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SEC Issues Custody Rule Guidance

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In February, the Securities and Exchange Commission (SEC) issued two significant pieces of guidance on arrangements that may result in an investment adviser having "custody" of its client assets as that term is defined in Rule 206(4)-2 (Custody Rule)[1] of the Investment Advisers Act of 1940 (Advisers Act).[2] The first piece of guidance was a Guidance Update issued by the SEC's Division of Investment Management. The second came in the form of a no-action letter (Letter) issued to the Investment Adviser Association (IAA) on February 21, 2017. This article discusses both and offers practical insight into compliance with the Custody Rule.

Background

Under the Custody Rule, an investment adviser is deemed to have "custody" of client assets when it or 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" it provides to its clients.[3] Additionally, the term "custody" includes any arrangement under which an investment adviser is "authorized or permitted to withdraw client funds or securities maintained with a custodian upon [its] instruction to the custodian."[4] When an investment adviser is deemed to have "custody," a number of regulatory requirements are triggered, including an independent verification by an accountant (a "surprise examination").[5] Accordingly, investment advisers must understand when they have custody of client assets. The SEC's recent guidance addresses instances in which investment advisers may not know that they have "custody" and, therefore, are subject to the various regulatory requirements of the Custody Rule.

Guidance Update

An IM Guidance Update published by the SEC's Division of Investment Management stated that investment advisers 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."[6] The Division of Investment Management found that some custodial agreements grant an adviser the broad power "to instruct the custodian to disburse, or transfer, funds or securities."[7] Where the adviser has that power, it may be deemed to have custody of the assets even though it did not intend to have such power and its contractual agreement with the client directly prohibits it from taking such action.[8]

The Division of Investment Management found that inadvertent custody arose from some commonly observed custodial agreement provisions: [9]

- A custodial agreement that grants the client's adviser the right to "receive money, securities, and property of every kind and dispose of same."
- A custodial agreement under which a custodian may rely on the "[adviser's] instructions without any direction" from the client and asks the client to "ratify and confirm any and all transactions with [the custodian]" made by the adviser.

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- A custodial agreement that provides authorization for the client's adviser to "instruct us to disburse cash from your cash account for any purpose . . . ."

After describing how advisers might have inadvertent custody of client assets, the SEC cautioned that rectifying inadvertent custody could not be accomplished through a bilateral agreement between the adviser and the client as the custody stems from the custodian's perception of the adviser's power.[10] The adviser can alter that perception by: (i) delivering a letter to the custodian that limits the adviser's authority to "delivery versus payment" notwithstanding a greater grant of power in the custodial agreement; and (ii) obtaining written acknowledgement of the limitation from the client and custodian.[11]

After providing common custodial agreement provisions that may create inadvertent custody, the Guidance Update specified one common provision which does not, in itself, create custody. The SEC stated that where a custodial agreement permits merely the deduction of advisory fees, "an adviser may have custody but not need a surprise examination, provided it otherwise complies with the exception under Rule 206(4)-2(b)(3) available to advisers with limited custody due to fee deduction."[12] A broader grant of power, however, likely constitutes custody.

We believe the Guidance Update may place a substantial burden on investment advisers. It will not be enough for investment advisers to review their own advisory agreements and other form documents. Instead, an adviser must work with all custodians holding its clients' assets to obtain and examine any custodial agreement provisions that might create inadvertent custody for the adviser. Moreover, the adviser would need to monitor those agreements for material changes in perpetuity. Of course, the simpler, but still burdensome, path to compliance may be to send letters to all clients and their custodians and obtain their acknowledgement of the adviser's limited power as a preventative measure.

The IAA No-Action Letter

Dovetailing the Guidance Update, in a letter dated February 15, 2017, the IAA asked the SEC staff to clarify that an investment adviser does not have custody under the Custody Rule "if it acts pursuant to a standing letter of instruction or other similar asset transfer authorization arrangement established by a client with a qualified custodian."[13] In the alternative, the IAA asked the SEC to state it would not recommend an enforcement action under Section 206(4) of the Act and the Custody Rule against an investment adviser acting pursuant to a standing letter of authorization (SLOA), as described in the Letter, without obtaining a surprise examination of the custodied assets as required by the Custody Rule.[14]

The IAA stated that it is common for an advisory client to grant its registered investment adviser the power, through a SLOA, to disburse funds to specifically-designated third parties. Granting such power to an investment adviser is especially helpful where the client owns multiple accounts with different purposes across multiple custodians. Under such an arrangement, the client grants authority to the adviser, then the client instructs the custodian to transfer assets to the designated third parties on the adviser's command. After issuing a SLOA, the client retains the power to change or revoke the arrangement, and the adviser's authority is limited by the specific terms of the SLOA.[15] It was the IAA's positon that such an arrangement did not constitute custody.[16]

