

Engaging on Non-DVP Custodial Practices and Digital Assets

Investment Advisers Act of 1940: Rule 206(4)-2

March 12, 2019

Karen Barr
President & Chief Executive Officer
Investment Adviser Association
818 Connecticut Avenue NW
Suite 600
Washington, DC 20006

Dear Ms. Barr:

In February 2017, the Division of Investment Management (“Division”) issued Guidance Update 2017-01, which discussed the custody rule under the Investment Advisers Act of 1940.^[1] Following that Guidance Update, investment advisers and other market participants raised issues regarding the regulatory status of investment adviser and custodial trading practices that are not processed or settled on a delivery versus payment (“Non-DVP”) basis. The staff welcomes engagement from advisers, other market participants, and the public on these issues,^[2] as well as on questions regarding the application of the Custody Rule to digital assets, and whether revisions to the Custody Rule could be helpful in addressing any of the above topics.^[3]

The Custody Rule is a key investor protection under the Advisers Act. When investment advisers have “custody,” or access to client funds or securities, there is an increased risk of misappropriation or misuse of these assets.^[4] 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.^[5] In 2003, the Securities and Exchange Commission (“Commission”) amended the definition of “custody” in the Custody Rule 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[.]”^[6] Custody includes authority and access to client securities and funds, not just physical possession.

In the adopting release for the 2003 amendments, the Commission discussed how authority to withdraw client funds or securities gives rise to custody. In that discussion, the Commission explained that the Custody Rule does not apply to “authorized trading.”^[7] While the Commission did not exempt “authorized trading” from the definition of custody, it stated the following in a footnote:

An [investment] 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 [investment] adviser could withdraw or misappropriate the funds or securities in its client’s custodial account.^[8]

Investment advisers commonly refer to this footnote as the “authorized trading” exception. The footnote does not address authorized trading of securities that do not settle on a delivery versus payment basis. The staff believes that questions surrounding Non-DVP trading, as well as additional questions and issues the staff has identified regarding the Custody Rule over the past 15 years, should be considered by the Commission. In this regard, amendments to the Custody Rule are on the Commission’s long-term unified agenda.^[9]

To inform future steps and in light of growth in the variety and complexity of the types of securities and other assets commonly utilized by registered investment advisers that settle on a Non-DVP basis, the staff, through the Division’s Analytics Office, has launched an initiative to gather information on Non-DVP practices. We welcome input from all interested parties on the following:

- What types of instruments trade on a Non-DVP basis? How do these instruments trade?

- Describe the risks of misappropriation or loss associated with various types of Non-DVP trading. What controls do investment advisers have in place to address the risks of misappropriation related to such trading? What types of independent checks, other than a surprise examination, do investment advisers use currently to test these controls?
- Are there particular types of securities transactions settled on a Non-DVP basis that present greater or lesser risk of misappropriation or loss?
- What role do custodians play in the settlement process of Non-DVP trading? What role do they play in mitigating risks of misappropriation or loss arising from such trading?
- For advisers who currently obtain surprise examinations, what is the marginal cost of adding accounts that trade on a Non-DVP basis to the list of client accounts provided to the accountant performing the surprise examination of a sample of client accounts?
- What challenges do investment advisers have in obtaining surprise examinations regarding Non-DVP traded securities? How do advisers to unaudited private funds that are subject to surprise examinations address these challenges?
- Are there types of external checks that could be more effective and less costly than surprise examinations with respect to Non-DVP traded securities?
- To what extent do Non-DVP assets appear on client account statements from qualified custodians? To what extent does an investment adviser have any influence over, or input into whether and how such assets appear on account statements? Are there any assets that trade on a Non-DVP basis that would not appear on a qualified custodian's account statements?
- To what extent could evolving technologies, such as blockchain/distributed ledger technology ("DLT"), provide enhanced or diminished client protection in the context of Non-DVP trading?

The staff expects to utilize what it learns in any future recommendations to the Commission with respect to any regulatory action that may be necessary or appropriate.

While we continue to explore these issues, the staff is concerned about the risks of misappropriation inherent in Non-DVP arrangements. Where trading or settlement does not occur through a delivery versus payment arrangement, there is a heightened risk that an investment adviser could misappropriate funds or securities in its client's custodial account. The Commission has noted that "[a]n [investment] adviser that holds clients' stock certificates or cash, even temporarily, puts those assets at risk of misuse or loss."^[10] The lack of a corresponding transfer of securities or client funds into the custodial account reduces the effectiveness of the custodian as an independent safeguard.

