POLICY STATEMENT

MASSACHUSETTS-REGISTERED INVESTMENT ADVISER COMPLIANCE WITH CUSTODY AND INDEPENDENT VERIFICATION REQUIREMENTS
DECEMBER 2019

SUMMARY POINTS

- **TRUSTEESHIP**:
  - Investment advisers have custody if their supervised persons are appointed as executors, conservators, or trustees of client account(s) and have the authority to withdraw client assets from the client's account(s). This is the case even if the executorship, conservatorship, or trusteeship arises as a result of family or personal relationship with the decedent, beneficiary, or grantor.

- **SPOUSES AND MINOR CHILDREN**:
  - In certain circumstances as outlined herein, the Division would not take action against an investment adviser that has custody solely from a supervised person's dealings with a spouse or child, and that investment adviser does not obtain Independent Verifications of client funds or securities.

- **STANDING LETTERS OF AUTHORIZATION**:
  - Investment advisers have custody if they are authorized, pursuant to standing letters of instruction or similar arrangements, to withdraw client funds or securities upon instruction to the custodian.
  - In certain circumstances as outlined herein, the Division would not take action against an investment adviser that has custody solely from a standing letter of instruction, and that investment adviser does not obtain Independent Verifications of client funds or securities.

- **DIRECT DEDUCTION OF FEES**:
  - Investment advisers that have authority to dictate how advisory fees are calculated or deducted from client accounts at a qualified custodian may have custody and may be required to obtain Independent Verifications, unless they comply with certain additional requirements outlined herein.
  - Investment advisers that do not have authority to dictate how advisory fees are calculated or deducted from client accounts at a qualified custodian do not have custody.

- **CLIENT LOGIN CREDENTIALS**:
  - Investment advisers have custody if they keep or store clients' login credentials to online custodial accounts.

OVERVIEW

In October 2018, the Massachusetts Securities Division (the "Division") conducted a survey of its registered investment advisers with respect to common ways in which they may have custody of client funds or securities. The Division received responses from 481 of the 972 registered investment advisers surveyed. While conducting the survey, the Division received numerous calls and emails from investment advisers with questions regarding custody. The Division is issuing this policy statement to provide guidance[1] on when investment advisers that are registered or required to be registered in Massachusetts may have custody of client funds or securities and what constitutes compliance with the Massachusetts Uniform Securities Act, MASS. GEN. LAWS ch. 110A (the "Act"), and the regulations promulgated thereunder, 950 MASS. CODE REGS. 10.00, *et seq*., (the "Regulations").

Massachusetts-registered investment advisers are encouraged to review the six types of custody below and determine (1) whether they have custody of client funds or securities and, if they do have custody, (2) whether they are in compliance with 950 MASS. CODE REGS. 12.205(5)(b).

This guidance covers custody as a result of: trusteeship and other similar relationships; joint accounts; general power of attorney; standing letters of authorization; direct deduction of fees; and storage of client login information.

950 MASS. CODE REGS. 12.205(5)(b)1. provides that "[c]ustody shall have the meaning defined in Rule 206(4)-2(d)(2) under the Investment Advisers Act of 1940 (17 CFR 275.206(4)-(2)(d)(2))," Rule 206(4)-2[2] defines custody as follows:

> Custody means holding, directly or indirectly, client funds or securities, or ***having any authority to obtain possession of them***. You have custody if a related person holds, directly or indirectly, client funds or securities, or ***has any authority to obtain possession of them***, in connection with advisory services you provide to clients. Custody includes:
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> > (i) Possession of client funds or securities (but not of checks drawn by clients and made payable to third parties) unless you receive them inadvertently and you return them to the sender promptly but in any case within three business days of receiving them;
> >
> > (ii) any arrangement (including a general power of attorney) under which you are authorized or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian; and
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> > (iii) any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of

[1] This Policy Statement is intended to serve strictly as guidance to assist investment advisers in making their own determinations regarding compliance with the Act and the Regulations. This Policy Statement addresses some, but not all, of the ways in which Massachusetts-registered investment advisers may have custody of client funds or securities. Nothing in this Policy Statement should be taken as legal advice as to any particular investment adviser's exemption, exclusion, or compliance with the Act and the Regulations.

[2] *See* 17 CFR 275.206(4)-2.

pooled investment vehicle, or trustee of a trust) that gives you or your supervised person legal ownership of or ***access to client funds or securities***.

[Emphasis added.]

The Regulations require an investment adviser who has custody of client funds or securities to comply with the provisions Rule 206(4)-2.[3] Accordingly, an investment adviser with custody is required to obtain an annual surprise examination or independent verification of the funds or securities (collectively, the "Independent Verification"),[4] unless otherwise exempt or excused from that requirement.

I. Trustee of a Client's Trust Account and Other Similar Relationships

An investment adviser has custody of client funds or securities if any of its investment adviser representatives or other staff (collectively, "supervised persons") serve as an executor of estate, a conservator, or a trustee of a trust created by, or for the benefit of, a client.

