SEC Staff Requests Industry Input on Custody Issues Involving Non-DVP Trading and Digital Assets

On March 12, 2019, the staff (the "Staff") of the Securities and Exchange Commission ("SEC") published a letter (the "Letter")[1] addressed to the Investment Adviser Association ("IAA") seeking input from investment advisers, other market participants and the public regarding (1) the regulatory status of investment adviser and custodial trading practices that are not processed or settled on a delivery versus payment ("Non-DVP") basis and (2) the application of Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940 (the "Advisers Act") to digital assets. The Letter was prompted by, among other things, issues raised by investment advisers and other market participants following the publication of the 2017 Guidance Update (as defined and described below).

DVP Trading under the Custody Rule

Background

The Custody Rule provides that it is a fraudulent, deceptive or manipulative act, practice or course of business for an investment adviser that is registered or required to be registered under the Advisers Act to have "custody" of client funds or securities unless they are maintained in accordance with the requirements of the Custody Rule. The rule defines "custody" to include physical possession of client funds or securities. In addition, as amended in 2003, the rule also defines "custody" to include, among other things, "[a]ny arrangement (including a general power of attorney) under which [an investment adviser is] authorized or permitted to withdraw client funds or securities maintained with a custodian upon [the investment adviser's] instruction to the custodian."[2] The 2003 Release included a discussion of how the authority to withdraw client funds or securities gives rise to custody, unless it is for authorized trading (the "authorized trading exception"). In particular, footnote 5 of the 2003 Release provided, "[A]n adviser has custody when it can control client funds or securities for purposes other than authorized trading…." Footnote 10 of the 2003 Release provided, "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

1 Engaging on Non-DVP Custodial Practices and Digital Assets (Mar. 12, 2019).

2 Rule 206(4)-2(d)(2)(ii). See Custody of Funds or Securities of Clients by Investment Advisers, Release No. IA-2176 (Sept. 25, 2003) ("2003 Release").

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the risk that an adviser could withdraw or misappropriate the funds or securities in its client's custodial account."

In 2017, the Staff published a guidance update (the "2017 Guidance Update")[3] cautioning investment advisers that they may have inadvertent custody if a custodial agreement between their client and the custodian granted them broader access to the client's accounts than did their investment management agreement with the client. The 2017 Guidance Update further stated that one way for an adviser to avoid custody in such an instance would be to draft a letter (or other form of document) addressed to the custodian that limits the investment adviser's authority to conduct transactions on a DVP basis. The 2017 Guidance Update also included an endnote similar to footnote 10 in the 2003 Release. That endnote provided, "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." However, in what many industry participants viewed as a departure from footnote 10 in the 2003 Release, the endnote continued on to provide, "This guidance update contemplates custody arising from authority that goes beyond such arrangements."[4] These statements in the 2017 Guidance Update caused concern throughout the industry that the Staff had, for the first time, limited the availability of the authorized trading exception only to instruments that settle on a DVP basis. The reference in the 2003 Release to DVP settlement in connection with the authorized trading exception had been understood by the industry to be an example of how to apply the authorized trading exception, and not, as the 2017 Guidance Update may imply, to mean that any arrangement other than authority to trade on a DVP basis constitutes custody. The Securities Industry and Financial Markets Association ("SIFMA") and the IAA, among other industry participants, expressed concerns that limiting the authorized trading exception to instruments that settle on a DVP basis would represent a major change in how the Custody Rule has been applied by investment advisers and clients.[5]

Input on Non-DVP Trading Sought by the Letter

In the Letter, the Staff acknowledges that investment advisers and other market participants have raised issues regarding the regulatory status of investment adviser and custodial trading practices that are not processed or settled on a DVP basis. Nonetheless, the Staff states that it believes questions surrounding Non-DVP trading should be considered by the SEC (i.e., through rulemaking rather than Staff guidance) and notes that amending the Custody Rule is on the SEC's long-term unified agenda. According to the Letter, the Staff has launched an initiative to gather information on Non-DVP practices, which would

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3 Division of Investment Management Guidance Update No. 2017-01, Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority (Feb. 2017).

4 2017 Guidance Update, n.1.

