The SEC provides new custody rule guidance to investment advisers

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Abstract

Purpose – *To summarize guidance from the Securities and Exchange Commission's ("SEC") Division of Investment Management regarding Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940.*

Design/methodology/approach – *This article summarizes the SEC's guidance on "inadvertent custody" created by broad authority in custodial agreements, custody created by standing letters of instruction, and adviser authority to transfer funds or securities between two or more of a client's accounts.*

Findings – *This article concludes that firms should review their existing client custodial agreements, standing letters of instruction and other arrangements carefully to determine whether they have custody and whether additional action is necessary.*

Originality/value – *This article contains information on the Custody Rule and related SEC guidance from experienced securities and financial services regulatory lawyers.*

Keywords *Investment advisers, US Securities and Exchange Commission (SEC), Investment Advisers Act of 1940, Securities, Custodial agreements, Custody Rule*

Paper type *Technical paper*

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In February 2017, the staff of the Securities and Exchange Commission's ("SEC") Division of Investment Management issued guidance providing additional clarity on Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940 (the "Advisers Act"):

- *Guidance on "inadvertent custody" created by broad authority in custodial agreements* – In an IM Guidance Update (www.sec.gov/investment/im-guidance-2017-01.pdf) the staff clarified that broad authority granted to advisers under certain client custodial agreements can create "inadvertent custody" even where the advisory agreement between an adviser and their client provides narrower authority – dealing with the inadvertent custody requires affirmative action by the adviser, client and custodian;
- *Guidance on custody created by standing letters of instruction* ("SLOAs") – In a no-action letter (www.sec.gov/divisions/investment/noaction/2017/investment-adviser-association-022117-206-4.htm) the staff clarified that that an adviser may have custody and a corresponding surprise exam requirement when an SLOA or other similar asset transfer authorization arrangement is established by a client with a qualified custodian unless the adviser meets the conditions in the no-action letter; and
- *Guidance on adviser authority to transfer funds or securities between two or more of a client's accounts* – In a modified FAQ (available at: www.sec.gov/divisions/investment/custody_faq_030510.htm as Question II.4) the staff clarified that they do not view an adviser as having custody where it has the limited authority to transfer a client's assets between the

client's accounts maintained at one or more qualified custodians subject to certain conditions.

The advisers act custody rule

The Custody Rule provides that it is a fraudulent, deceptive or manipulative act under the Advisers Act for an SEC registered investment adviser to have custody of client funds or securities unless they are maintained in accordance with the requirements of the Custody Rule. Among other things, where an adviser has custody of client funds or securities, it must obtain a surprise examination of client assets by an independent public accountant. An adviser is deemed to have custody where it or its related person directly or indirectly holds client funds or securities or has any authority to obtain possession of them in connection with its advisory services to clients. Custody also includes any agreement or other arrangement where an adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon its instruction to the custodian. The Custody Rule has been a frequent source of confusion for advisers and the industry has sought increased clarity defining custody. The Custody Rule has also been the source of frequent regulatory and compliance issues for advisers. In a 2017 Risk Alert from the SEC, the staff included Custody Rule violations among the top five compliance topics most frequently identified in deficiency letters to advisers following exams.

Inadvertent custody created by custodial agreements (IM Guidance Update)

Provisions creating inadvertent custody

In the IM Guidance Update, the staff cautions advisers to be aware that an adviser may inadvertently have custody of client funds or securities because of a provision in a separate custodial agreement entered into between its advisory client and a qualified custodian. The staff notes that a custodial agreement between a client and custodian may grant an adviser broader access to client funds or securities than the adviser's own agreement with the client. As a result, an adviser may inadvertently have custody and be subject to the surprise examination requirement even though it did not intend to have that access or even know that it had the access. The staff has observed that the terms of certain custodial agreements permit a client's adviser to instruct the custodian to disburse, or transfer, funds or securities resulting in custody for the adviser. Examples include any custodial agreement:

- that grants the client's adviser the right to receive money, securities and property of every kind and dispose of same;
- under which a custodian may rely on an adviser's instructions without any direction from the client and which ratifies and confirms any transactions with the custodian made by an adviser for the client's account; or
- that provides authorization for the client's adviser to instruct the custodian to disburse cash from the client account for any purpose.

