GUEST COLUMN

The Custody Rule Under the Investment Advisers Act: Time for a Change

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Rule 206(4)-2, the so-called "custody rule" adopted under the Investment Advisers Act of 1940 (the "Advisers Act"),[1] is unnecessarily complex and difficult to implement. It is also vigorously enforced and from time to time has been the subject of informal guidance published by the staff of the Securities and Exchange Commission ("SEC" or the "Commission").[2] As a result, compliance with the custody rule is challenging, and advisers run a relatively high risk of regulatory compliance deficiencies or possible enforcement actions. This leaves many in the industry scratching their heads: Clearly, the investor protection goals underlying the custody rule are important, but does the complexity of the custody rule further those goals?

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In light of pending changes to the Commission membership and new leadership in the Division of Investment Management (the "Division"), an opportunity exists to step back and reconsider the efficacy of existing regulations. Updating the custody rule should be high on the Division's to-do list. Making necessary changes, subject to the notice and comment process inherent in formal rulemaking, can help ensure that the Commission's investor protection mandate continues to be adequately addressed while providing badly needed clarification of the custody rule so that investment advisers better understand and can meet their obligations.

A Brief History of the Custody Rule

A key tenet of the Advisers Act is that investment advisers have a fiduciary duty to their clients. Among other things, this means that investment advisers must maintain client funds and securities in such a way "that they will be insulated from and not be jeopardized by any unlawful activities or financial reverses, including insolvency" of an investment adviser.[3] Failure to do so is deemed a form of fraud under Section 206 of the Advisers Act.[4]

In 1960, Congress gave the Commission rulemaking authority under Section 206 that was prompted, in part, by a "concern about the custodial practices of advisers and the safety of client assets."[5] In 1962, the Commission used this authority to adopt Rule 206(4)-2 which, for the first time, required registered investment advisers to implement a set of controls to protect client assets over which they maintained custody.[6]

As originally adopted, the custody rule required registered investment advisers with custody of client funds and securities to deposit client funds in a bank account that only contained client funds, and that was maintained in the name of the adviser as agent or trustee for its clients. Registered investment advisers were also required to segregate and identify securities beneficially owned by each client, and to hold them in a "reasonably safe" place.[7] Investment advisers were required to inform their clients where custody of their funds and securities was maintained, and advisers with custody were required to engage an independent public accountant to conduct an annual surprise examination of client assets.

In 2003, the custody rule was amended to "reflect modern custodial practices and clarify circumstances under which an adviser has custody of client assets and thus must comply with the [custody] rule."[8] When it proposed the 2003 amendments, the Commission noted that, in the more than 40 years since the custody rule was first adopted, its staff had "attempted to accommodate . . . evolving business practices, and to reduce unnecessary compliance burdens on advisers, by issuing numerous no-action and interpretive letters and releases . . . to clarify the operation of the rule."[9] Unfortunately, by the SEC's own admission, the result was "diminished . . . transparency of the rule's requirements because an adviser seeking to understand the rule [had to] review a large body of letters in addition to the rule itself."[10]

Among other things, the 2003 amendments eliminated the need for

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an adviser to engage an independent public accountant to conduct a surprise examination with respect to client accounts for which the adviser had a "reasonable belief" that a "qualified custodian" was providing account statements directly to the clients.[11] The Commission acknowledged that the cost of an annual surprise examination might not be justified, since "experience [had] shown that the [then] current rule [had] limited deterrent effect."[12]

In 2009, however, the Commission reversed itself. In the wake of enforcement actions brought against Bernie Madoff and others alleging fraudulent misappropriation of investor assets, the Commission proposed amendments to the custody rule that would "decrease the likelihood that client assets [could be] misused, or . . . increase the likelihood that fraudulent activities [would be] discovered earlier," thereby potentially mitigating client losses.[13] Among other things, the proposed amendments required advisers to undergo an annual surprise verification of client funds and securities held by a qualified custodian.[14]

The Commission received more than 1,300 comment letters on the proposed 2009 amendments. While commenters generally supported the goal of strengthening safeguards of client assets, industry participants were concerned that certain aspects of the proposal would create redundancies and others could be read so broadly as to infer custody in almost every instance. Nevertheless, the amended custody rule was adopted with minimal changes.[15]

As currently effective, therefore, the custody rule generally requires that registered investment advisers with custody of client assets:

(i) maintain such assets with a qualified custodian;

(ii) notify clients of the name of the custodian holding their assets when the account is opened and thereafter notify clients if changes are made to the custodial agreement;

(iii) have a reasonable belief, after "due inquiry," that the qualified custodian sends an account statement to each client at least quarterly; and

(iv) verify, by an annual surprise examination conducted by an independent public accountant, the client funds and securities held by the qualified custodian.

