

# Custody Rule Refresher: Review of Most Recent SEC Guidance

Nov 20 2018

Practice Area: Securities Law

---

As the end of the year rapidly approaches, it is a good time for investment advisers ("Advisers") to refresh their memories and evaluate their practices with relation to Rule 206(4)-2 of the Investment Advisers Act of 1940, which is referred to as the "Custody Rule." As a means for reviewing important aspects of this complicated rule, this *Legal Update* outlines Securities and Exchange Commission ("SEC") staff guidance from the last two years concerning its approach to enforcing Custody Rule requirements. Though this *Legal Update* is not exhaustive, it is intended to highlight Custody Rule concepts and thereby encourage review of your practices and compliance with the Custody Rule.

## Custody Rule Basics

The purpose of the Custody Rule is to provide protection for client funds or securities ("Client Assets") against the possibility of "being lost, misused, misappropriated or subject to investment advisers' financial reverses, including insolvency."<sup>1</sup> Under the Custody Rule, it is a "fraudulent, deceptive, or manipulative act" when an Adviser has custody of Client Assets unless the Adviser complies with certain requirements or an exception applies.<sup>2</sup> To comply with the Custody Rule, an Adviser who is deemed to have custody must: (1) have a qualified custodian, maintaining client assets in appropriate accounts; (2) notify clients when opening an account for the client with another qualified custodian; (3) believe, after due inquiry, that the other custodians provide periodic account statements; and (4) establish an arrangement with an independent public accountant to perform annual surprise audits. The surprise audit requirement can make compliance with the Custody Rule expensive and challenging.

In order to know if Custody Rule requirements apply to Client Assets, Advisers need to be aware of when they have custody. SEC regulations define custody as "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them."<sup>3</sup> Custody includes having possession<sup>4</sup> or legal ownership of Client Assets, or it can include "any arrangement... under which [an Adviser is] authorized or permitted to withdraw client funds or securities maintained with a custodian upon [the Adviser's] instruction to the custodian."<sup>5</sup>

## Arrangements That Constitute Custody and SEC Guidance

Understanding the types of arrangements that constitute custody is challenging and has created confusion for Advisers. Nevertheless, the importance of understanding when certain arrangements give Advisers custody over Client Assets is clear—an Adviser must determine if the Adviser has custody to know if the requirements of the Custody Rule apply to Client Assets. The following summarizes SEC staff guidance from the years 2017 and 2018 related to the arrangements that can constitute custody.

### **Inadvertent Custody: The Staff's 2017 IM Guidance Update and 2018 FAQ Response**

In February 2017, the staff ("Staff") of the SEC's Division of Investment Management published an IM Guidance Update<sup>6</sup> addressing inadvertent custody. In this guidance, the Staff indicated that an Adviser could inadvertently have custody over Client Assets as a result of provisions in custodial agreements between a client and a custodian (which is generally a bank or broker-dealer that holds the client's assets). In other words, an Adviser could be deemed to have custody even though the Adviser was not a party to the custodial agreement and had no knowledge of the relevant provision in a custodial agreement. The Staff explained that "an adviser would have custody where the custodial agreement enables the adviser to withdraw, or transfer, client funds or securities upon instruction to the custodian." With such powers, an Adviser has custody even if the Adviser's agreement with the client conflicts with the relevant custodial agreement provision. This is because, in the Staff's view, custody hinges on the custodian's perspective that the Adviser has authorization to withdraw Client Assets based on the custodial agreement, notwithstanding the Adviser's agreement with the client.

On June 5, 2018, the Staff published additional guidance regarding inadvertent custody in its list of frequently asked questions ("FAQs") regarding the Custody Rule.<sup>7</sup> FAQ II.11 addresses concerns that Advisers without knowledge of clients' custodial agreements might need to comply with the Custody Rule to avoid possible ramifications of non-compliance. To ease this concern, the Staff provided that an Adviser does not need to abide by Custody Rule requirements if the Adviser (1) does not have a copy of a client's custodial agreement, (2) does not know or have reason to know whether a custodial agreement would result in inadvertent custody, and (3) inadvertent custody would be the only basis for custody. Provided these three conditions are met, the Staff would not recommend enforcement against an Adviser for failure to abide by Custody Rule requirements, even though the Adviser may be deemed to actually have inadvertent custody. However, the Staff also noted that this relief would not apply if an Adviser "recommended, requested, or required a client's custodian."

Given the Staff's guidance, Advisers need to be aware of the possibility that inadvertent custody can arise from custodial agreements and take steps, as appropriate, to avoid inadvertent custody. As a starting point, Advisers should evaluate what they know about their clients' custodial agreements. If an Adviser knows or has reason to know that a client's custodial agreement gives the Adviser authority to withdraw the client's funds, the Adviser has two options. The Adviser must either comply with the Custody Rule or take advantage of the means discussed in the IM Guidance to avoid unintended custody. The IM Guidance provides that an Adviser can avoid inadvertent custody with relation to a client's assets by (1) sending a letter to the custodian limiting the Adviser's authority to "delivery versus payment" despite anything to the contrary in the custodial agreement and (2) having the client and custodian consent in writing to acknowledge the new arrangement.

