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SEC Update

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Custody Rule Guidance

The Staff of the United States Securities and Exchange Commission's (SEC) Division of Investment Management recently issued guidance on Rule 206(4)-2 (the custody rule) under the Investment Advisers Act of 1940 (Advisers Act). The Staff provided some clarity regarding three situations where questions have arisen about whether an adviser has custody of client assets.

The guidance was provided in three forms: a no-action letter to the Investment Adviser Association;[1] a new investment adviser "frequently asked questions" or "FAQ" regarding the definition of "custody" under the custody rule;[2] and a new Division of Investment Management Guidance Update regarding custodial contracts that may result in an adviser inadvertently being deemed to have custody.[3]

The custody rule generally prohibits an investment adviser registered under the Advisers Act to have custody of client funds or securities unless certain requirements are met. One requirement is that when an adviser has custody of client assets it is subject to a surprise examination by an independent public accountant at least annually. An adviser is deemed to have custody of a client's assets under the custody rule when the adviser "holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them in connection with its advisory services."[4]

Custody Issues Created by SLOA's—No Action Letter

The no-action letter, which was issued by the Staff on February 21, 2017, provided clarification regarding whether an investment adviser that exercises limited authority pursuant to a standing letter of authorization (SLOA) or other similar asset transfer authorization arrangement established by a client with a qualified custodian would have custody of those assets subject to the SLOA. A SLOA may be utilized by a client that wants to allow an adviser the ability to disburse funds to a third party designated by the client. Some recent examinations by the SEC have alleged violations of the custody rule when the adviser given the SLOA was not subject to a surprise examination.

In the no-action letter, the Staff concluded that it will not recommend enforcement action against advisers acting pursuant to a SLOA, if the following conditions are met:

1. The client provides a written instruction to the qualified custodian that includes the client's signature, the third party's name, and either the

third party's address or the third party's account number at a custodian to which the transfer should be directed.
2. The client authorizes the investment adviser, in writing, to direct transfers to the third 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 custodian.
5. The investment adviser has no authority or ability to designate or change the identity of the third party, the address, or any other information about the third party contained in the client's instruction.
6. The investment adviser maintains records showing that the third party is not a related party of the investment adviser or located at the same address as the investment adviser.
7. The client's custodian sends the client a written initial notice confirming the instruction and a written annual notice reconfirming the instruction.

If an investment adviser satisfies these requirements it would not be required to obtain a surprise examination. It would still be considered, however, to have custody of the client assets subject to the SLOA. This would require that any assets subject to a SLOA be reported in Item 9 of the adviser's Form ADV. The no-action letter states that investment advisers that have client assets under custody as a result of an SLOA must report these assets on Form ADV at the next annual updating amendment after October 1, 2017.

Custody Definition – FAQ

In addition to the no-action letter discussed above, the Staff released a new FAQ in which it states that, if certain conditions are met, an adviser will not be deemed to have custody of assets as a result of having authority to transfer client assets between the client's accounts. In particular the FAQ provides that such an adviser would not be deemed to have custody if its authority is limited to directing the transfer of client assets between accounts held at one or more qualified custodians, provided that the client has given the adviser written authorization to make such transfers and a copy of such authorization has been provided to the transferring qualified custodian specifying the client accounts over which such authority is granted.

The Staff states that the client's authorization must be specific and must include the identification of the accounts by ABA routing number or the name of the receiving custodian.

The FAQ further states that the authority of an adviser to transfer assets between client accounts held at the same custodian, or at affiliated qualified custodians that both have access to the sending and receiving account numbers and client account name, is not deemed to constitute "custody" and therefore does not require further specification of client accounts in the authorization.

Inadvertent Custody—IM Guidance Update

A new IM Guidance Update from the Staff discusses the potential for an adviser to have custody of client assets due to the wording of the custodial contract between its client and such client's custodian, even if the contract between the adviser and its client does not contemplate such custody. This can occur when the agreement between the client and the custodian grants an adviser broader access to client funds and securities than is contemplated in the advisory contract. The guidance gives several examples of such situations:

- The custodial agreement gives the adviser the right to "receive money, securities, and property … and to dispose of same."
- The custodial agreement allows the custodian to rely on instructions from the adviser without direction from the client.
- The custodial agreement authorizes the adviser to instruct a custodian to disburse cash from a client's account for any purpose.

The Staff has adopted the position that an adviser will be deemed to have custody of client assets if the underlying custodial agreement authorizes it to withdraw client funds, even where the advisory agreement does not permit such withdrawal.

The guidance suggests that an adviser may avoid inadvertent custody by drafting a letter addressed to the custodian that limits the adviser's authority to "delivery versus payment," notwithstanding the wording of the custodial agreement, and to have the custodian and client provide written consent to such arrangement. The guidance notes some custodial agreements allow the deduction of advisory fees but do not grant other rights. In such situations, although an adviser would be considered to have custody it would not be required to comply with the surprise examination requirements.

Conclusion

The recent guidance from the Staff gives some clarity regarding the custody rule as it applies to advisers. It also highlights, however, the custody rule's complexity and the need for advisers to pay close attention to their arrangements regarding client assets to see if any changes are necessary to remain in compliance.

NOTES

1 Investment Adviser Association, SEC Staff No-Action Letter (Feb. 21, 2017), available at *https://www.sec.gov/divisions/investment/noaction/2017/investment adviser-association-022117-206-4.htm.*

2 SEC Division of Investment Management, "Staff Responses to Questions About the Custody Rule," Question II.4 (updated Feb. 21, 2017), available at *https://www.sec.gov/divisions/investment/custody_faq_030510.htm.*

3 SEC Division of Investment Management, IM Guidance Update "Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority," No. 2017-01 (February 2017), available at *https://www.sec.gov/investment/im-guidance-2017-01.pdf.*

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