The instructions to Form ADV[5] define the term "client" as "[a]ny of your firm's investment advisory clients. This term includes clients from which your firm receives no compensation, such as family members of your supervised persons. If your firm also provides other services (e.g., accounting services), this term does not include clients that are not investment advisory clients."

The Division acknowledges that the U.S. Securities & Exchange Commission (the "SEC") has stated that it would not view an investment adviser to have custody of client funds or securities if its supervised person was appointed as executor, conservator, trustee, or a similar status because of the supervised person's "family or personal relationship" with the client.[6] However, the Division has not adopted this position.

Accordingly, if a Massachusetts-registered investment adviser or its supervised persons has legal ownership of or access to client funds or securities in any capacity (e.g., executor, conservator, trustee), the investment adviser has custody and must comply with 950 MASS. CODE REGS. 12.205(5)(b).

However, the Division will not recommend or take enforcement action against an investment adviser for failing to obtain an Independent Verification in the following limited circumstance:

(1) The investment adviser's supervised person serves as an executor of estate, a conservator, or a trustee of a trust created by, or for the benefit of, a client; and

(2) The client associated with the estate or trust is the spouse or minor child of the supervised person.

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[3] *See* 950 MASS. CODE REGS. 12.205(5)(b).
[4] *See* 17 CFR 275.206(4)-2(a)(4).
[5] Publicly available at http://www.sec.gov/about/forms/formadv-instructions.pdf.
[6] "When a supervised person of an adviser serves as the executor, conservator or trustee for an estate, conservatorship or personal trust solely because the supervised person has been appointed in these capacities as a result of family or personal relationship with the decedent, beneficiary or grantor (and not as a result of employment with the adviser), we would not view the adviser to have custody of the funds or securities of the estate, conservatorship, or trust." *Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Release No. 2968, footnote 139 (December 30, 2009).

II. Joint Accounts with Clients

A Massachusetts-registered investment adviser has custody of client funds or securities if its supervised person's name is on a client's account held at a qualified custodian. However, the Division will not recommend or take enforcement action against an investment adviser for failing to obtain an Independent Verification in the following limited circumstance:

(1) The investment adviser's supervised person is listed as an account holder of, or otherwise has his or her name on, a client account; and

(2) The client on the joint account is the spouse or minor child of the supervised person.

III. General Power of Attorney

A Massachusetts-registered investment adviser has custody of client funds or securities if a supervised person has general power of attorney for a client. However, the Division will not recommend or take enforcement action against an investment adviser for failing to obtain an Independent Verification in the following limited circumstance:

(1) The investment adviser's supervised person has general power of attorney for a client; and

(2) The client is the spouse or minor child of the supervised person.

IV. Standing Letters of Authorization

An investment adviser has custody if the investment adviser has authority to withdraw client funds or securities held in a client's account at a qualified custodian upon instruction to the custodian. Accordingly, an investment adviser has custody if it has authority to transfer client funds or securities pursuant to a standing letter of instruction or other similar asset transfer authorization arrangement (collectively, "SLOA") established by the client with its qualified custodian.

The Division acknowledges that staff members of the SEC's Division of Investment Management[7] commented that they exclude certain transfers from the term "authority to withdraw."[8] In response to a question about the custody rule and SLOAs, staff of the SEC's Division of Investment Management wrote:

> We do not interpret the authority to withdraw assets to include the limited authority to transfer a client's assets between the client's accounts maintained at one or more qualified custodians if the client has authorized the adviser in writing to make such transfers and a copy of that authorization is provided to the qualified custodians, specifying the client accounts maintained with qualified custodians.

The Division has not adopted the interpretation of the SEC's Division of Investment Management staff.

[7] This interpretation is put out by staff of the Division of Investment Management of the SEC and is not an official rule, regulation, or statement of the SEC.

[8] *See* "Staff Responses to Questions About the Custody Rule," Question II.4., available at https://www.sec.gov/divisions/investment/custody_faq_030510.htm.

Accordingly, a Massachusetts-registered investment adviser has custody if it has the authority to instruct the custodian to withdraw client funds or securities pursuant to a SLOA and transfer them to any other account. However, the Division will not recommend or take enforcement action against an investment adviser that acts pursuant to a SLOA to transfer funds or securities out of a client's account with the qualified custodian to any account, whether a first party or third party, for failing to obtain an Independent Verification in the following limited circumstance:

(1) The client provides an instruction to the qualified custodian, in writing, that includes the client's signature, the receiving party's name, and either the receiving party's address or the receiving party's account number at a custodian to which the transfer should be directed;

(2) The client authorizes the investment adviser, in writing, either on the qualified custodian's form or separately, to direct transfers to the receiving party either on a specified schedule or from time to time;

(3) The client's qualified custodian performs appropriate verification of the instruction, such as a signature review or other method to verify the client's authorization, and provides a transfer of funds notice to the client promptly after each transfer;

(4) The client has the ability to terminate or change the instruction to the client's qualified custodian;

(5) The investment adviser has no authority or ability to designate or change the identity of the receiving party, the address, or any other information about the receiving party contained in the client's instruction;

(6) The investment adviser maintains records showing that the receiving party is not a related party of the investment adviser or located at the same address as the investment adviser; and

(7) The client's qualified custodian sends the client, in writing, an initial notice confirming the instruction and an annual notice reconfirming the instruction.

