Proskauer

SEC Issues New Sources of Custody Rule Guidance

March 28, 2017

On February 21, 2017, the SEC's Division of Investment Management provided additional guidance with respect to Rule 206(4)-2 under the Investment Advisers Act of 1940, as amended (the Custody Rule). The guidance addressed the following three scenarios concerning whether an investment adviser has custody of client assets: (i) where the adviser possesses limited power to transfer client funds or securities pursuant to a standing letter of instruction or other similar asset transfer authorization arrangement (a SLOA) established by the client with a qualified custodian; (ii) where the adviser inadvertently has custody of client funds or securities because of provisions in a separate custodial agreement between the client and a qualified custodian; and (iii) where the adviser has the authority to transfer client funds or securities between two or more of the client's accounts with the same qualified custodian or different qualified custodians (i.e., "first-person transfers").

Standing Letters of Authority

The staff's response to a letter from the Investment Adviser Association addressed situations where a client grants its investment adviser the limited power in a SLOA to direct the client's custodian to disburse funds to one or more third parties as specifically designated by the client and then instructs the qualified custodian to accept the adviser's direction to move money to the designated third party or parties. In these situations, the adviser is authorized to act merely as an agent for the client, and the client retains the power to change or revoke the arrangement.

As an initial matter, the staff noted that whether a SLOA implicates the Custody Rule depends on the adviser's discretion to act and an arrangement that is structured so that the adviser does not have discretion as to the amount, payee and timing of transfers under a SLOA would not implicate the Custody Rule. The staff then noted that any 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. It went on to conclude that an adviser that enters into a SLOA would therefore have custody of client assets and be required to comply with the Custody Rule. Notwithstanding that view, the staff stated that it would not recommend enforcement action for a violation of the Custody Rule against an investment adviser if that adviser does not obtain a surprise examination where it acts pursuant to such 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 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;

- The client has the ability to terminate or change the instruction to the client's 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 adviser and is not located at the same address as the adviser; and

- The client's qualified custodian sends the client, in writing, an initial notice confirming the instruction and an annual notice reconfirming the instruction.

The staff acknowledged that investment advisers, qualified custodians and their clients will require a reasonable period of time to implement the processes and procedures necessary to comply with the no-action relief. Without specifying what that period will be, the staff did note that beginning with the next annual updating amendment after October 1, 2017, an investment adviser should include client assets that are subject to a SLOA that result in custody in its response to Item 9 of Form ADV.

Inadvertent Custody

In IM Guidance Update 2017-01, the staff discussed circumstances it has encountered where an investment adviser may inadvertently have custody of client funds or securities under the Custody Rule because of provisions in a separate custodial agreement between its client and a qualified custodian.

The staff cautioned advisers to be aware that they may have custody due to the authority resulting from the various agreements that may be in place. The custodial agreement between a client and the custodian may grant an adviser broader access to client funds or securities than the adviser's own agreement with the client. The staff noted that depending on the wording of these agreements, the adviser may have custody and be subject to the surprise examination requirement of the Custody Rule, even though it did not otherwise intend to.

As an initial matter, the staff observed that, in some cases, the agreement between a client and a qualified custodian might permit the client's adviser to instruct the custodian to transfer funds or securities. The staff acknowledged, however, that an adviser's authority to issue instructions to a broker-dealer or a custodian to effect or settle trades does not constitute custody for purposes of the Custody Rule. It further noted that custodians generally are under instructions to transfer funds (or securities) out of a client's account only upon the corresponding transfer of securities (or funds) into the account (i.e., a "delivery versus payment" arrangement) and that such an arrangement minimizes the risk that an adviser could withdraw or misappropriate the securities or funds in the account. The guidance update contemplates custody that arises from authority that goes beyond the foregoing arrangements and provides the following examples of agreements between clients and qualified custodians that might give rise to custody:

- A custodial agreement that grants the 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 [adviser's] instructions without any direction from you. You hereby ratify and confirm any and all transactions with [the custodian] made by [adviser] for your account."

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

The staff stated its belief that an adviser would have custody where the custodial agreement enables the adviser to withdraw or transfer client funds or securities, notwithstanding a provision in the advisory agreement or other separate bilateral restriction between the adviser and the client to the contrary.

The guidance update cautions advisers to be aware of the possibility that they may have inadvertent custody and, if applicable, take steps to ensure that they comply with the Custody Rule. One way offered by the update for an adviser to avoid such inadvertent custody is to draft a letter or other document to the custodian that limits the adviser's authority to "delivery versus payment," notwithstanding the wording of the custodial agreement, and have the client and custodian provide written consent to acknowledge the new arrangement.

First-Person Transfers

The staff revised the answer to question II.4 to its list of responses to questions about the Custody Rule relating to "first-person transfers", which addresses whether an adviser has custody if it has the authority to transfer funds or securities between two or more of a client's accounts maintained with the same qualified custodian or different qualified custodians. In the original response, the staff stated that in determining custody it did not interpret the authority to withdraw assets to include the adviser's limited authority to transfer a client's assets between the client's accounts maintained at one or more qualified custodians if the client has authorized the adviser in writing to make such transfers and a copy of that authorization is provided to the qualified custodians, specifying the client accounts maintained with qualified custodians.

The revision clarifies the staff's view that "specifying" would mean that the written authorization signed by the client and provided to the sending custodian would state with particularity the name and account numbers on the sending and receiving accounts (including the ABA routing number(s) or name(s) of the receiving custodian(s)). The authorization would not need to be provided to the receiving custodian.

The revision primarily affects wire transfers between client accounts at different qualified custodians. The staff noted that an adviser's 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 numbers and client account name does not constitute custody and does not require further specification of client accounts in the authorization.

Conclusion

The SEC's Office of Compliance Inspections and Examinations (OCIE) recently noted Custody Rule compliance as one of the five most frequent compliance topics identified in examinations of registered advisers in a risk alert issued on February 7, 2017 by the agency's National Examination Program. Specifically, OCIE warned advisers of the risk of failing to recognize that they may have custody as a result of certain authority over client accounts. In light of this admonition, advisers would be well-served to examine the scope of their own authority over client funds and/or securities in light of the guidance discussed above.