In addition, under the current custody rule, if the qualified custodian holding the assets is a "related person" of the adviser, the adviser must obtain from the related person an internal control report from an accountant registered with and inspected by the Public Company Accounting Oversight Board ("PCAOB").

Evolution of Interpretation of the Custody Rule

Since the adoption of the 2009 amendments, the SEC staff has continued to receive questions regarding the applicability of the custody rule to certain types of situations and securities, as well as technical compliance with the provisions of the rule. The staff maintains a list on the Commission's website of responses to "frequently asked questions" ("FAQs") regarding the custody rule.[16] As a technical matter, the responses to the FAQs represent the views of the staff and do not have the authority of regulation. Practically speaking, however, industry participants view these as similar to regulation in the sense that failure to comply with the staff's view could result in a referral to enforcement.

The SEC staff has also published interpretive guidance updates related to (i) the treatment of privately offered securities under the custody rule;[17] (ii) the application of the custody rule to special purpose vehicles and escrows established by private funds;[18] and (iii) the existence of so called "inadvertent custody."[19] Similar to the FAQs, such guidance represents the views of the SEC staff and not regulatory action by the Commission. Nonetheless, they are generally treated by industry participants as having the weight of regulation, albeit without the benefit of public notice and comment.

Insight into the views of the SEC staff regarding the custody rule can also be gleaned from a series of no-action and interpretive letters issued after the most recent amendments to the custody rule.[20] Many such letters address circumstances under which an investment adviser may not have to obtain a surprise examination of client accounts held at a qualified custodian, as otherwise required by the custody rule.

For example, in 2017, the Investment Adviser Association obtained relief from the surprise examination requirement for investment advisers exercising limited authority over client accounts pursuant to standing letters of instruction or other asset transfer authorization established by a client with a qualified custodian.[21] Similarly, in 2012, the Investment Company Institute sought and obtained relief enabling investment advisers that manage mutual funds and act as program managers for state-created college savings plans ("529 plans") to treat 529 plans as pooled investment vehicles for purposes of the custody rule.[22] As a result, investment advisers can rely on the exception from the requirement to obtain surprise examinations if they obtain an annual audit of a 529 plan's financial statements and provide such audited financial statements to the state agency responsible for oversight of the 529 plan within 120 days of the plan's fiscal year-end.

Finally, the views of the Commission and its staff are apparent from settled enforcement actions brought against registered investment advisers for violations of Rule 206(4)-2.[23] Thus, for example, where the Commission has determined that the audited financial statements of a private fund did not comply with U.S. generally accepted accounting principles ("GAAP"), notwithstanding the existence of an opinion regarding such compliance from an independent

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public accountant, investment advisers have been deemed unable to rely on the pooled investment vehicle exception to obtaining a surprise examination, and thus in violation of the custody rule.[24]

FAQs, interpretive guidance, no-action letters issued by the SEC staff, and administrative proceedings settled by the Commission are not subject to public notice and comment. Nonetheless, they have the effect of broadening the interpretation of the custody rule. Indeed, given the current posture of the Commission and its staff, the breadth of the custody rule is such that registered investment advisers may be well advised to assume they have custody in almost every instance where the question arises.

Time to Revise the Rule

There are recurring areas of confusion about the custody rule that are ripe for review. Several of these are summarized below, along with suggestions for how to resolve the issues.

"Constructive" v. "Actual" Custody. Over time, the concept of custody has expanded so that advisers without physical custody (*i.e.,* with "constructive" custody) are deemed to have custody of client funds and securities for purposes of the custody rule. For example, earlier this year, the staff took the position 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."[25] That is, an adviser may be deemed to have constructive custody of assets by virtue of a contract to which it is not a party, and about which it may have no specific knowledge.

