sifma asset management group | IAA INVESTMENT ADVISER ASSOCIATION

March 7, 2018

Dalia Blass
Director
Division of Investment Management

Peter B. Driscoll
Director
Office of Compliance Inspections and Examinations

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: IM Guidance Update No. 2017-01 - Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority (the "**February 2017 Guidance**" or the "**Guidance**")[1]

Dear Ms. Blass and Mr. Driscoll:

The undersigned associations (the "**Associations**")[2] appreciate the Staff's active dialogue over the past year regarding our members' concerns and questions related to the February 2017 Guidance. Following our most recent meeting with Staff from the Division of Investment Management ("**IM**") and Office of Compliance Inspections and Examinations ("**OCIE**"), we believe that it would be helpful to set forth (I.) our members' understanding of Rule 206(4)-2 (the "**Custody Rule**") promulgated by the Commission under the Investment Advisers Act of 1940 (the "**Advisers Act**"); (II.) the changes in interpretation of the Custody Rule raised by the Guidance, and resulting negative consequences; and (III.) the types of controls investment advisers already have in place that are reasonably designed to address the risk of misappropriation. We are firmly committed to continuing to work with the Staff to find a solution to issues raised by the Guidance and hope that this letter is helpful in moving forward.

[1] The February 2017 Guidance is available at: https://www.sec.gov/investment/im-guidance-2017-01.pdf.

[2] See end of letter for descriptions of the Asset Management Group of the Securities Industry and Financial Markets Association ("**SIFMA AMG**") and the Investment Adviser Association ("**IAA**").

I. Investment Advisers' Understanding of the Custody Rule

A. The "authorized" scope of an investment adviser to obtain possession of client funds or securities is restricted by the IMA between the client and investment adviser

An investment adviser defines the scope of its relationship with its advisory clients, including the extent to which the investment adviser can transfer client funds and securities, through the Investment Management Agreement ("**IMA**")[3] it enters into with the client. The investment adviser's investment authority is established by the IMA itself and, in many cases, through related investment guidelines. IMAs commonly include a provision expressly providing that the investment adviser does not have custody of client assets, nor any authority to transfer securities and funds to themselves (other than due to the deduction of advisory fees from client accounts). These clients, in turn, establish a custody account and grant investment advisers authority to transfer assets held in the custody account through a custody agreement ("**Custody Agreement**").[4] As such, the custodian holds the client's cash and securities and transfers them upon instruction by an investment adviser who is bound by the authority granted in its IMA. Many of these same clients in their IMAs and related investment guidelines grant investment advisers authority to trade in a wide variety of asset classes and instruments—including those that do not settle "delivery-versus-payment" ("**DVP**").

Investment advisers have determined that, for the advisory client relationship described above, they do not have custody of client funds or securities under the Custody Rule. This view is grounded in the Custody Rule's definition of "custody" as "holding, directly or indirectly, client funds or securities, or having any ***authority*** to obtain possession of them."[5] The definition of custody also includes "[a]ny arrangement (including a general power of attorney) under which you ***are authorized or permitted*** to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian." Investment advisers are not "authorized or permitted" to take actions that would violate the terms of their IMAs. As such, an investment adviser would not view itself as being "authorized" to obtain possession of client funds or securities pursuant to a Custody Agreement to which it is not a party when the exercise of authority under that Custody Agreement would violate the investment adviser's IMA.

B. Custody arises from control of client funds or securities for purposes other than authorized trading

Given that the central function of investment advisers is to manage investments for their advisory clients, it stands to reason that trading authority is excluded from the "authority" giving rise

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[3] The term IMA used herein refers broadly to arrangements between investment advisers and their clients to provide discretionary advisory services.

[4] The term Custody Agreement as used herein refers broadly to any agreements or other documents that form the relationship between a client and custodian.

[5] Rule 206(4)-2(d)(2) (emphasis added).

to custody under the Custody Rule. The 2003 adopting release ("**2003 Adopting Release**")[6] of the Custody Rule explains that custody includes authority to access client accounts for purposes other than authorized trading (the "**Authorized Trading Exception**").

The Authorized Trading Exception is explained in two footnotes in the 2003 Adopting Release. Footnote 5 states, in respect of an example clarifying when an investment adviser has custody, that custody is "control of client funds or securities ***for purposes other than authorized trading***."[7] In addition, footnote 10 states that "[a]n adviser's authority to issue instructions to a broker-dealer or a custodian to effect or to settle trades does not constitute 'custody'."[8] The footnote goes on to explain that "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."[9] Based on the unconditional statement in footnote 5 and the use of the word "generally" in footnote 10, investment advisers have long understood that "authorized trading" includes—but is not limited to—trading that settles DVP.

