Client Update
The Custody Rule Clarified (Again)

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In a recent Risk Alert, the staff of the Office of Compliance Examinations and Inspections ("OCIE") of the Securities and Exchange Commission ("SEC") observed that one of the most frequent deficiencies identified in OCIE examinations was the failure of investment advisers to recognize that they might be deemed to have custody of client assets for purposes of Rule 206(4)-2 ("Custody Rule") under the Investment Advisers Act of 1940 ("Advisers Act").[1] On February 21, the staff of the SEC's Division of Investment Management provided additional guidance under the Custody Rule that addressed three situations where there have been significant questions as to whether an investment adviser has custody of client assets:

- when the adviser has limited authority to transfer client assets pursuant to a standing letter of instruction or other similar asset transfer authorization arrangement ("SLOA") established by a client with a qualified custodian;
- when an agreement between the client and its custodian appears to provide the adviser with access to client assets—even if the investment adviser is not a party to such agreement; and
- when the adviser has the authority to move money between the client's own accounts ("first-person transfers").

This guidance, collectively, illustrates the complexity of the Custody Rule and the need for a registered investment adviser to take steps to assure that it complies with the Custody Rule—including recognizing those situations where it has custody.

[1] *See* Client Update: Advisers Beware! OCIE Announces Most Frequent Compliance Topics (Feb. 9, 2017), *available at* http://www.debevoise.com/insights/publications/2017/02/advisers-beware-ocie.

SLOA CUSTODY

A client will often grant its investment adviser a SLOA providing the limited power to disburse funds to one or more third parties as specifically designated by the client. After granting the investment adviser this limited authorization, the client then instructs the qualified custodian for the client's account to accept the investment adviser's direction on the client's behalf to move money to the third party designated by the client on the SLOA.

There is some confusion as to whether the use of a SLOA results in the investment adviser having custody of client assets. In a no-action letter to the Investment Advisers Association,[2] the SEC staff concluded that a SLOA may be sufficient to result in an investment adviser having custody if it provides the adviser with the authority to withdraw client funds or securities maintained with a qualified custodian upon its instruction for a purpose other than authorized trading. On the other hand, the staff acknowledged that an arrangement that is structured so that the investment adviser does not have discretion as to the amount, payee, and timing of transfers would not implicate the Custody Rule.

One consequence of this position is that an investment adviser that is deemed to have custody as a result of a SLOA would be required to undergo a surprise examination by an accounting firm as required by the Custody Rule. The staff concluded that it would not recommend enforcement action for a violation of the Custody Rule if a registered adviser did not obtain a surprise examination where it acts pursuant to a SLOA under the following circumstances:

- The client provides an instruction to the qualified custodian, 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.
- 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.
- The 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.

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[2] 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.

- The client has the ability to terminate or change the instruction to the qualified custodian.
- 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.
- 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.
- The qualified custodian sends the client, in writing, an initial notice confirming the instruction and an annual notice reconfirming the instruction.

The SEC staff recognized that investment advisers, qualified custodians and clients will require "a reasonable period of time to implement the processes and procedures necessary to comply with" the no-action relief. The letter does not specify what that period will be, but it does note that an investment adviser that has SLOAs should, beginning with the next annual Form ADV updating amendment after October 1, 2017, include client assets that are subject to a SLOA that result in custody in its response to Item 9 of Form ADV, Part 1A. This suggests that the SEC staff will be flexible in allowing investment advisers to implement the conditions of the relief.

In addition to taking steps to bring their SLOAs within the scope of the relief, an investment adviser that has a SLOA will have to take steps to assure that it complies with other aspects of the Custody Rule, including forming a reasonable basis, after due inquiry, for believing that the qualified custodian sends quarterly account statements directly to the client.

INADVERTENT CUSTODY

A new IM Guidance Update addresses situations where an investment adviser may inadvertently have custody of client funds or securities because of provisions in a separate custodial agreement entered into between its advisory client and a qualified custodian.[3] That is, 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 contemplates, thus providing

[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.

the adviser with custody even though it does not intend to have access to client accounts. The IM Guidance provides several examples of such provisions:

- The custodial agreement grants the client's adviser the right to "receive money, securities, and property of every kind and dispose of same."
- The custodial agreement provides that the custodian may rely on the adviser's instructions without any direction from the client.
- The custodial agreement provides authorization for the client's adviser to instruct the custodian to disburse cash from the client's account "for any purpose."

The IM Guidance also notes that a separate bilateral restriction between the adviser and the client would be insufficient to prevent the adviser from having custody where the custodial agreement enables the adviser to withdraw or transfer client funds or securities upon instruction to the custodian.

The IM Guidance suggests that an adviser take steps to assure that it does not have custody under these circumstances (or to comply with the Custody Rule if it does). The IM Guidance suggests one way for an adviser to avoid such inadvertent custody: providing the custodian with a letter or other document that limits the adviser's authority to "delivery versus payment"—that is, authority to issue instructions to transfer funds (or securities) out of a client's account only upon corresponding transfer of securities (or funds) into the account. The client and the custodian would have to provide a written acknowledgement of the new arrangement.

The IM Guidance does not impact arrangements that permit the adviser to deduct its advisory fees (without granting any other rights that would impute custody); in these circumstances, the adviser is deemed to have custody but is not required, under certain circumstances, to undergo a surprise examination.

In any event, the IM Guidance suggests that investment advisers review their clients' arrangements with custodians to assure that they do not result in providing the adviser with custody for purposes of the Custody Rule.

FIRST-PERSON TRANSFERS

Finally, the SEC staff updated its response to a FAQ relating to first-person transfers—*i.e.*, where an adviser has the authority to move money between the

client's own accounts.[4] The FAQ presents the question of whether an adviser has custody if it has authority to transfer client funds or securities between two or more of a client's accounts maintained with the same qualified custodian or different qualified custodians. The answer had been that such an arrangement did not result in custody, but there had been questions as to level of specificity required by the client's authorization.

The updated response requires the client's authorization to be extremely specific. The written authorization must state "with particularity" the name and account numbers on sending and receiving accounts (including the ABA routing number(s) or name(s) of the receiving custodian) such that the sending custodian has a record that the client has identified the accounts for which the transfer is being effected as belonging to the client. That authorization does not need to be provided to the receiving custodian. Moreover, in the staff's view, an adviser's authority to transfer client assets between the client's accounts 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 (*e.g.*, to make first-party journal entries) does not constitute custody and does not require further specification of client accounts in the authorization.

CONCLUSION

The SEC staff guidance provided by the SLOA no-action letter, the IM Guidance and the updated FAQ provides important clarification concerning the scope of the Custody Rule. The guidance also demonstrates both the complexity and non-intuitive aspects of the Custody Rule—particularly the circumstances that are deemed to result in an investment adviser having custody of client assets. In undertaking the annual compliance review required by Rule 206(4)-7 of the Advisers Act, an investment adviser should be particularly mindful of its compliance with the Custody Rule, particularly in light of this new guidance.

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Please do not hesitate to contact us with any questions.

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[4] 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.