

# Legal Update

## SEC Staff Seeks Public Comment Regarding Custody Issues Associated with Non-DVP Arrangements and Digital Assets

On March 12, 2019, the staff of the Division of Investment Management of the US Securities and Exchange Commission (the "Staff" and the "SEC," respectively) published a letter to the Investment Adviser Association requesting comment from all interested parties regarding custody issues associated with (i) investment adviser and custodial trading practices that are not processed or settled on a delivery-versus-payment ("Non-DVP") basis and (ii) digital assets.<sup>1</sup> The Staff noted that investment advisers and other industry participants have continued to raise issues on these topics in relation to Rule 206(4)-2, the custody rule under the Investment Advisers Act of 1940 (the "Custody Rule" and "Advisers Act," respectively). In the letter, the Staff announced that it is open to receiving public input on both these issues through the launch of an information-gathering initiative.

### Background on the Custody Rule

Investment advisers registered under the Advisers Act are subject to the Custody Rule if they have "custody" of client funds and securities.<sup>2</sup> For these purposes, "custody" is generally defined as "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."<sup>3</sup> A footnote in the 2003 adopting release amending the Custody Rule clarified that a registered adviser with the authority to issue instructions to a broker-dealer or custodian to effect or to settle trades under a "delivery versus payment" arrangement does not constitute "custody" under the Advisers Act, commonly referred to as the "authorized trading" exception.<sup>4</sup> The adopting release stated that delivery versus payment arrangements minimize the risk that an adviser could withdraw or misappropriate the funds or securities in its client's custodial account.<sup>5</sup>

### Non-DVP Trading/Custodial Arrangements

Notably, the "authorized trading" exception does not apply to non-DVP trading and custody arrangements, so advisers that manage client accounts trading in instruments that do not settle on a DVP basis must analyze whether they have "custody" over client assets for purposes of the Custody Rule.<sup>6</sup> This type of non-DVP settlement is typical, for example,

in the syndicated loan market (where ownership of a loan is transferred by the loan agent upon receipt of notification from the buyer and the seller, without regard to whether and when payment is made)<sup>7</sup> and in certain derivatives markets (potentially including, e.g., bilateral foreign exchange, which takes place on a payment-versus-payment basis in which each counterparty is obligated to make a final transfer of one or more currencies only if the other counterparty has made a final transfer of one or more currencies).<sup>8</sup>

In light of the growth in Non-DVP arrangements, and the continued questions from registered advisers that manage Non-DVP assets for clients, the Staff launched this initiative to gather additional information regarding Non-DVP custodial arrangements. The Staff stated that it would welcome input from the public on the following issues related to Non-DVP custodial arrangements:

- 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?<sup>9</sup>

Noting that amendments to the Custody Rule are on the SEC's long-term unified agenda, the Staff stated that it expects to utilize what it learns from this information-gathering initiative to inform any future recommendations to the SEC with respect to any regulatory action that may be necessary or appropriate.<sup>10</sup> While noting that it would continue to explore the above issues, the Staff emphasized its concern about the potential heightened risk of misappropriation resulting from Non-DVP arrangements and that advisers utilizing these arrangements should seek to ensure that their internal controls and procedures adequately address the requirements set forth in the Custody Rule to

mitigate against the risk of misappropriation.<sup>11</sup>

## Custody Issues Related to Digital Assets

In addition to Non-DVP custodial arrangements, the Staff noted the growth of the digital asset market and increased adviser focus on investment in digital assets on behalf of their clients. The Staff, in conjunction with the staff of the SEC's Strategic Hub for Innovation and Financial Technology ("FinHub"), has reached out to industry participants to further understand and discuss related compliance issues in connection with digital asset investments, particularly cryptocurrencies and related products.<sup>12</sup> A public forum on these issues will also be held at the SEC's headquarters on May 31, 2019.<sup>13</sup>

In connection with this continued dialogue and in an effort to further its understanding of how the characteristics of digital assets impact the application of the Custody Rule, the Staff is seeking further public input on the following questions related to digital assets (noting that further follow-up questions may arise due to the rapid changes in this area):

- 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? 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 SEC? What considerations are included within this analysis?
- 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 investment 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) 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?<sup>14</sup>

## Submission of Comments

Advisers and other market participants that may be affected by Non-DVP custody arrangements or that are contemplating the offering of or investment in potential digital asset investment products should strongly consider submitting comments in response to the Staff's request for input. This is an opportunity to potentially shape any future amendments, or possible future exemptions, to the Custody Rule, as several of the SEC's questions relate to certain of the Custody Rule's key requirements (e.g., questions on the surprise audit requirement, cost-effective external check alternatives, the role of custodians in Non-DVP arrangements, whether digital assets constitute funds or securities, and the settlement process for certain digital assets). One industry trade group, the Loan Syndications and Trading Association, has already stated that they intend to submit comments, noting that they have been previously in dialogue with the Staff regarding Non-DVP custody issues related to the loan trading and settlement market.<sup>15</sup> Other questions posed by the SEC relate to the basic application of the Advisers Act to those who manage digital assets for others and of the Custody Rule to digital assets as a general matter.