The subsequent amendment to the Custody Rule, finalized in 2009 and published in the Federal Register in 2010 ("**2010 Adopting Release**"),[10] did not alter or change the Authorized Trading Exception to custody.

Investment advisers have not viewed the question of whether they have custody to depend upon the method of settlement. In practice, investment advisers routinely invest client assets through instruments that settle through various methods. Some settle DVP while others, such as loans, derivatives, private fund interests, and certain foreign securities, do not settle DVP.

II. February 2017 Guidance

As we have discussed with the Staff throughout the year since the issuance of the February 2017 Guidance, the Guidance set forth a standard for custody vastly different from the understanding

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[6] Custody of Funds or Securities of Clients by Investment Advisers; Final Rule, 68 Fed. Reg. 56692 (Oct. 1, 2003) (the "2003 Adopting Release").

[7] 2003 Adopting Release, n. 5 ("In our proposed rule, our first example of custody referred to 'possession or control' of client funds or securities, but commenters suggested that the term 'control' improperly suggested that an adviser that merely has trading authority over a client's securities account has custody for purposes of the rule. See infra note 10. We believe that the definition and other examples make it clear that an adviser has custody when it can control client funds or securities for purposes other than authorized trading, and that the word 'control' is therefore not needed in the first example.") (emphasis added).

[8] 2003 Adopting Release, n 10.

[9] *Id.* (emphasis added).

[10] Custody of Funds or Securities of Clients by Investment Advisers; Final Rule, 75 Fed. Reg. 1456 (Jan. 11, 2010) (the 2010 Adopting Release, collectively with the 2003 Adopting Release, the "Adopting Releases").

of investment advisers. In addition, the standard articulated by the Guidance would require massive efforts by investment advisers, clients and custodians to retool and re-paper in order to comply with the Guidance. This process would take significant time, and cannot be accomplished instantly or even over a period of months. This significant change and the inability to simply and quickly adopt measures that would address the Guidance have left investment advisers uncertain on how to move forward without further action by the Staff.

A. The Guidance interpreted "authorize" to include an investment adviser violating its IMA

Although custody arises when an investment adviser is "authorized or permitted to obtain possession" of client funds or securities, the Guidance stated that authorization may include acts permitted by agreements to which an investment adviser is not a party (and even if such authorization is unknown to the investment adviser) that would violate the terms of agreements to which the investment adviser ***is*** a party, namely the investment adviser's IMA with the client. The Guidance refers to this type of custody as "inadvertent custody."[11]

Specifically, the Guidance states that "an investment adviser may inadvertently have custody of client funds or securities because of provisions in a separate custodial agreement entered into between its advisory client and a qualified custodian." The Guidance then states that the Custody Agreement gives the investment adviser custody even where "provisions in a custodial agreement and advisory agreement conflict as to an investment adviser's authority to withdraw, or transfer, client funds or securities upon instruction to the custodian." Nowhere in the Guidance is "inadvertent custody" dependent upon the investment adviser having knowledge of or agreeing to the terms of the Custody Agreement. As a result, the Guidance interprets the term "authorized" to include an investment adviser's unknown ability to act in a manner that breaches its agreement with its client.[12]

Given that the Custody Rule and its Adopting Releases gave no indication that custody should be interpreted in this way, this pronouncement surprised investment advisers who believed that the term "authorized" carried its typical, dictionary meaning, such as Merriam-Webster's definition, "to

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[11] Prior to the publication of the Guidance, the closest concept to the Guidance's "inadvertent custody" was an investment adviser inadvertently receiving payment belonging to a client, regarding which IM provided relief in 2007. *See* SEC Staff No-Action Letter 132-3 (Sept. 20, 2007), *available at* https://www.sec.gov/divisions/investment/noaction/2007/iaa092007.pdf. Also, although there were indications in 2013 regarding broad Custody Agreement language used by one bank custodian, investment advisers were not aware of the scope and applicability beyond the one custodian.

[12] Under the position set out in the Guidance, investment advisers would be required to seek out Custody Agreements for each and every client account in order to determine whether the investment adviser has custody. This process would be time-consuming and potentially fruitless, as custodians have no obligation to provide investment advisers with these agreements and, based on our experience, do not provide Custody Agreements to non-parties, including investment advisers. Investment advisers typically would have to conduct due diligence on many different custodial relationships (larger investment advisers will have potentially thousands of custodial relationships to verify), with little or no resulting investor protection impact.

invest especially with legal authority."[13] Based upon this typical meaning, the investment advisers did not view themselves as being invested with legal authority to take acts that violated the very agreement(s) that gave them the authority to act on behalf of their advisory clients.