Moreover, the staff's position suggests that the terms of a custody agreement between an advisory client and a qualified custodian would trump the terms of the advisory contract between the adviser and its client.[26] In other words, an adviser who, in good faith, negotiates an advisory contract with a client to ensure that it does not have custody of the client's funds and assets may not get the benefit of that bargain. Under the staff's guidance, if the custodian believes that the adviser can withdraw or transfer client assets, then the adviser has constructive custody, regardless of its agreement with its client about its authority to do so.

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The staff suggested that advisers may address this issue by drafting a letter to the custodian that limits the adviser's authority to "delivery versus payment," and by having the client and the custodian provide written consent to the terms of that letter. In other words, a registered investment adviser should seek to unilaterally convert a third-party bilateral agreement into a tri-party agreement.

This is, quite simply, an untenable position for registered investment advisers. Leaving aside the implications of such an action under general contract law, the practical implications of such a notice and consent process could be significant for large investment advisers that have thousands of client accounts, as well as relationships with hundreds of custodian banks. Implementing and maintaining a compliance infrastructure to effectively deal with such documents would be labor intensive and costly without any significant corresponding investor protection benefit. Moreover, failure to adequately implement such a compliance program could, unfortunately, lead to more custody-related compliance failures.

The Commission should revise the custody rule to deal with situations in which an adviser or its related person has actual "custody" of client assets, in the plain-English sense of the word. Investor protection concerns regarding an adviser's authority over such assets, including conflicts of interest inherent in an adviser's ability to move client assets to pay its own fees, would be more appropriately addressed in regulations designed to address specifically identified risks, rather than trying to broaden the concept of custody beyond a general understanding of the term.

Surprise Examination Requirement. The Commission acknowledged in the 2009 Adopting Release that the surprise examination requirement could have a significant impact on smaller advisers that maintain client assets with a qualified custodian. It suggested that it would direct the SEC staff to evaluate that impact and would ask the staff to recommend amendments to address the burden on small advisers. To date, however, no further action has been taken to resolve this concern.

The Commission should seek data on the impact of the surprise examination requirement on smaller advisers, and conduct a cost-benefit analysis of this requirement of the rule in light of industry experience since the custody rule was last amended.

Privately Offered Securities. The custody rule currently requires a qualified custodian to hold privately offered securities. In interpretative guidance,[27] the SEC staff recognized that there is little risk that an adviser could misappropriate privately offered securities that are not generally transferrable. That relief, however, does not go far enough.

In IMGU 2013-04, the SEC staff provided limited relief to advisers to audited pooled investment vehicles, taking the view that such advisers need not maintain with a qualified custodian instruments such as nontransferable stock certificates or "certificated" LLC interests that were obtained in a private

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placement. It did not extend that relief to unaudited pools.

The nature of such certificated privately offered securities, however, is consistent regardless of whether a pooled investment vehicle is audited or unaudited. That is, they are generally transferrable only with the prior consent of the issuer or other holders of the issuer's outstanding securities. Moreover, ownership of such securities is recorded on the books of the issuer or its transfer agent, and a certificate, in and of itself, generally cannot be used to effect a change in beneficial ownership of such private securities. Requiring that unaudited pooled investment vehicles maintain such securities with a qualified custodian and subjecting them to a surprise examination therefore provides no meaningful benefit to investors.

Conclusion

It is undisputed that there are important investor protection goals underlying the custody rule. As currently written, however, the rule seems to create more problems than it solves. It is complex, confusing, and unduly burdensome. As the staff itself has pointed out, many times advisers don't even know that they have custody.[28]

In part, the confusion seems to be due to circumstances similar to those existing in 2003, which prompted the Commission to revise the custody rule. As before, the SEC staff has attempted to accommodate evolving business practices and practitioners' questions by issuing FAQs, no action and interpretive letters, and enforcement releases that clarify their view of how the custody rule should operate. Once again, however, the result seems to be "diminished . . . transparency of the rule's requirements because an adviser seeking to understand the rule must review a large body of [ancillary documents] in addition to the rule itself."[29]

It is time for the SEC to once again revisit the custody rule in light of the realities of the current market place. Importantly, the Commission should limit the custody rule to circumstances in which an adviser or its related person has actual "custody" of client assets, in the plain English sense of the word. To the extent it has investor protection concerns regarding other manners in which advisers may have access to or authority over client assets, the Commission should consider its other existing regulations, or rulemaking authority, and address those concerns in narrowly tailored regulations that do not confuse the concept of custody with that of access.