The Staff anticipates making submissions public, so industry participants should consider this fact when contemplating a submission.<sup>16</sup>

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*For more information about the topics raised in this Legal Update, please contact any of the following lawyers.*

**Stephanie M. Monaco**

+1 202 263 3379

[smonaco@mayerbrown.com](mailto:smonaco@mayerbrown.com)

**Adam D. Kanter**

+1 202 263 3164

[akanter@mayerbrown.com](mailto:akanter@mayerbrown.com)

**J. Paul Forrester**

+1 312 701 7366

[jforrester@mayerbrown.com](mailto:jforrester@mayerbrown.com)

**Matthew F. Kluchenek**

+1 312 701 8798

[mkluchenek@mayerbrown.com](mailto:mkluchenek@mayerbrown.com)

**David L. Beam**

+1 202 263 3375

[dbeam@mayerbrown.com](mailto:dbeam@mayerbrown.com)

**Leslie S. Cruz**

+1 202 263 3337

[lcruz@mayerbrown.com](mailto:lcruz@mayerbrown.com)

**Peter M. McCamman**

+1 202 263 3299

[pmccamman@mayerbrown.com](mailto:pmccamman@mayerbrown.com)

<sup>1</sup> SEC Division of Investment Management, Staff Letter: Engaging on Non-DVP Custodial Practices and Digital Assets to Karen Barr, President & CEO of the Investment Adviser Association: (March 12, 2019), available at <https://www.sec.gov/investment/non-dvp-and-custody-digital-assets-031219-206> (hereinafter the “2019 IAA Staff Letter”).

<sup>2</sup> 17 CFR § 275.206(4)-2. Advisers that have “custody” of client assets are subject to various requirements under the Custody Rule, including (but not limited to) a requirement that advisers must maintain such assets with a “qualified custodian,” must have a reasonable belief that the qualified custodian provides clients with quarterly account statements, and (unless an exception applies) undergoes an annual surprise audit by an independent public accountant. In addition, advisers that self-custody or maintain assets with a qualified custodian affiliated with the adviser must obtain an “internal control report” (e.g., a SOC 1/SSAE-type report).

<sup>3</sup> *Id.* An adviser may also be considered to have custody of client funds and securities if a control affiliate had custody over such assets. *Id.*

<sup>4</sup> Custody of Funds or Securities of Clients by Investment Advisers, Release No. IA-2176 (Sept. 25, 2003) (the “2003 Release”). Under a “delivery versus payment” arrangement, 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.

<sup>5</sup> *Id.* See also 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>.

<sup>6</sup> The SEC Staff recently issued conditional no-action relief to an administrative agent for syndicated loans that also acted (or that had affiliates that also acted) as an investment adviser for pooled investment vehicles or separately managed accounts that are also lenders under such syndicated loans. Madison Capital Funding LLC, SEC No-Action Letter (Dec. 20, 2018), available at <https://www.sec.gov/investment/madison-capital-funding-122018-206-4>. Based on the administrative agent’s ability to access the assets of the loan syndicate on a non-DVP basis, it would be viewed as having “custody” under the Staff’s position noted above, triggering the application of the Custody Rule. In addition, the administrative agent was concerned that because it typically established a single bank account for all participants in a loan syndicate, the arrangement would fail to comply with certain other requirements under the Custody Rule. The SEC Staff

granted no-action provided the administrative agent complied with 11 different conditions, a full discussion of which is described in the above-linked no-action letter. *Id.*; see also the Mayer Brown Legal Update: SEC Grants Conditional No-Action Relief from the Custody Rule for Certain Administrative Agents under Syndicated Loans (Dec. 26, 2018), available at <https://www.mayerbrown.com/en/perspectives-events/publications/2018/12/sec-grants-conditional-noaction-relief-from-the-cu>.

<sup>7</sup> See, e.g., The Loan Syndications and Trading Association, *The SEC Speaks on Custody for Loans* (Mar. 13, 2019), available at <https://www.lsta.org/news-and-resources/news/the-sec-speaks-on-custody-for-loans> (hereinafter the “2019 LSTA Statement”).

<sup>8</sup> See Federal Reserve Bank of New York Foreign Exchange Committee, *Foreign Exchange Transactions: Execution to Settlement Recommendations for Non-Dealer Participants*, at 13 (Jan. 19, 2016) available at <https://www.newyorkfed.org/medialibrary/microsites/fxc/files/2016/fxc011916.pdf>.

<sup>9</sup> 2019 IAA Staff Letter.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *Id.* (citing SEC Division of Investment Management, 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 (Jan. 18, 2018), available at <https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm>).

<sup>13</sup> SEC, Press Release: SEC Staff to Hold Fintech Forum to Discuss Distributed Ledger Technology and Digital Assets, available at <https://www.sec.gov/news/press-release/2019-35>.

<sup>14</sup> 2019 IAA Staff Letter.

<sup>15</sup> 2019 LSTA Statement.

<sup>16</sup> The SEC has provided an email address in order to submit information: IMOCC@sec.gov (noting that submitters should insert “Custody Rule and Non-DVP Trading” or “Custody Rule and Digital Assets” in the subject line).

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