The SEC’s “Inadvertent Custody” Guidance May Hurt Clients More than Advisers
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It’s hard to think of anything more important than safeguarding client assets from theft or fraud. For that reason, the SEC’s custody rule (“Custody Rule”)³ rightly aims at protecting client assets from misappropriation by investment advisers. However, we are unsure of the value of recent efforts by the SEC’s Division of Investment Management and staff (“IM”) to clarify when an adviser may unwittingly have “custody.”⁴ Indeed, we believe that the IM’s recently released “inadvertent custody” guidance will ultimately complicate the relationship among an adviser, its client and the client’s custodian without providing demonstrable additional protection. These new requirements will also increase an already heavy compliance burden for advisers, and that cost will eventually be felt by clients. We see other means to better protect client assets under the Custody Rule.

In February, the IM warned advisers that they could have “inadvertent custody” in several circumstances. Most relevant here is IM guidance that if provisions in the client’s custodial agreement give advisers broader control of the funds and securities than is provided in the agreement between client and adviser,⁵ then the adviser may have inadvertent custody, including where the custody agreement:

- Grants advisers the right to “receive money, securities, and property of every kind and dispose of same.”
- Allows the custodian to rely on an adviser’s instructions without any direction from the client and the client grants authority to advisers to effect “any and all transactions” from the account.
- Grants an adviser authority to instruct the custodian to disburse cash from the client’s cash account for any purpose.⁶

This guidance clarifies when an adviser’s authority may impute “custody” and how it can be avoided by getting the custodian’s acknowledgement of stricter requirements under the advisory contract. By doing so, however, the guidance shifts the focus from what is permitted by the client’s direct authorization of the adviser to the custodian’s agreement with the client, and thus imposes a burden on the adviser to seek clarification of its authority from the custodian.

We have several concerns relating to the approach outlined by the IM, which are summarized below.

The IM position seems to assume that the adviser will be able to identify and change provisions in the custody agreement even though the adviser is not a party and often does not know the custody contract’s contents. In some cases, the client may be prohibited from disclosing them to the adviser. The IM position also seems to assume that a custodian will be willing to work with the adviser and/or client to clarify the limitations on authority. This is unlikely, in our view. Even if the team members want to help, the custodial firm itself may not wish to do so. Any changes or “clarifications” will be reviewed by the firm’s legal advisors, who will assess whether the language creates any additional risks or burdens for the custodian. A natural aversion to risk may often lead to a conclusion of “doing no harm” and saying no. Thus, even a simple “letter of clarification” may invite no response or, more likely, a form letter declining to adopt it.

So our first concern with the SEC’s approach is the apparent impracticality of the solution.

Second, since the custodian often gets a copy of the adviser-client contract, we are not convinced that, as a matter of law, the custodian can disclaim the limitations on authority set out in the advisory contract. Here, the issue is the meaning of “actual” authority versus “apparent” authority under common law.

An adviser’s agreement with its client sets out its “actual” authority, while what seems to underlie the SEC’s advice is the belief that broader language in the custodial agreement vests a third party, the adviser,
with “apparent” authority to direct the custodian. We are unsure how apparent authority attaches to a person who is unaware of it, as is the case when the client is not permitted to share the custody agreement with the adviser. One might respond that “apparentness” is in the eye of the beholder, i.e., the custodian, and from the custodian’s perspective it has contracted with the client on the basis that all of its advisers are granted the same breadth of authority as stated in the custodian’s contract. As if in anticipation of this discussion, the IM’s guidance states that the client and the adviser are not competent to agree contractually to prevent the adviser from having custody where the custodial agreement says otherwise. According to the IM, “from the [...] custodian’s perspective the client has authorized the adviser to withdraw the client’s funds or securities.”

Our question would be, then, whether this presumption should change where, as is often the case, the client submits the advisory contract to the custodian. If the custodian learns that the adviser’s actual authority under the client contract is more limited than what is in the custody agreement, basic principles of agency law would seem to hold that the custodian can only rely on the narrower instructions within the adviser’s actual authority. In other words, knowledge of actual authority should override apparent authority.

It is worth emphasizing here that the focus of the IM’s guidance is not allocation of liability between the custodian and the adviser for loss of client assets from a bad instruction. Rather, the much narrower issue is whether the adviser can escape heightened compliance obligations from inadvertent custody. If, as we believe, a custodian’s receipt of the advisory contract may shift liability under agency law from adviser to custodian, it would then seem unnecessary for the IM to require additional steps in its guidance on inadvertent custody.

In fairness to the SEC, many custodians disclaim various avenues of liability under custody agreements and these agreements are often printed forms that the custodian, especially broker-dealers, will not negotiate. Thus, a client’s remedies may be less robust against a custodian, especially those outside the SEC’s primary jurisdiction, than against an adviser as a regulated entity under the Investment Advisers Act of 1940. This highlights what we believe is a third problem with the SEC’s directive.

While the SEC regulates custodians that are broker-dealers, it lacks primary jurisdiction over banks and other corporate custodians, and therefore the inadvertent custody rules can cover all advisers (at least those regulated at the federal level) but not all custodians. This may explain why rather than giving advisers and clients the ability to simply fix the inadvertent custody problem themselves, the SEC instead seemed to place the on-off switch with the custodian. Perhaps the IM guidance did not recognize the challenges with doing so as we outlined above. Presumably the SEC could correct this now, at least for the custodians it does regulate, such as broker-dealers, or seek uniformity with other regulators for all custodians.

Last, as a final note, we believe the IM’s focus is perhaps missing part of the forest for the trees. As noted, broker-dealers typically do not negotiate their forms and the forms themselves may include broad exculpation of liability. Custody agreements with banks typically include exculpations as well. In addition, bank contracts often exclude language that is required to form a valid and enforceable custody relationship and to grant the client an enforceable right to retain its securities in the event of bank insolvency.8 While we are confident the SEC is acting earnestly and we commend their efforts to help the industry with the problem of inadvertent custody, we would encourage further attention to those custody agreements that in our view provide inadequate legal protections to client assets.

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10 Rule 206(4)-2 of the Investment Advisers Act of 1940, as amended.
11 “Custody” is defined in Rule 206(4)-2, in part, to mean “holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them...” and includes “[a] ny arrangement (including a general power of attorney) under which [an adviser is] authorized or permitted to withdraw client funds or securities maintained with a custodian upon [its] instruction to the custodian.”
13 This guidance update was one of three new IM pronouncements on custody. In a letter to the Investment Adviser Association, SEC No-Action Letter (Feb. 21, 2017), available at https://www.sec.gov/divisions/investment/noaction/2017/investment-adviser-association-022117-206-4.htm, the IM addressed the situation in which the client authorizes an adviser to transfer money to a third party pursuant to a standing letter of instruction or other similar asset transfer authorization arrangement (SLOA) provided to the custodian. In Staff Responses to Questions About the Custody Rule, Question I.I.4 (updated Feb. 21, 2017), available at https://www.sec.gov/divisions/investment/custody_faq_030510.htm, the IM addressed custody issues where the client authorizes the adviser to move assets between the client’s own accounts.
14 See Restatement (Third) of Agency § 3.11 (2006).