The SEC determined that a SLOA, as described by the IAA may, in fact, lead to an investment adviser having custody of its client assets as contemplated by the Custody Rule. The general rule, as articulated by the SEC, is that an "investment adviser with the power to dispose of client funds or securities for any purpose other than authorized trading has access to the client's assets" and thus has custody of those assets.[17] Because the SLOA or other similar authorization would permit the investment adviser "to withdraw client funds or securities maintained with a qualified custodian upon its instruction," an investment adviser entering into an SLOA or similar arrangement would have custody of client assets and would be required to comply with the Custody Rule.

The SEC then stated that it would not recommend enforcement action under Section 206(4) of the Adviser Act or the Custody Rule against an investment adviser that enters into a SLOA that meets the following requirements and does not obtain a surprise examination:[18]

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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.

1. 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.
2. 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.
3. The client has the ability to terminate or change the instruction to the client's qualified custodian.
4. 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.
5. 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.
6. The client's qualified custodian sends the client, in writing, an initial notice confirming the instruction and an annual notice reconfirming the instruction.

We believe few SLOAs or similar arrangements currently in place would satisfy these extensive requirements. The SEC seems to agree. It noted that investments advisers, qualified custodians, and their clients would need "a reasonable period of time" to comply with the relief provided by the no-action letter.[19] Further, the SEC stated that any investment adviser that is party to a SLOA that results in custody would not need to include the affected client assets in its response to Item 9 of Form ADV until the next annual updating amendment after October 1, 2017.[20]

The Letter, on its face, could be construed broadly to cover a number of common arrangements. However, the Letter was limited by a SEC statement published the same day.[21] In that statement, the SEC explained that the limited authority to transfer assets between accounts, whether with the same custodian or different custodian, provided that the client has authorized the adviser to make the transfers between specified accounts and has provided the custodians a copy of the authorization, does not constitute custody.[22] The SEC also noted that an adviser's ability to transfer client assets between accounts at the same custodian or between affiliated custodians that have access to both account numbers and client account name does not amount to custody.[23] Therefore, the Letter seems to directly affect only SLOAs and similar arrangements under which the adviser has the authority to withdraw and disburse clients assets.

Despite the limiting effect of the SEC's statement, advisers who are currently parties to a SLOA or similar arrangement should carefully review the terms of those arrangements. Where the arrangements do not meet the seven conditions for relief stated in the Letter, the adviser should work to either: (i) change the terms of the arrangement; or (ii) comply with the terms of the Custody Rule and disclose those assets in the next annual amendment to Form ADV after October 1, 2017.

Conclusion

The SEC's recent guidance may generate significant anxiety among investment advisers concerned about becoming subject to the requirements of the Custody Rule. In particular, the SEC's recent guidance raises the specter of "custody" arising from longstanding SLOA arrangements or even from contracts the investment advisers have not seen or do not regularly review. Please feel free to contact us with any questions you may have.

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[1] 17 CFR 275.206(4)-2 (2017).
[2] 15 USC 80b et al (2017).
[3] 17 CFR 275.206(4)-2(d)(2) (2017).
[4] 17 CFR 275.206(4)-2(d)(2)(ii) (2017).

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[5] 17 CFR 275.206(4)-2 (2017). Under the Custody Rule, among other things, an investment adviser must: maintain client funds and securities with a "qualified custodian" either under the client's name or under the investment adviser's name as agent or trustee for the client; notify its clients promptly upon opening a custodial account on their behalf and when there are changes to the information required in the notification; and have a reasonable basis, after due inquiry, for believing that the qualified custodian sends quarterly account statements directly to the client.
[6] SEC, *IM Guidance Update: Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority* (Feb. 2017), available at www.sec.gov.
[7] *Id.*
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] *Id.*
[12] *Id.*
[13] SEC, *Investment Advisers Act of 1940 – Section 206(4) and Rule 206(4)-2; Response to the Investment Adviser Associatio*n (Feb. 21, 2017), *available a*t https://www.sec.gov/divisions/investment/noaction/2017/investment-adviser-association-022117-206-4.htm.
[14] *Id.*
[15] *Id.*
[16] *Id.*
[17] *Id.*
[18] *Id.*
[19] *Id.*
[20] *Id.*
[21] SEC, *Staff Responses to Questions About the Custody Rule* (Feb. 21, 2017), *available at* https://www.sec.gov/divisions/investment/custody_faq_030510.htm.
[22] *Id.*
[23] *Id.*

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