If the Guidance's interpretation of "authorized" is applied in practice, the number of investment advisers that have custody under current business practices would increase from around 30% to a significantly higher number of investment advisers,[14] and expand the number of advisory accounts that would come within the scope of the Custody Rule. Indeed, nearly all investment advisers that manage institutional accounts (and many that manage high net worth ("**HNW**")/retail accounts) could, as a result, have "inadvertent custody" of client assets under the Guidance.[15] As this change in percentage demonstrates, the February 2017 Guidance represents a substantial departure from the settled understanding of an investment adviser's authorization.

B. The Guidance and subsequent discussions with the Staff raise questions regarding the Trading Authorization Exception

While the Guidance does not explicitly provide Staff views on the Trading Authorization Exception, the Guidance's solution to avoiding "inadvertent custody" and further discussions with the Staff have raised questions about Staff interpretations of this important exception.

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[13] Definition of "authorized," Merriam-Webster, *available at*: https://www.merriam-webster.com/dictionary/authorize (accessed Mar. 1, 2018):

> Definition of authorize authorized; authorizing
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> transitive verb
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> 1 : to endorse, empower, justify, or permit by or as if by some recognized or proper authority (such as custom, evidence, personal right, or regulating power) a custom authorized by time
>
> 2 : to invest especially with legal authority : empower She is authorized to act for her husband.
>
> 3 archaic : justify

[14] Based on an average of responses from 2010 to 2016 to Form ADV's Item 9A(1)(a) and (b) ("Do you have custody of any advisory clients' (a) cash or bank accounts? (b) securities?"), approximately 28% of investment advisers answered yes to having custody of cash or bank accounts and approximately 27% answered yes to having custody of securities. The highest single-year percentage for answering yes to these questions was approximately 32%.

[15] In working with the Staff to understand the implication of the Guidance, the Associations have spoken with many custodians, particularly those that handle institutional accounts. While terms of Custody Agreements were not shared, we have been informed that broad authorization is typically provided in Custody Agreements for institutional clients without regard to an investment adviser's IMA. Custodians indicated that they were not operationally able to provide granular monitoring of all client accounts, beyond the terms of the Custody Agreement.

Specifically, the Guidance states that, "[o]ne 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." The Guidance's limitation of this solution to DVP led to further discussions with the Staff in which the Staff has questioned the extent to which the type of settlement impacts an investment adviser's ability to rely upon the Authorized Trading Exception.

Much like the Guidance's statements on "inadvertent custody," investment advisers were surprised by the implication that the Trading Authorization Exception could be limited to authority to trade instruments that settle DVP. Indeed, many IMAs that prohibit investment advisers from having custody also grant authorization through related investment guidelines to trade derivatives and other instruments that settle non-DVP, demonstrating the common understanding of both clients and investment advisers on the interpretation of the Custody Rule. While the 2003 Adopting Release makes reference to DVP settlement in connection with the Trading Authorization Exception, these references were understood as examples of how to apply the exception and were accompanied by unconditional statements indicating that custody is "control of client funds or securities ***for purposes other than authorized trading***."[16]

Limiting the Trading Authority Exception to instruments that settle DVP would represent an additional, major change in how the Custody Rule has been applied by investment advisers and clients. Given the prevalence and importance of derivatives, loans, private fund investments, certain foreign securities, and other non-DVP settling instruments, this new interpretation would also have the significant consequence that many investment advisers for institutional clients (and some advisers for HNW/retail clients) would have custody over nearly all separate accounts that they manage merely by virtue of the investment strategies or hedging tools employed in the portfolio.

C. The Guidance has significant, negative impacts for advisory clients and requires major changes to business practices in order for investment advisers to comply

The major change in standards introduced by the Guidance led to confusion and questions from investment advisers, including: a) how to interpret custody; b) which accounts the Staff viewed as in scope; c) which instruments generally and specifically should be categorized as non-DVP; and d) how to comply with a changed standard that provided no implementation period. Indeed, the significant increase in investment advisers and accounts that, overnight and without warning, were or could be viewed under the Guidance as being subject to the Custody Rule would require, among other steps:

- Amendments to thousands of IMAs to remove language prohibiting investment advisers from having custody;

[16] 2003 Adopting Release, n. 5 (emphasis added).

