March 7, 2017

Registered Investment Advisers Take Note: New SEC Custody Rule Guidance

Registered investment advisers should take note of recent pronouncements by the staff of the SEC's Division of Investment Management (the "Division") regarding Rule 206(4)-2 (the "Custody Rule") of the Investment Advisers Act of 1940. The Division makes clear that many advisers may unwittingly have custody of client assets under the Custody Rule. Investment advisers should consider taking steps to avoid having imputed custody and take steps to comply with new requirements for standing letters of authorization.

IM Guidance Warns That Custodial Agreements May Impute Custody

Imputed Custody Because of Ability to Withdraw Assets. In February 2017, the Division issued an IM Guidance Update (the "Update")[1] cautioning investment advisers that common contractual provisions in custody agreements that many clients have with their custodians may impute custody of client funds or securities to investment advisers under the Custody Rule, unless advisers take steps to avoid inadvertent custody. Investment advisers with custody of client assets would be subject to the Custody Rule's requirement to have an annual surprise examination of client assets by an independent public accountant.

Specifically, the Division cautioned advisers to be aware of the possibility that custodial agreements impute custody to an adviser if language in custody agreements merely permits the adviser to instruct a custodian to disburse, or transfer, funds or securities. This is because the definition of custody turns on whether the adviser **is permitted** to "withdraw" client funds or securities upon instruction to the custodian. According to the Division, this would be the case even if the adviser had a separate agreement with the client specifically providing to the contrary.[2] The Division's view is based on the premise that, from the custodian's perspective, the client has authorized the adviser to withdraw the client's funds or securities and the custodian may not be aware of any contrary provisions in other agreements.

Sample Contractual Language Provided by the Division. Examples of potentially problematic language in custody agreements between a client and its custodian noted in the Update include:

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1 IM Guidance Update, February 2017, No.2017-1 "Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority."

2 It is common for investment advisory agreements to contain provisions attempting to limit an adviser's authority to withdraw or maintain custody of client funds or securities. However, according to the Division, this is insufficient to prevent an adviser from having custody if the client's agreement with its custodian gives the adviser authority to withdraw the client's funds or securities.

- A custody agreement giving 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 [client]. [Client] hereby ratif[ies] and confirm[s] any and all transactions with [the custodian] made by [adviser] for your account."
- A custodial agreement that gives an investment adviser authority to "instruct [the custodian] to disburse cash from [client's] cash account for any purpose . . . ."

The Division also provided sample language for custody agreements that would allow advisers to avoid the annual surprise exam requirement of the Custody Rule. The language is:

> "(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: (a) securities trading activity; or (b) 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."

Steps to Avoid Imputed Custody. The Division notes that advisers can take steps to avoid having custodial agreements impute custody to the adviser. The Division provides one potential solution in the Update—drafting a letter addressed to the custodian that limits the adviser's authority to "delivery versus payment"[3], notwithstanding language in the custody agreement. Advisers choosing to take this step would be required to get written consent from both the client and the custodian acknowledging this new arrangement. We believe that investment advisers should consider sending such a clarifying letter to address this potential issue and not rely on custodians or clients taking the initiative. (However, this solution may not work in certain circumstances since many instruments do not settle on a delivery-versus-payment basis (e.g., certain privately placed securities and derivatives)). Also, advisers may want to consider incorporating appropriate steps into their client onboarding process and reviewing their 206(4)-7 custody procedures, if applicable.

No-Action Letter Provides Clarity That Standing Letter of Authorizations Impute Custody

On February 21, 2017, the Division issued a no-action letter confirming that investment advisers have custody of client assets under the Custody Rule if the adviser exercises limited authority pursuant to a standing letter of instruction or similar asset transfer authorization established by a client with a custodian ("SLOA").[4] It is common practice for a client to give an investment adviser the limited power in an SLOA to disburse funds to third parties as specifically designated by (and acting merely as agent for) the client. In these arrangements, the custodian is instructed by the client to accept the adviser's direction on the client's behalf to transfer money to the third party designated by the client. According to the no-action letter, there was confusion and uncertainty in the industry as to whether an SLOA would impute an investment adviser with custody. The no-action letter not only makes clear that the Division believes that an investment adviser that enters into an SLOA would have custody of client assets, it goes on to state that any investment adviser with the power to dispose of client funds or securities for any purpose other than authorized trading has access to client assets.