Apart from the Custody Rule, investment advisers have an obligation to safeguard clients' assets. Accordingly, registered investment advisers also have an obligation to review internal controls to reduce the risk of misappropriation or loss, and should address this risk in their compliance policies and procedures required by Rule 206(4)-7 under the Advisers Act.^[11] In complying with these obligations, investment advisers who issue instructions to a broker-dealer or a custodian to effect or to settle trades through Non-DVP arrangements may find it useful to look to the procedures and controls set forth in the 2009 amendments to the Custody Rule and accompanying interpretive release to reduce the risk of misappropriation described above.^[12]

Custody of Digital Assets

The digital asset market has grown rapidly and some advisers have sought to invest in digital assets on behalf of their clients. In light of this innovation, the Division staff, together with staff of the Commission's Strategic Hub for Innovation and Financial Technology ("FinHub"), has engaged with investment advisers, broker-dealers, service providers, market observers, academics and others to understand and discuss related compliance questions.^[13] Through this dialogue, staff and market participants have discussed, among other things, whether and how characteristics particular to digital assets affect compliance with the Custody Rule. These characteristics include, for example, 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.

To further inform our consideration of how characteristics of digital assets impact the application of the Custody Rule, the staff welcomes additional public input. Below, we have identified some questions on which input would be

appreciated. We note that the digital asset markets are swiftly developing and additional questions may arise from these developments.

- What challenges do investment advisers face in complying with the Custody Rule with respect to digital assets? What considerations specific to the custody of digital assets should the staff evaluate when considering any amendments to the Custody Rule? For example, are there disclosures or records other than account statements that would similarly address the investor protection concerns underlying the Custody Rule’s requirement to deliver account statements?
- To what extent are investment advisers construing digital assets as “funds”, “securities”, or neither, for purposes of the Custody Rule?^[14] What considerations are advisers applying to reach this conclusion?
- To what extent are investment advisers including digital assets in calculating regulatory assets under management for purposes of meeting the thresholds for registering with the Commission? What considerations are included within this analysis?^[15]
- To what extent do investment advisers use state chartered trust companies or foreign financial institutions to custody digital assets? Have these investment advisers experienced similarities/differences in custodial practices of such trust companies as compared to those of banks/broker-dealers?
- What role do internal control reports, such as System and Organization Controls (“SOC”) 1 and SOC 2 reports (Type 1 and 2), play in an adviser’s evaluation of potential digital asset custodians? What role should they play?
- How should concerns about misappropriation of digital assets be addressed and what are the most effective ways in which technology can be leveraged to address such concerns? How can client losses due to misappropriation of digital assets most effectively be remedied?
- What is the settlement process of peer-to-peer digital asset transactions (*i.e.*, transactions where there is no intermediary) and what risks does this process present? What is the settlement process for intermediated transactions in digital assets, such as those that execute on trading platforms or on the over-the-counter markets, and what risks does this process present?
- To what extent do investment advisers construe digital assets as “securities” for purposes of determining whether they meet the definition of an “investment adviser” under section 202(a)(11)^[16] of the Advisers Act? What considerations are included in such an analysis?
- To what extent can DLT be used more broadly for purposes of evidencing ownership of securities? Can DLT be useful for custody and recordkeeping purposes for other types of assets, and not just digital asset securities? What, if any, concerns are there about the use of DLT with respect to custody and recordkeeping?

We welcome input and engagement from all interested parties regarding the potential considerations posed by digital assets with respect to the Custody Rule.

If you would like to let the Division staff know your views regarding the Custody Rule and Non-DVP trading and/or digital assets, we are providing an email box as a convenient method for you to communicate with the staff; we encourage you to communicate through the following address: IMOCC@sec.gov and insert “Custody Rule and Non-DVP Trading” or “Custody Rule and Digital Assets” in the subject line. The staff anticipates making submissions public.^[17]

Please contact Melissa Rovers Harke, Senior Special Counsel, or Thankam A. Varghese, Senior Counsel, at (202) 551-6787 or (202) 551-6825 if you have any questions with respect to the foregoing. We look forward to engaging on these important questions.

Sincerely,

Paul G. Cellupica
Deputy Director and Chief Counsel
Division of Investment Management

^[1] Division of Investment Management Guidance Update 2017-01, Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority, available at <https://www.sec.gov/investment/im-guidance-2017-01.pdf> (“2017 Guidance Update”).