The staff believes that where a custodial agreement authorizes the adviser to withdraw client funds or securities notwithstanding a provision in the advisory agreement to the contrary, a separate restriction between the adviser and client would be insufficient to prevent the adviser from having custody.

Dealing with problematic custodial agreement provisions

The staff notes that one way for an adviser to avoid inadvertent custody where these custodial agreement provisions exist would be to:

- draft a letter (or other form of document) 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 client and custodian provide written consent to acknowledge the new arrangement.

The staff notes that without client and custodian consent, the adviser would retain the authority conferred under the original agreement, and the adviser would continue to have custody.

The staff also notes in the guidance that if a custodial agreement permits the deduction of advisory fees in accordance with the exception in Rule 206(4)-2(b)(3) under the Advisers Act and does not grant other rights that would impute custody to the adviser, then an adviser may have custody but does not need to comply with the surprise examination requirements. For example, such a custodial agreement might provide:

1. [Custodian name] is permitted to rely upon the authority of the [adviser] to provide instructions to disburse cash from your cash account if [custodian] in good faith believes such instructions to be given in connection with or in accordance with:
   - securities trading activity; or
   - the payment of fees that you owe [adviser].
2. Any other instructions to disburse cash from your accounts must come from you or other persons whom you have authorized to do so in accordance with the agreement, but excluding your [adviser].
3. Your [adviser] will not have the authority to provide us with any instruction to disburse cash from your accounts on your behalf except as contemplated above.

Custody issues created by SLOAs (no-action letter)

In the no-action letter, the staff notes that an adviser generally has custody where a client grants the adviser power in a SLOA to conduct third-party transfers (*i.e.* to instruct the qualified custodian to accept the adviser's direction on the client's behalf to move money to a third party designated in the SLOA). However, the staff notes that, depending on the extent of the adviser's discretion to act under a SLOA, it may not implicate the Custody Rule. For example, an adviser does not have custody if it does not have discretion as to the amount, payee, and timing of transfers under a SLOA. The no-action letter notes that advisers that have client assets and that have custody as a result of an SLOA should report these assets on its Form ADV beginning with its next annual updating amendment after October 1, 2017.

The letter provides no-action relief from the surprise examination requirement for advisers acting pursuant to a SLOA if:

- the client provides a signed written instruction to the custodian that includes the third party's name and address or account number at the custodian;
- the client provides written authorization to the adviser to direct transfers to the third party on a specified schedule or from time to time;
- the custodian appropriately verifies the client's authorization and provides a transfer of funds notice to the client promptly after each transfer;
- the client has the ability to terminate or change the instruction to the custodian;
- the adviser has no authority or ability to designate or change the identity, address or other information about the third party contained in the client's instruction;
- the adviser maintains records showing the third party is not a related party of the adviser and is not located at the same address of the adviser; and
- the custodian sends the client a written initial notice confirming the instruction and a written annual notice reconfirming the instruction.

Adviser authority to transfer client funds or securities between client accounts (modified FAQ)

In a modified FAQ, the staff explains that the authority to transfer a client's funds or securities between the client's accounts maintained at one or more qualified custodians does not give the adviser custody if:

- the client has authorized the adviser in writing to make such transfers; and
- a copy of that authorization is provided to the sending custodian specifying the name and account numbers for the sending and receiving accounts (including the ABA routing number(s) or name(s) of the receiving custodian).

The FAQ also clarifies that the adviser does not have custody, and specification of client accounts is not required solely as a result of the adviser having the authority to transfer a client's funds or securities between the client's accounts maintained:

- at the same qualified custodian; or
- between affiliated qualified custodians that have access to both the sending and receiving account numbers and client account name.

What to do now

In light of the SEC guidance, advisers should review existing client custodial agreements, SLOAs and other arrangements carefully to determine whether they have custody and whether additional action is necessary. Given the IM Guidance Update, firms cannot rely solely on restrictions in their advisory agreement to determine whether they have custody. Firms should consider Form ADV disclosures, operational practices and compliance policies and procedures in light of their reviews and the SEC guidance. Firms that determine they have existing Custody Rule problems should move quickly to address those issues.

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