5 See Letter to Dalia Blass from SIFMA and IAA (Mar. 7, 2018) ("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 [high net worth]/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.").

"inform future steps." The Letter requests input regarding (i) the risks of misappropriation or loss associated with Non-DVP trading, (ii) the types of instruments that trade on a Non-DVP basis (and whether certain types of securities present a greater or lesser risk of misappropriation or loss), (iii) the role of custodians in the settlement of Non-DVP trades, (iv) the costs and challenges of subjecting Non-DVP trades to a surprise examination (and whether other types of external checks would be more effective and less costly than surprise examinations), (v) to what extent Non-DVP assets appear on client account statements from qualified custodians, and (vi) to what extent evolving technologies (e.g., blockchain/distributed ledger technology ("DLT")), can provide enhanced or diminished client protection in the context of Non-DVP trading.

In addition to requesting industry input, the Staff also expresses concerns about the risks of misappropriation inherent in Non-DVP arrangements, and emphasizes that investment advisers should address these risks in their compliance policies and procedures. The Staff suggests that investment advisers that issue instructions to broker-dealers or custodians to effect or settle trades may find it useful to look to the procedures and controls set forth in the 2009 amendments to the Custody Rule and the accompanying interpretive release.[6]

Custody of Digital Assets

The Letter also describes the Staff's efforts to engage with market participants, including, among others, investment advisers and broker-dealers, to understand how characteristics particular to digital assets affect compliance with the Custody Rule.[7] To further inform the Staff's consideration of this issue, the Letter requests input regarding (i) the challenges faced by investment advisers in complying with the Custody Rule with respect to digital assets, (ii) whether there are considerations specific to custody of digital assets that the Staff should evaluate when considering Custody Rule amendments, (iii) the extent to which investment advisers construe digital assets as "funds," "securities," or neither, for purposes of the Custody Rule and to determine whether they meet the definition of an "investment adviser" under section 202(a)(11) of the Advisers Act, (iv) the use of state-chartered trust companies or foreign financial institutions to custody digital assets, (v) the role of internal control reports (e.g., System and Organization Controls ("SOC") 1 and SOC 2 reports (Type 1 and 2)) in an adviser's evaluation of potential digital asset custodians, (vi) ways to address misappropriation concerns with respect to digital assets, (vii) the settlement process and attendant risks of peer-to-peer digital asset transactions (i.e., transactions where there is no intermediary) and intermediated transactions (e.g., those executed on trading platforms or over-the-counter markets), and (viii) the extent to which DLT can be used more broadly for purposes of evidencing ownership of securities. These requests follow a request from the Staff in January 2018 for input from the industry regarding how registered funds holding substantial amounts of digital assets and

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6 See Custody of Funds or Securities of Clients by Investment Advisers, Release No. IA-2968 (Dec. 30, 2009) (detailing the policies and procedures investment advisers with custody of client assets should consider as part of their compliance program); Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 under the Investment Advisers Act of 1940, Release No. IA-2969 (Dec. 30, 2009) (describing the control objectives the internal control report required by Rule 206(4)-2(a)(6) should include).

7 Characteristics of digital assets mentioned in the Letter include the use of DLT to record ownership, the use of public and private cryptographic key pairings to transfer digital assets, the "immutability" of blockchains, the inability to restore or recover digital assets once lost, the generally anonymous nature of DLT transactions, and the challenges posed to auditors in examining DLT and digital assets.

related products would satisfy the requirements (including custody requirements) of the Investment Company Act of 1940 and its rules.[8] In addition, the SEC's Office of Inspections and Examinations listed the treatment of digital assets (including in connection with the safety of client funds and assets) as one of its 2019 examination priorities.[9]

Conclusion

Although the Letter requests industry input in two discrete areas, the Staff announced at the 2019 IAA Compliance Conference that it is reviewing the Custody Rule holistically. The purpose of the Letter, according to the Staff, is to facilitate information gathering so that the Staff can be better informed before putting pen to paper when amending the Custody Rule advances to the Commission's short-term agenda.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

8 Letter to SIFMA and the Investment Company Institute from Dalia Blass (Jan. 18, 2018).

9 2019 Examination Priorities, Office of Compliance Inspections and Examinations, Securities and Exchange Commission (Dec. 20, 2019).

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