The Division did provide some relief to investment advisers that enter into SLOAs. The Division agreed not to recommend enforcement action if an adviser acts pursuant to an SLOA without complying with the annual surprise exam required under the Custody Rule if the following representations outlined in the letter were met:

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[3] The Update notes that an adviser's authority to issue instructions to a broker-dealer or a custodian to effect or to settle trades does not constitute "custody" and that custodians are generally under instructions to transfer funds (or securities) out of a client's account only upon "delivery versus payment", which is a corresponding transfer of securities (or funds) into the account. According to the SEC, "delivery versus payment" minimizes the risk that an adviser could withdraw or misappropriate the funds or securities in its client's custodial account.

[4] The staff's no-action letter can be found here.

1. 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.

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.

An adviser with an SLOA would need to comply with the other requirements of the Custody Rule (e.g., account statement delivery requirements).

The Division noted that investment advisers, custodians and clients will need a reasonable period of time to implement the necessary procedures to comply with the no-action relief. No definitive time was specified by the Division. The incoming letter from the Investment Adviser Association (IAA) requesting the no action relief noted that it would likely take at least six months to implement the necessary procedures. Therefore, advisers should make every effort to comply with the representations within six months or take other action (e.g., accepting custody and the surprise exam requirement or, in the alternative, choosing not to assist clients in managing transfers among accounts.) The IAA has stated that since many of these representations involve the qualified custodians' operations, the IAA collaborated closely with four major custodians to ensure that the representations would be able to be met. It is unclear how long other custodians will need and, therefore, advisers should act promptly to coordinate with custodians.

Form ADV Disclosure. Advisers who have SLOAs are still deemed to have custody of client assets, even if the adviser follows the requirements outlined in the no-action letter. This means that the investment adviser should include client assets that are subject to an SLOA in its response to Item 9 of Form ADV. The Division specified that this should be included beginning with the next annual updating Form ADV amendment after October 1, 2017.

Revision to Custody Rule FAQ II.4

The Division also revised SEC FAQ II.4 under the Custody Rule.[5] This FAQ again makes clear the Division's view that an adviser will be deemed to have custody if it has the authority to withdraw client assets maintained with a custodian. The FAQ deals with so-called "first-person" transfers under which a client gives an adviser the authority to move money between a client's own accounts. The FAQ states that an adviser would not be deemed to have custody if it has the authority to make these types of transfers if:

- the client has authorized the adviser in writing to make such transfers,
- a copy of that authorization is provided to the qualified custodians, and
- the written authorization specifies the client accounts maintained with qualified custodians.

[5] Available here.

The FAQ states what the staff's view of "specifying" means. It provides that the written authorization should 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) so 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. (This written authorization does not need to be provided to the receiving custodian.)

This FAQ does not apply to transfers between a client's own accounts at the custodian or between affiliated qualified custodians that both have access to the sending and receiving account numbers and client account name (i.e., first-party journal entries). These types of transfers do not constitute custody and do not require further specification of client accounts in the authorization.

What Should Advisers Do Now

The Division's new Custody Rule guidance, along with the recent National Exam Program Risk Alert by the staff of the SEC's Office of Compliance Examinations and Inspections observing that one of the most frequent exam deficiencies in investment adviser examinations was the failure of advisers to recognize that they might be deemed to have custody of client assets, illustrate the complexity of the Custody Rule and the Division's continued focus on compliance with the Custody Rule.

Advisers should take prompt action to comply with the Division's new Custody Rule guidance. This may include implementing new procedures for SLOAs, deciding to accept custody and the surprise exam requirement if an adviser decides to continue to facilitate individual client account transfers, and taking steps to avoid imputed custody under custody agreements.

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