- Completion of internal client processes and approvals for clients to agree to amend IMAs—an extensive, time-consuming process for many advisory clients;

- In some cases where clients may not be able or willing to permit the investment adviser to have custody (other than due to the deduction of advisory fees from client accounts), changes to IMAs to exclude assets classes that do not settle DVP and client approval for transfers from custody accounts, limiting hedging instruments and investments crucial to many advisory clients' investment objectives;

- In other cases where clients may not be able or willing to permit investment advisers to have custody and where investment advisers may not be able to make investments or hedge risks crucial to satisfying the advisory client's investment objectives, termination of IMAs and liquidation of portfolios;

- Set up of costly and labor-intensive surprise exams for a new population of client accounts over which the investment adviser may need additional permissions from clients to give auditors access;

- Re-calibration of standards for surprise exams, requiring auditors to adjust practices;

- Changes to investment advisers' internal infrastructure to differentiate between clients that utilize instruments settling non-DVP and to accommodate having custody of client assets;

- Determination of changes to the investment adviser's Form ADV filings, both in terms of whether to indicate that the investment adviser has custody and the amount of client funds and securities over which the investment adviser has custody;

- Assessment of whether other requirements of the Custody Rule need to be addressed; and

- Determination of how to address additional costs not previously contemplated by the advisory services agreed with the client.

Although the Guidance offered one way to avoid "inadvertent custody"—as discussed above, "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"—the Associations' discussions with custodians revealed that this proposed option was not practicable for a significant number of clients. Custodians for institutional clients could not implement the solution suggested because automated systems utilized to process the high volume of transfers did not differentiate between types of settlement and could not be used to track granular limits of an investment adviser's trading authority without significant rebuilds. The high volume of transfers for institutional clients also means that manual options would likewise be costly and similarly not practicable. In addition, as custodians did not agree to provide this service to an overwhelming percentage of clients (institutional and many HNW/retail), those clients would need to renegotiate

their Custody Agreements. Although more granular controls are offered for some HNW/retail accounts, again, for the clients that did not contract with custodians for this service, their Custody Agreements would need to be re-considered to the extent the HNW/retail client's custodian has the infrastructure to provide this service.

Given this significant work required and the questions that arose regarding how to reconcile the Guidance with the common understanding of the Custody Rule before the Guidance, the Associations have engaged in discussions with the Staff to try to address these issues. To date, the Associations do not have further clarity from the Staff on these issues. In light of this uncertainty, investment advisers struggle to move forward with the major business changes required to comply with the Guidance.

In addition, during this interim period, some investment advisers have had to file Form ADVs while many others have a March 31, 2018 filing deadline requiring them to indicate whether or not they have custody, and if so, the amount of cash and securities over which they have custody. Investment advisers have been left unable to apply the Guidance in answering this question. Even if an investment adviser determined that the Guidance, as applied, meant that it now needed to answer "yes" to whether it has custody, the investment adviser would then need to complete the steps described above to comply within an impracticable timeframe and without knowing whether and how the Staff will address these concerns.

Further, the Associations respectfully believe that such a significant change to the standard used to determine custody under the Custody Rule must be done through the notice-and-comment process under the Administrative Procedure Act. The Guidance expanded the scope of the Custody Rule beyond what is "fairly encompassed" by the text of the Custody Rule itself, thus triggering the need to engage in a rulemaking. Not only would notice and comment provide helpful feedback on existing controls that mitigate potential risks, implementation challenges and a cost-benefit assessment, a rulemaking also recognizes that a change in standard has occurred and those subject to the new standard need an implementation period to adjust business practices. None of these benefits from these requirements were present for this Guidance.

III. Investment Advisers Currently Have Controls Reasonably Designed to Protect Client Funds and Securities from Misappropriation

The Custody Rule is only one of the protections afforded to advisory clients under the Advisers Act. Investment advisers, as fiduciaries under the Advisers Act, take reasonable steps to protect against a number of risks that may arise, including the risk of misappropriation. [17] We have previously provided the Staff, and we list in the attached appendix, some examples of risks that may arise related to broad authorization in Custody Agreements and authority to trade instruments that settle non-DVP along with illustrative examples of controls that investment advisers use to address the risks, as appropriate to their businesses. As these examples demonstrate, protection of client funds and securities are already built into the Advisers Act beyond the Custody Rule, notwithstanding the issuance of the February 2017 Guidance. As fiduciaries, investment advisers

[17] *See, e.g.*, Rule 206(4)-7 under the Advisers Act (the compliance program rule) and OCIE's Risk Alert, *Strengthening Practices for Preventing and Detecting Unauthorized Trading and Similar Activities* (Feb. 27, 2012), *available at*: https://www.sec.gov/about/offices/ocie/riskalert-unauthorizedtrading.pdf.

take seriously the risk of misappropriation and actively review these measures based on the existing requirements of the Advisers Act applicable outside of the Custody Rule.

