GREENWICH COMPLIANCE

SPOTLIGHT ON

The SEC Custody Rule FAQ

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The SEC offered additional guidance and a related No Action letter in February 2017 regarding the SEC's Custody Rule (rule 206(4)-2 under the Investment Advisers Act of 1940), updating the Custody FAQs previously issued by the Commission in 2010. The SEC guidance specifically discussed instances where a standing letter of authorization allowing an Advisor to transfer funds to a third party resulted in the Advisor being deemed to have "Custody" under the SEC's Custody Rule, with some limited exceptions.

We have presented the questions and the relevant sections of the SEC Custody FAQs (in italics), which best address each question. We have also included hyperlinks to the SEC's FAQs and No Action Letter.

1. Can an Advisor transfer funds between custodial accounts of clients without being deemed to have Custody?

The SEC addressed this topic in Question II.4 of its Custody Rule FAQs (as well as the other questions referenced below), which are available at https://www.sec.gov/divisions/investment/custody_faq_030510.htm

The SEC explained that the Advisor will not have custody if the Advisor only transfers assets between different accounts of the client at one or more qualified custodians based on the client's written instructions specifying the name and account numbers for the sending and receiving accounts and these instructions are on file with the sending custodian (broker).

Q: *Does an adviser have 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?*

A: *Under rule 206(4)-2(d)(2)(ii), an adviser has custody if it has the authority to withdraw client assets maintained with a qualified custodian upon the adviser's instruction to the custodian. We do not interpret the authority to withdraw assets to include the 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. In the staff's view, "specifying" would mean that the written authorization signed by the client and provided to the sending custodian states 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 both have access to 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. (Modified February 21, 2017.)*

2. Can an Advisor direct the custodian (broker) to send funds directly to the client or the client's address using instructions on file without being deemed to have Custody?

The SEC addressed this in Question II.5.A of its Custody Rule FAQs. The SEC explained that the Advisor does not have custody by merely instructing the custodian to remit funds to the client to the address of record for the client, as requested by the client. This exception only applies if (a) the client grants a written authorization to the Advisor, (b) the custodian receives a copy of that written authorization, and (c) the Advisor does not have authority to open an account on behalf of the client or designate or change the client's address of record with the custodian.

Q: *Does an adviser have custody if it has authority to instruct the qualified custodian that maintains a client's account to remit the funds or securities from the account to the same client at his or her address of record?*

A: *We do not interpret the authority to instruct the qualified custodian maintaining a client's account to remit the funds or securities from the account from time to time to the same client at his or her address of record as having custody if (1) the client has granted such authority to the adviser in writing and a copy of that authorization is provided to the qualified custodian, (2) the adviser has no authority to open an account on behalf of the client; and (3) the adviser has no authority to designate or change the client's address of record with the qualified custodian. (Modified September 9, 2010)*

3. Is an Advisor deemed to have Custody if the custodian (broker) deducts advisory fees from the client's account based on a fee methodology and instructions the client submitted to the custodian (broker) (e.g., using one of Interactive Broker's Automatic Calculations and Billing Methodology)?

The SEC addressed this in Question III. of its Custody Rule FAQs, explaining that the Advisor does not have Custody if the client's Custodian deducts advisory fees based on a written methodology and instructions submitted in writing by the client. In this case, the Custodian is acting as an "agent" for the client and this arrangement should not create a custodial relationship for the Advisor as he has no discretion to alter the client's instructions to the custodian. The arrangement is between the client and the Custodian and it is not up to the Advisor as to whether fees are remitted to the Advisor . The client can choose at any time to use a different method of payment, or not pay the Advisor at all.

Q: *A client has instructed its custodian to debit the client's account for advisory fees each quarter. The custodian makes all fee calculations, based on the advisory contract. The adviser does not calculate the fee, nor does it send a bill. Does the adviser have custody?*

A: *If the qualified custodian is not a related person of the adviser, the adviser does not have custody. Under these circumstances, the custodian is acting only as agent for the client, and the adviser does not have access to the client's funds. (Modified May 20, 2010.)*

4. Can an Advisor transfer funds to a third party without being deemed to have custody?

We have reviewed the No Action letter of February 17, 2017, from the SEC's Office of Investment Management to the Investment Adviser's Association addressing whether an Advisor would be deemed to have Custody under the SEC's Custody Rule when a standing letter of authorization signed by the client allows the Advisor to transfer funds from the client's account to a third party. The SEC stated that this would constitute custody, but it would not recommend enforcement if the Advisor satisfied the conditions listed below. The letter also indicated that the SEC would allow "a reasonable period of time" for Advisors to ensure that their practices were in line with prerequisites of the letter. The SEC specifically stated that its No Action relief applied only if the Advisor does not have any discretion as to the amount, payee, and timing of any third-party transfers. In particular, the SEC's No Action letter stated:

Notwithstanding this view, staff of the Division of Investment Management would not recommend enforcement action to the Commission under Section 206(4) of, and Rule 206(4)-2 under, the Advisers Act against an investment adviser if that adviser does not obtain a surprise examination where it acts pursuant to such an arrangement under the following circumstances:

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.*

Links:

https://www.sec.gov/divisions/investment/custody_faq_030510.htm
https://www.sec.gov/investment/im-guidance-2017-01.pdf
https://www.sec.gov/divisions/investment/noaction/2017/investment-adviser-association-022117-206-4.htm

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