[2] The 2017 Guidance Update highlighted the staff's views on certain circumstances where an investment adviser could have custody of client funds and securities for purposes of Rule 206(4)-2 ("Custody Rule") under the Investment Advisers Act of 1940 ("Advisers Act") because of provisions in a separate custodial agreement entered into between its advisory client and a qualified custodian. The 2017 Guidance Update further stated that one way for an investment adviser to avoid custody in those circumstances 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 "delivery versus payment" basis.

[3] The Division previously issued a letter inviting engagement on questions relating to the application of the Investment Company Act of 1940, including the custody provisions of that Act, to cryptocurrencies and related products. *See Staff Letter: Engaging on Fund Innovation and Cryptocurrency-related Holdings* to Paul Schott Stevens, President & CEO, Investment Company Institute and Timothy W. Cameron, Asset Management Group – Head, Securities Industry and Financial Markets Association, from Dalia Blass, Director, Division of Investment Management, U.S. Securities and Exchange Commission, Jan. 18, 2018, available at <https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm>. *See also infra* at n. 9.

[4] *See, e.g.*, GW & Wade, LLC, Release No. IA-3706 (Oct. 28, 2013).

[5] Rule 206(4)-2.

[6] 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").

[7] *See* 2003 Release. The Commission stated that "an adviser with power of attorney to sign checks on a client's behalf, to withdraw funds or securities from a client's account, or to dispose of client funds or securities for any purpose other than authorized trading has access to the client's assets."

[8] *See* 2003 Release.

[9] *See* Agency Rule List – Spring 2018, 3235-AM32, U.S. Securities and Exchange Commission (Amendments to the custody rule for investment companies and investment advisers) available at https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST¤tPubId=201804&showStage=longterm&agencyCd=3235&Image58.x=34&Image58.y=16&Image58=Submit.

[10] 2003 Release.

[11] When the Commission adopted Rule 206(4)-7 in 2003, it stated that "an [investment] adviser's policies and procedures, at a minimum, should address . . . to the extent . . . relevant to the [investment] adviser . . .

[s]afeguarding of client assets from conversion or inappropriate use by advisory personnel." *See* Compliance Programs of Investment Companies and Investment Advisers, Release No. IA-2204 (Dec. 17, 2003).

[12] *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 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).

[13] *See Staff Letter: Engaging on Fund Innovation and Cryptocurrency-related Holdings*, *supra* note 3. We continue to welcome input and engagement on the questions raised in the staff letter.

[14] *See* Rule 206(4)-2(a).

[15] *See* Form ADV, Item 5.F. ("In determining the amount of your regulatory assets under management, include the securities portfolios for which you provide continuous and regular supervisory or management services as of the date of filing this Form ADV...[a]n account is a securities portfolio if at least 50% of the total value of the account consists of securities. For purposes of this 50% test, you may treat cash and cash equivalents (*i.e.*, bank deposits, certificates of deposit, bankers acceptances, and similar bank instruments) as securities.")

[16] *See* Section 202(a)(11) of the Advisers Act: "Investment adviser" means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include (A) a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956, which is not an investment company, except that the term "investment adviser" includes any bank or bank holding company to the extent that such bank or bank holding company serves or acts as an investment adviser to a registered investment company, but if, in the case of a bank, such services or actions are performed through a separately identifiable department or division, the department or division, and not the bank itself, shall be deemed to be the investment adviser; (B) any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession; (C) any broker or dealer whose performance of such services is solely incidental to the

conduct of his business as a broker or dealer and who receives no special compensation therefor; (D) the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation; (E) any person whose advice, analyses, or reports relate to no securities other than securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, or securities issued or guaranteed by corporations in which the United States has a direct or indirect interest which shall have been designated by the Secretary of the Treasury, pursuant to section 3(a)(12) of the Securities Exchange Act of 1934, as exempted securities for the purposes of that Act; (F) any nationally recognized statistical rating organization, as that term is defined in section 3(a)(62) of the Securities Exchange Act of 1934, unless such organization engages in issuing recommendations as to purchasing, selling, or holding securities or in managing assets, consisting in whole or in part of securities, on behalf of others; (G) any family office, as defined by rule, regulation, or order of the Commission, in accordance with the purposes of this title; or (H) such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order.

[17] Submissions received will be posted without change; personal identifying information in the submission will not be redacted or edited so you should submit only information that you wish to make available publicly.