The Division will not recommend or take enforcement action only if the investment adviser has complied with all seven of these requirements.

V. Direct Deduction of Fees

An investment adviser has custody of client funds or securities if there is any arrangement under which the investment adviser is authorized to withdraw client funds or securities upon instruction to the client's custodian. Accordingly, certain fee-deduction arrangements result in an investment adviser having custody.

A. Adviser or Third Party Calculates and Adviser Instructs Custodian to Deduct Advisory Fee

A Massachusetts-registered investment adviser has custody if it has the authority to directly deducts, or to instruct a custodian to directly deduct, its adviser fees from clients' accounts. A Massachusetts-registered investment adviser does have custody in the following scenarios:

- An investment adviser does have custody if the investment adviser has the authority to instruct the custodian to deduct advisory fees directly from the client's account on a given day and in a given amount.

- An investment adviser does have custody if the investment adviser has the authority to instruct the custodian to deduct advisory fees directly from the client's account, even if the investment adviser hires a third-party to calculate its advisory fees.

In both of the above-situations, the Massachusetts-registered investment adviser would have custody of the client's funds or securities because of its authority to instruct the manner of deduction by the custodian. Accordingly, the investment adviser must fully comply with 950 MASS. CODE REGS. 12.205(5)(b).

Pursuant to this Regulation, the Massachusetts-registered investment adviser can exempt itself from the Independent Verification requirement if it (a) has written authorization from the client to deduct advisory fees from the account held with the qualified custodian; and (b) sends the qualified custodian and client an invoice or statement of the amount of the fee to be deducted from the client's account each time a fee is directly deducted.[9]

Documentation demonstrating compliance with these procedures must be maintained and preserved for a period of not less than five (5) years, the first two (2) years in an appropriate office of the investment adviser.

B. Custodian or Third-Party Adviser Calculates and Deducts Advisory Fee

A Massachusetts-registered investment adviser does not have custody if the investment adviser has no authority to directly deduct, or to instruct the amount or frequency that a custodian directly deducts, its advisory fee from clients' accounts. A Massachusetts-registered investment adviser does not have custody in the following scenarios:

- An investment adviser does not have custody if its client has entered into an agreement with a custodian that requires the custodian to calculate and deduct the investment adviser's fees directly from the client's account.

- An investment adviser does not have custody if it utilizes a sub-adviser or third-party investment adviser (collectively, "Third-Party Adviser") in managing its clients' assets and the Third-Party Adviser gives the investment adviser a portion of the advisory fee that the Third-Party Adviser calculated and deducted, or calculated and instructed the custodian to deduct, directly from the client's account.

[9] *See* 950 MASS. CODE REGS. 12.205(5)(b).

However, in both of these scenarios, the investment adviser has a fiduciary obligation to its clients. To satisfy this obligation, the investment adviser should, at a minimum, review the agreed-upon fee listed on its advisory agreement(s) with a client, ensure that the fee is the same as the fee on the client's custodial agreement(s), and verify the accuracy of the fee deducted each time by the custodian.

VI. Client Login Credentials

Many, if not most, qualified custodians grant clients online access to their custodial accounts by using login credentials. With this online access, a client generally has direct access to funds or securities in the custodial accounts. An investment adviser who keeps or stores a client's login credentials has access to client funds or securities and would need to fully comply with 950 MASS. CODE REGS. 12.205(5)(b).[10]

The Division has determined this policy statement to be necessary and appropriate for the public interest, for the protection of investors, and consistent with the purposes fairly intended by the policy and provisions of the Massachusetts Uniform Securities Act and the regulations promulgated thereunder.

Effective December 2019.

[10] Depending on the terms of the client's agreement with the custodian, an investment adviser's use of the client's own unique login credentials may be deemed a breach of that agreement. The North American Securities Administrators Association ("NASAA") has adopted a model rule making it an unethical or prohibited practice to access a client's account by using the client's own unique identifying information such as usernames and passwords. The Division has not adopted the NASAA model rule at this time, but may consider doing so in the future. A copy of the model rule is available at https://www.nasaa.org/adopted-model-rule/.

TABLE 1

The following table provides general guidance on ways in which a Massachusetts-registered investment adviser may have custody of client funds or securities.

	Investment Adviser Has Custody	Investment Adviser Does Not Have Custody	Investment Adviser May Have Custody
Supervised Person is Trustee of a Client's Trust Account or Has Other Similar Relationship	✓		
Supervised Person Has Joint Accounts with Clients	✓		
Supervised Person Has General Power of Attorney	✓		
Investment Adviser Has Standing Letters of Authorization	✓		
Investment Adviser Directly Deducts Fees			✓
Investment Adviser Stores Client Login Credentials	✓		