June 15, 2018

LOCKE LORD® QUICK Study

Investment Adviser and Fund Management FUNDamentals™

SEC Staff Provides Guidance Regarding Inadvertent Custody by Investment Advisers

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Investment Advisers Act Rule 206(4)[1] (the "Custody Rule") is designed to protect client funds and securities from being lost, misused, or otherwise misappropriated by investment advisers. As such, the Custody Rule provides that it is a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Investment Advisers Act of 1940 (the "Advisers Act") for a registered investment adviser to have custody of client funds or securities unless certain requirements are met. Unless an exemption applies, these requirements include the mandate that all client accounts for which an adviser has custody be subject to verification by an independent public accountant on at least an annual basis.

In February 2017 , the SEC Staff provided guidance concerning the Custody Rule, which caused many advisers to reassess whether they would be deemed to have "custody" of client funds and securities as defined under the Custody Rule.[2] Under the Custody Rule, custody is defined as "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them."[3] Under the February 2017 guidance, the SEC Staff focused on when an adviser would have "inadvertent custody" of client assets. In its guidance, the Division noted that whether an adviser may inadvertently have custody of client assets may depend on the provisions in a custodial agreement between its advisory client and a qualified custodian, to which the client's adviser is not a party.[4] If a custodial agreement authorizes the adviser to withdraw or transfer client funds or securities upon instruction to the custodian, the adviser has inadvertent custody.[5] In such case, an adviser will be subject to the surprise examination requirement.[6] The Division has stated that an exception to the surprise examination requirement is available for narrowly structured custodial agreements that only permit the deduction of advisory fees.[7]

On June 5, 2018, the Division of Investment Management (the "Division") published two new FAQs focused on whether an adviser would inadvertently have custody of client funds in certain circumstances.[8]

In the first question, the Division considered whether an advisory firm would be required to comply with the Custody Rule if the adviser does not know whether any of its clients' custodial agreements would give the adviser inadvertent custody. The Division responded that an adviser that: (1) does not have a copy of a client's custodial agreement and (2) does not know, or have reason to know whether the agreement would give the inadvertent custody, does not have to comply with the Custody Rule if inadvertent custody would be the sole basis for custody. Importantly, the Division noted that this relief is not available if the adviser recommended, requested, or required a client's choice of custodian.

In the second question, the Division considered the Custody Rule implications of an investment adviser's method for deducting its advisory fee. In the question, the adviser indicated it had three categories of clients: (i) accounts for which the adviser had custody and complied with the Custody Rule, (ii) accounts

1 17 CFR 275.206(4).

2 For additional information regarding the February 2017 guidance, please see our prior FUNDamentals Quickstudy, which can be found here.

3 17 CFR 275.206(4)-2(d)(2).

4 IM Guidance Update No. 2017-01.

5 *Id.*

6 *Id.*

7 *Id.*

8 Division of Investment Management

for which the adviser relied on the fee deduction exemption to the Custody Rule, and (iii) certain other accounts for which the adviser is unaware if its clients' custodial agreements give the adviser inadvertent custody because the adviser did not have copies of the relevant custodial agreements. Moreover, the adviser noted that it has not recommended, requested, or required its clients to use their chosen custodians. Consistent with its position in the first new FAQ, the Division would not recommend enforcement action if the adviser relied on the exception in the Custody Rule of fee deduction for the accounts in the second and third category above. The Division did note that it expects the adviser to continue to comply with the surprise examination requirement with respect to the first category of accounts.

We will continue to monitor developments regarding the Custody Rule, and will provide future client updates. For more information on the matters discussed in this *Locke Lord QuickStudy*, please contact the authors.

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