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We are committed to continuing to engage with the Staff as it develops new guidance to resolve the issues raised by the February 2017 Guidance. We are available to answer any questions or follow up requests that the Staff may have.

Respectfully submitted,

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APPENDIX

THE ASSOCIATIONS' CURRENT DRAFT LIST OF SAMPLE CONTROLS RESONABLY DESIGNED TO ADDRESS RISKS ARISING FROM BROAD AUTHORIZATION IN CUSTODY AGREEMENTS AND TRADING OF INSTRUMENTS THAT SETTLE NON-DVP[18]

Example 1: The risk that instructions are transmitted by unauthorized personnel or in a manner inconsistent with an investment adviser's policies and procedures

Sample controls present at investment advisers to address this risk, tailored, as appropriate, to the risk arising from their business:

- Maintaining a list of personnel authorized to instruct the movement of client funds or securities between the client's custodian(s) and counterparties ("**Authorized Persons**") and keeping the custodian(s) informed of the up-to-date Authorized Persons list.

- Training of Authorized Persons regarding the investment adviser's policies, procedures and protocols with which they must comply in sending instructions to custodians/counterparties and evidencing or receiving an acknowledgement that the Authorized Person has completed the training.

Example 2: The risk that Authorized Persons transmit instructions unrelated to client investments or client instructions

Sample controls present at investment advisers to address this risk, tailored, as appropriate, to the risk arising from their business:

- Separation of responsibilities of an investment adviser's personnel or the institution of other checks and balances. For example, an investment adviser may: use persons other than Authorized Persons to reconcile transfers between the custody account and counterparties; outsource reconciliation; and/or exclude Authorized Persons from having any authority to make investment or trading decisions for client accounts.

[18] These examples are only examples, and, in providing them, the Associations do not intend to imply that these risks are present for every investment adviser, are the only risks present, or that a certain type or number of controls is required. Depending on its business, an investment adviser may determine that the risk is not present or, if the risk is present, that other, similarly robust controls not listed here are more appropriate to mitigate the risk.

- Having transfer instructions sent to the custodian accompanied by transaction information. For example, the investment adviser may arrange with the custodian that transfer instructions must be accompanied with trade information communicated via industry standard protocols.

- Straight-through processing ("**STP**") of settlement such that a trade confirmation or transactional obligation initiates an automated process that generates a transfer instruction from the investment adviser to the custodian. An investment adviser may arrange with the custodian that transfer instructions will be generated via an STP system, absent which additional approval from an investment adviser's personnel will be required (such as the verification of non-routine instructions by the custodian described above).

Example 3: The risk that, for non-DVP transactions, custodians will accept non-standard settlement instructions to transfer client funds or securities to an account not designated by the client.

Sample controls present at investment advisers to address this risk, tailored, as appropriate, to the risk arising from their business:

- Enhanced requirements for large, non-repetitive transfers. For example, an investment adviser may arrange with the custodian that non-repetitive transfers above a certain threshold require approval from two Authorized Persons.

- Verification of non-routine instructions. For example, an investment adviser may arrange for the custodian to call and confirm instructions with an additional Authorized Person if the custodian receives instructions by facsimile when instructions are typically communicated by other means.

- Real-time controls that limit the Authorized Person's ability to instruct delivery of funds or securities to/from specific counterparties. For example, the client may identify for a client investment (e.g., private fund) the accounts into which any redemption or distribution proceeds should be transferred. Likewise, a client may establish standing settlement instructions accessed by the trading counterparty through industry standard protocols.

Example 4: The risk that unauthorized transfers will not be detected or will not be reflected in the records of the custodian or adviser

Sample controls present at investment advisers to address this risk, tailored, as appropriate, to the risk arising from their business:

- Review of instructions to transfer. For example, an investment adviser may periodically reconcile transfer activity to confirm that the balance in the client's custody account matches the activity in the client's investment portfolio.

- Review on a periodic basis that (a) transferred client funds or securities match information provided by a counterparty relevant to a position in the client's investment portfolio; and (b) documents generated and/or reviewed by third parties (or counterparties) reflect the transfer of client funds or securities associated with the client's transaction.

- Review on a periodic basis of client account trading activity for indications of inappropriate transfers.

- Internal or external audit/testing of controls relating to the handling of client funds and securities. For example, an investment adviser may spot check whether security positions and cash balances are complete, accurate, and timely.