U.S. Securities and Exchange Commission

Investment Advisers Act of 1940 – Section 206(4) and Rule 206(4)-2

February 21, 2017

Laura L. Grossman
Assistant General Counsel
Investment Adviser Association
1050 17th Street, NW
Suite 725
Washington, DC 20036-5514

Dear Ms. Grossman:

Your letter dated February 15, 2017 requests clarification that an investment adviser does not have custody as set forth in Rule 206(4)-2 ("Custody Rule") under the Investment Advisers Act of 1940 ("Advisers Act") 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 ("SLOA"). Alternatively, your letter requests our assurance that we would not recommend enforcement action to the Securities and Exchange Commission ("Commission") under Section 206(4) of the Advisers Act and the Custody Rule against an investment adviser if it acts pursuant to a SLOA, as described in your letter, without obtaining a surprise independent verification (a "surprise examination") as required by Rule 206(4)-2(a)(4) under the Advisers Act.

Facts

You state the following:

It is common for a client to grant its registered investment adviser the limited power in a SLOA to disburse funds to one or more third parties as specifically designated by the client.[1] 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. The qualified custodian takes that instruction in writing directly from the account holder (the investment adviser's client), and the investment adviser's authority is limited by the terms of that instruction. The investment adviser is authorized to act merely as an agent for the client. The client retains full power to change or revoke the arrangement.

You further state that there is widespread confusion and uncertainty among investment advisers, qualified custodians, broker-dealers, compliance professionals and legal counsel as to whether a SLOA would impute an investment adviser with custody.

Analysis

The Custody Rule is designed to protect client funds or securities from being lost, misused, misappropriated or subject to investment advisers' financial reverses, including insolvency.[2] The Custody Rule provides that it is a fraudulent, deceptive or manipulative act, practice or course of business within the meaning of Section 206(4) of the Advisers Act for an investment adviser that is registered or required to be registered under the Advisers Act to have "custody" of client funds or securities unless they are maintained in accordance with the requirements of the rule.[3] In this regard, where an investment adviser has custody of client funds or securities, it must obtain a surprise examination of client assets by an independent public accountant.[4]

Under the Custody Rule, an investment adviser has "custody" of client funds or securities where it or its related person[5] "holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services [it] provide[s] to clients . . . ."[6] Moreover, "custody" includes "[a]ny 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 . . . ."[7] You contend that an investment adviser simply following a client's instructions to transfer assets pursuant to the limited authority granted to the investment adviser under a SLOA and the investment adviser's corresponding direction to the qualified custodian do not result in an investment adviser "holding" client funds, give an investment adviser "authority to obtain possession" of client funds, or authorize or permit an investment adviser to "withdraw client funds" for any purpose, as contemplated by the Custody Rule.

We disagree. An investment adviser with power to dispose of client funds or securities for any purpose other than authorized trading has access to the client's assets.[8] We believe that a letter of instruction or other similar asset transfer authorization arrangement established by a client with a qualified custodian would constitute an arrangement under which an investment adviser is authorized to withdraw client funds or securities maintained with a qualified custodian upon its instruction to the qualified custodian. An investment adviser that enters into such an arrangement with its client would therefore have custody of client assets and would be required to comply with the Custody Rule. 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.

We understand 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 this relief. In addition, 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 (see note 1 above) in its response to Item 9 of Form ADV.

This conclusion is based on all of the facts and representations set forth in your letter. You should note that any different facts or representations might require a different conclusion. Further, this response expresses our position only with respect to enforcement action, and does not express any legal conclusion on the issues presented.

Aaron T. Gilbride
Senior Counsel
Chief Counsel's Office

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[1] The staff understands that there is no standardized format for a SLOA. Investment advisers, qualified custodians and their clients have developed a wide variety of SLOAs for third-party transfers, each of which could implicate the Custody Rule depending on the extent of the adviser's discretion to act. For example, an arrangement that is structured so that the investment adviser does not have discretion as to the amount, payee, and timing of transfers under a SLOA would not implicate the Custody Rule.

[2] *Adoption of Rule 206(4)-2 Under the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 123 (Feb. 27, 1962).

[3] Rule 206(4)-2. 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. *See* Rule 206(4)-2(a)(1)-(3). A qualified custodian is a broker-dealer, bank, savings association, futures commission merchant or non-U.S. financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients'

assets in customer accounts segregated from its proprietary assets. *See* Rule 206(4)-2(d)(6).

[4] Rule 206(4)-2(a)(4). Where client assets are maintained by the investment adviser itself or a related person, rather than an independent qualified custodian, the accountant performing the surprise examination must be registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board.

[5] Rule 206(4)-2(d)(7) defines "related person" as "any person, directly or indirectly, controlling or controlled by [the investment adviser], and any person that is under common control with [the investment adviser]."

[6] Rule 206(4)-2(d)(2).

[7] Rule 206(4)-2(d)(2)(ii).

[8] *Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2176 (Sep. 25, 2003), text accompanying footnote 10.

Incoming Letter

The Incoming Letter is in Acrobat format.

http://www.sec.gov/divisions/investment/noaction/2017/investment-adviser-association-022117-206-4.htm

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