the SEC staff to highlight problems with the Guidance. Most notably, the recommended remedial action in the Guidance – having every client and custodian acknowledge in a new document a limit on the adviser's authority – failed to take into account that an adviser to SMAs is likely to have a large number of clients and a significant number of custodians are likely to be involved in such SMA arrangements. Many trade groups requested that the SEC staff change the Guidance because it was virtually impossible to comply with the Guidance's recommendation.

- 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 acknowledgements from each custodian is administratively burdensome and time consuming and may end up incomplete.

- 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 were unlikely to be quickly provided to the adviser and, in some cases, would not be provided.

- Many custodians will not send an adviser the custody agreement between custodian and client 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 custody 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.

The trade groups also informed the SEC staff that there were problems with the Guidance's language that could be read to eliminate the AT Exemption to the Custody Rule with respect to securities that do not trade on a DVP basis. While the Guidance was unclear on this point, such a reading would require an adviser to treat an SMA as subject to the Custody Rule if the SMA held non-DVP assets, regardless of the terms of the custody agreement or advisory agreement. In particular, this created potential issues for SMAs that held loans, OTC derivatives, private fund interests and other securities that do not settle DVP.

Observations

The Response steps back from the Guidance's interpretation of the Custody Rule. The Response's logic – that an adviser does not have custody when the adviser does not have a copy of a client's custody agreement and does not know, or have reason to know, the agreement's contents – is an outcome much closer to the plain language of the Custody Rule and tracks industry practice better. The Response should greatly reduce the probability that an adviser would be deemed to have inadvertent custody as described in the Guidance.

A potentially troubling item in the Response is the proviso that, to benefit from the Response, the adviser must not recommend the client's custodian. In practice, clients may ask an adviser to recommend a custodian, and an adviser may respond based upon prior positive experiences with one or more custodians. The proviso in the Response suggests that an adviser may want to avoid recommendations or, instead, maintain a list of multiple custodians and temper any potential "recommendation" to neutral statements that (i) it has had a positive experience with the listed custodians, (ii) there are other good custodians in the marketplace and (iii) the ultimate decision remains with the client.

The Response is welcome news to SMA advisers. However, the SEC staff has still ***not addressed*** problems caused by language in the Guidance that could be read to eliminate the AT Exemption to the Custody Rule with respect to securities that do not trade on a DVP basis.

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