### **Standing Letters of Authorization: The Staff's 2017 No-Action Letter**

The Staff's February 21, 2017 no-action letter<sup>8</sup> clarifies application of the Custody Rule in relation to certain arrangements established in standing letters of authorization ("SLOA"). The no-action letter specifically addresses a situation in which a client's SLOA gives an Adviser limited power to distribute the client's funds—which are held by a custodian—to one or more third parties as stipulated by the client. In a SLOA, a client may, for example, instruct an Adviser to pay the client's bills or taxes out of the client's assets. Though such an arrangement seems to give the Adviser power only to act as an agent for the client, the no-action letter clearly states that an Adviser acts as a custodian in such circumstances. This is because the Custody Rule applies when a SLOA gives the Adviser ability to distribute Client Assets to a third party. According to the no-action letter, an Adviser with authority to "dispose of client funds or securities for any purpose other than authorized trading has access to the client's assets" and therefore has custody.

Notwithstanding the fact that a SLOA, as described above, would render an Adviser subject to the Custody Rule, the no-action letter establishes limited relief for Advisers with custody in such circumstances. The Staff will not recommend an enforcement action for an Adviser—acting in accordance with such a SLOA—that does not obtain a surprise audit as required by the Custody Rule if:

1. The client provides an instruction to the qualified custodian [holding Client Assets], in writing, 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, either on the qualified custodian's form or separately, 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 qualified 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 qualified custodian sends the client, in writing, an initial notice confirming the instruction and an annual notice reconfirming the instruction.

Given the guidance provided in the no-action letter, Advisers should be aware that their activity pursuant to SLOAs may be subject to the Custody Rule. If an Adviser disburses a client's funds to third parties under a SLOA, the Adviser must comply with the Custody Rule requirements, but the Adviser does not need to have a surprise audit if the seven circumstances listed above pertain to the situation.

#### **Authority to Transfer Client Assets Between a Client's Various Accounts: The Staff's 2017 FAQ Response**

On February 21, 2017, the Staff updated FAQ II.4,<sup>9</sup> which pertains to arrangements that give Advisers the ability to move a client's assets between the client's different accounts. Under the Custody Rule, an Adviser has custody if the Adviser has authority to withdraw Client Assets by providing direction to the custodian holding the assets. The updated FAQ identifies two situations that the Staff does not construe to be "authority to withdraw assets" and thus do not invoke Custody Rule requirements. The Staff, according to FAQ II.4, does not view an Adviser's authority to constitute custody when: (1) the Adviser "has limited authority to transfer a client's assets between the client's accounts maintained at one or more qualified custodians" if the client provides written authorization for the transfer, which specifies the name and account numbers on the sending and receiving accounts, and the sending custodian receives a copy of the authorization so that it will have a record of the client and accounts identified for the transfer; or (2) the Adviser "has authority to transfer client assets between the client's accounts at the same qualified custodian or between affiliated qualified custodians that both have access to the sending and receiving account number and client account name." Accordingly, Advisers—who have authority to transfer a client's assets between that client's accounts—should consider their arrangement to determine how it corresponds with the guidance in this FAQ.

#### **Conclusion**

The Staff's guidance over the last two years helps to demystify the Custody Rule and makes compliance somewhat easier for Advisers. It also highlights the importance of Adviser's written arrangements with clients. In order to avoid ramifications of Custody Rule non-compliance, Advisers need to review client arrangements to determine if Custody Rule requirements apply. As you prepare to transition to a new year, consider your current arrangements with clients and evaluate your practices in relation to such arrangements.

---

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

<sup>2</sup> 17 CFR 275.206(4)-2.

<sup>3</sup> 17 CFR 275.206(4)-2(d)(2).

<sup>4</sup> Note that under the Custody Rule, possession will not constitute custody if an Adviser receives the client's funds or securities inadvertently and returns them to the sender within three business days of receiving them.

<sup>5</sup> 17 CFR 275.206(4)-2(d)(2)(ii).

<sup>6</sup> 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>.

<sup>7</sup> SEC Division of Investment Management, "Staff Responses to Questions About the Custody Rule," Question II.11 (June 5, 2018), available at: [https://www.sec.gov/divisions/investment/custody\\_faq\\_030510.htm](https://www.sec.gov/divisions/investment/custody_faq_030510.htm).

<sup>8</sup> Investment Adviser Association, SEC Staff No-Action Letter (February 21, 2017), <https://www.sec.gov/divisions/investment/noaction/2017/investment-adviser-association-022117-206-4.htm>.

<sup>9</sup> SEC Division of Investment Management, "Staff Responses to Questions About the Custody Rule," Question II.4 (modified February 21, 2017), available at: [https://www.sec.gov/divisions/investment/custody\\_faq\\_030510.htm](https://www.sec.gov/divisions/investment/custody_faq_030510.htm).

---

von Briesen & Roper Legal Update is a periodic publication of von Briesen & Roper, s.c. It is intended for general information purposes for the community and highlights recent changes and developments in the legal area. This publication does not constitute legal advice, and the reader should consult legal counsel to determine how this information applies to any specific situation.