Inadvertent Custody

May 2017

By Jim Leahy and Jessica Romano

The Custody Rule[1] provides that if a registered investment adviser ("Manager") is deemed to have custody of client funds or securities, it must comply with certain requirements of the Custody Rule. Most Managers comply with the Custody Rule by (i) maintaining client assets with qualified custodians such as banks and prime brokers and (ii) completing and distributing, within 120 days[2] of fiscal year end, financial statements prepared in accordance with US GAAP to investors in their pooled investment vehicles. This well-known and widely adopted two-step compliance regime only works for pooled investment vehicles[3]. It does not work for separately managed accounts ("SMAs"). If a Manager has custody of an SMA, other than through the ability to deduct its advisory fees, then the Manager must, among other things, complete an annual "surprise audit." This surprise audit is different from the scheduled year-end GAAP audit we referred to above. Consequently, many Managers try to ensure that they do not have custody of their SMA's assets. Toward that end, investment management agreements ("IMAs") will often state that it is the intent of the parties that the Manager not have custody of the SMA's assets. This statement of intent is a good start but it is not the end of the Manager's responsibility or analysis with respect to the Custody Rule.

The Manager must also carefully review the terms of any custodial or prime brokerage agreements ("Custodial Agreement") it enters into on behalf of its SMA client to see if it has custody of the SMA's assets despite explicit contractual provisions to the contrary in the IMA. The Manager would be deemed to have custody of SMA assets if the Custodial Agreement permits the Manager to withdraw client funds or securities upon the Manager's instructions to the custodian.[4] The SEC's staff of the Division of Investment Management has recently clarified that it does not believe that a Manager's limited ability

[1] Investment Advisers Act of 1940, Rule 206(4)-2.

[2] Fund of funds have a longer time: 180 days. Commodity Trading Advisers and Commodity Pool Operators have only 90 days to complete their financial statements. Investment Advisers Act Release No. 3960 (Oct. 29, 2014) is an example of an administrative cease and desist proceeding against Sands Brothers Asset Management, LLC (a registered investment adviser) for failure to timely distribute audited financial statements to the investors of pooled investment vehicles.

[3] Managers typically identify these vehicles in Form ADV Part 1A as private funds.

[4] See IM Guidance Update No. 2017-01 (Feb. 2017), Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority, *available at* https://www.sec.gov/investment/im-guidance-2017-01.pdf.

370 Lexington Avenue, Suite 511
New York, NY 10017
(212) 257-5790
www.orical.org

to transfer a client's assets between certain specified accounts of such client pursuant to written authority maintained at the custodian would amount to the right to withdraw client funds.[5]

In addition to Custodial Agreements, the Manager must also consider the terms of any standing letter of instruction or other similar asset transfer authorization arrangement established by a client with a qualified custodian ("SLOA"). Clients may grant a Manager the limited power in a SLOA to disburse funds to one or more third parties as specified in the SLOA. In a recent SEC No-Action Letter,[6] the SEC staff indicated that such an arrangement would constitute custody but that a surprise audit would not be required if seven conditions were fulfilled:

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.

[5] Staff Responses to Questions About the Custody Rule, Question II.4 (updated as of Feb. 21, 2017): "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 as 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)"

[6] Investment Adviser Association, SEC No-Action Letter (Feb. 21, 2017).

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 note that there is a wide diversity of SMA staff capabilities. Many SMA's do not want to be troubled by operational concerns; others do not have the requisite expertise in-house. Still others may be located in different continents and time zones from the Manager. But where the SMA is able, a Manager may request that the SMA handle operational aspects of managing the account, such as wire transfers to meet margin calls and posting of collateral. In other cases, the Manager can maintain the relationship with the custodial account but request dual signatures—one from the Manager and one from the SMA—to move cash or securities. These solutions may permit a Manager to avoid custody and the obligation to conduct a surprise audit. In any event, we believe Managers should delve beyond the terms of the IMA to make determine whether or not they have custody of their client's assets.

If you have any questions about any aspect of your SEC/CFTC compliance program or the Custody Rule in particular, please contact any one of our attorneys whose contact information is set forth below.

Jim Leahy
Partner
jleahy@orical.org
212-257-5783

Gregory Florio
Partner
gflorio@orical.org
212-257-5781

Jessica Romano
Associate
jromano@orical.org
212-257-5874

Vanessa Sasson
Associate
vsasson@orical.org
212-257-5785

Laurel Mason
Associate
lmason@orical.org
212-257-5787