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[1] 15 U.S.C. § 80b-1 *et seq.*

[2] See, *infra*, notes 17-19 and related text.

[3] See, *Custody or Possession of Funds or Securities of Clients*, SEC Rel. No. 40IA-122 (Nov. 3, 1961).

[4] 15 U.S.C. § 80b-6.

[5] See, *Custody of Funds or Securities of Clients by Investment Advisers*, SEC Rel. No. IA-2044 (July 18, 2002) (the "2002 Proposing Release") at n.4 and related text.

[6] See, *Custody or Possession of Funds or Securities of Clients*, SEC Rel. No. 40IA-123 (Feb. 27, 1962).

[7] *Id*.

[8] 2002 Proposing Release. The Commission noted that not only had "portions of the rule ... become outdated or inconsistent with modern custodial practices[, but that] business practices also have evolved, increasing the likelihood that advisers may obtain custody of client assets in circumstances that [the Commission] may not have anticipated in 1962."

[9] *Id*. at n.12. The Commission noted that the Division of Investment Management had issued approximately 90 no-action and interpretive letters related to the custody rule and one related interpretive release.

[10] *Id*.

[11] See, *Custody of Funds or Securities of Clients by Investment Advisers,* SEC Rel. No. IA-2176 (Sept. 25, 2003).

[12] 2002 Proposing Release.

[13] See, *Custody of Funds or Securities of Clients by Investment Advisers,* SEC Rel. No. IA-2876 (May 20, 2009) ("2009 Proposing Release").

14 *Id*.

[15] See, *Custody of Funds or Securities of Clients by Investment Advisers,* SEC Rel. No. IA-2968 (Dec. 30, 2009) ("2009 Adopting Release").

[16] See, *Staff Responses to Questions About the Custody Rule* (available at https://www.sec.gov/divisions/investment/custody_faq_030510.htm). The FAQs are periodically revised (most recently on February 21, 2017) as new interpretive questions are raised with the staff.

[17] Division of Investment Management Guidance Update, No. 2013-04 (Aug. 2013) (available at https://www.sec.gov/divisions/investment/guidance/im-guidance-2013-04.pdf) ("IMGU 2013-04").

[18] Division of Investment Management Guidance Update, No. 2014-07 (June 2014) (available at https://www.sec.gov/investment/im-guidance-2014-07.pdf).

[19] Division of Investment Management Guidance Update, No. 2017-01 (Feb. 2017) (available at https://www.sec.gov/investment/im-guidance-2017-01.pdf) ("IMGU 2017-01").

[20] In the 2009 Adopting Release, the Commission pointed out where its rulemaking superseded then-effective no action relief granted by its staff. Certain pre-2009 no-action relief, however, remains effective and relevant. See, *e.g., American Bar Association Subcommittee on Private Investment Entities,* SEC Staff No-Act. Ltr. (Aug. 10, 2006); *Deloitte & Touche,* LLP, SEC Staff No-Act. Ltr. (Aug. 28, 2006).

[21] *Investment Adviser Association,* SEC No-Act. Ltr. (Feb. 21, 2017).

[22] *Investment Company Institute,* SEC No-Act. Ltr. (Sept. 5, 2012).

[23] In addition to enforcement actions brought against registered investment advisers and their associated persons under Rule 206(4)-2, the Commission has brought action against other parties (*e.g.,* independent public accountants) for causing an adviser to violate Rule 206(4)-2 (see, *e.g., In the Matter of Altschuler, Melvoin and Glasser LLP, et al.* (Oct. 4, 2010)).

[24] See, *e.g., In the Matter of Potomac Asset Management Company, Inc., et al.,* Rel. No. IA-4766 (Sept. 11, 2017).

[25] See, IMGU 2017-01, *supra* note 19.

[26] *Id.* "An adviser could . . . have custody when provisions in a custodial agreement and advisory agreement conflict as to an adviser's authority to withdraw, or transfer, client funds or securities upon instructions to the custodian. . . . notwithstanding a provision in the advisory agreement to the contrary."

[27] See, *supra*, note 17.

[28] See, *Significant Deficiencies Involving Adviser Custody and Safety of Client Assets,* National Exam Program Risk Alert (Mar. 4, 2013) (available at https://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf).

[29] See, *supra*, note 9 and related text.