

SEC Issues Final Amendments to Investment Adviser Custody Rule

The “Modernization” of Rule 206(4)-2 under the Advisers Act

October 24, 2003

By Scott P. Tarra
starra@financialreg.com

Summary

The Securities and Exchange Commission (“SEC”) adopted certain amendments to Rule 206(4)-2 (“Custody Rule”) which regulate the custody practices of investment advisers registered under the Investment Advisers Act of 1940 (“Advisers Act”). Although the original rule was drafted to require advisers to implement certain controls for the protection of client assets, the final rule amendments are designed to further enhance the existing protections afforded to advisory client’s assets, align the rule with current custodial practices, and to provide clarification to certain circumstances under which advisers have custody.

The final rule amendments are effective November 5, 2003. However, advisers must comply with the amended rule by April 1, 2004.

The final rule amendments effectively update the standing custody rule to accomplish the following objectives:

- Provide a definition of “custody” and certain circumstances under which advisers may have custody of client funds or securities;
- Require advisers that have custody of client funds or securities to maintain those assets with a “qualified custodian.”¹

- Provide certain relief from sending account statements and from undergoing an annual surprise examination in the event that the adviser’s qualified custodian sends account statements directly to the adviser’s clients;
- Amend the Form ADV by removing the requirement that advisers with custody include an audited balance sheet in their disclosure brochure to clients.

Definition of Custody

An adviser shall be deemed to have “custody” when it holds, “directly or indirectly, client funds or securities or [has] any authority to obtain possession of them.”² In an attempt to clarify the definition of custody, the SEC provides three examples of certain circumstances under which advisers have custody of client funds or securities:

1. Temporary Possession

Advisers that hold client stock certificates or cash, even temporarily,³ expose its client’s assets to a heightened level of risk associated with the potential for misuse or loss. Therefore, an adviser has custody when it has possession of client funds or securities, even for a brief period. Temporary possession shall also apply to advisers that forward clients’ funds or securities, although advisers may *prepare* certain documents, including stock certificates, for forwarding to a custodian or third-party without having custody.

¹ Release No. IA-2176; File No. S7-28-02

² Amended SEC Rule 206(4)-2(c)(1)

³ Amended SEC Rule 206(4)-2(c)(1)(i)

Exception

The final amendments *exclude* an adviser's "inadvertent receipt" of client funds or securities, provided that the adviser returns them to the sender within three (3) business days of receipt.

The rule also clarifies that an adviser's possession of a check drawn by the client and made payable to a third party is *not* considered possession of client funds within the meaning of the custody rule. Moreover, checks made payable to the adviser for payment of advisory fees due to the adviser do not represent "client funds" within the meaning of the custody rule.

2. Authority to Withdrawal Funds

The definition of custody shall also apply to an adviser that has authority to withdrawal funds or securities for a client's account. Even though the adviser might not have *actual* possession of client assets, having the authority to obtain possession is enough under the rule to constitute custody.

Therefore, custody shall apply to an adviser that maintains the following authority:

- Authorization to deduct advisory fees or other expenses directly from a client's account;
- Maintain power of attorney to sign checks on behalf of advisory clients;
- Authorization to withdraw funds or securities from a client's account or to dispose of client funds or securities for any purpose other than authorized trading.

Exception

The rule does *not* apply to an adviser that has authority to issue instructions to broker/dealers or custodians to effect or settle trades on behalf of their advisory clients.

3. Legal Ownership and Accessibility

An adviser that acts in any capacity that gives it legal ownership of, or access to, client funds

or securities, is also deemed to have custody. Some of the more common examples of legal ownership are seen in firms that act as both general partner and investment adviser to a limited partnership (LP), or advisers that act as both managing member and investment adviser of a limited liability company (LLC) or another type of investment vehicle, or as both trustee and investment adviser of a trust. In these examples, the general partner, managing member, and trustee generally have some degree of authority to dispose of funds and securities in the corresponding account.

Exception

The rule does *not* apply to advisers that also act as general partners for real estate partnerships unless the partnership is an advisory client of the investment adviser. A similar exception would apply where a supervising person such as portfolio manager engages the advisory firm to advise an estate, conservatorship or personal trust for which the supervised person serves as executor, conservator or trustee solely because the person has been appointed as a result of family or personal relationship with the decedent, beneficiary or grantor (and not a result of employment with the adviser).⁴

Use of Qualified Custodians

The amended rule requires that advisers with custody of customer funds or securities maintain them with a "qualified custodian." The qualified custodian must hold the funds or securities in an account either under the client's name or under the adviser's name as agent or trustee for its clients. The client funds and securities must be held on behalf of the client by the qualified custodian so that the qualified custodian can provide account information to the clients.

Definition of a Qualified Custodian

The term "qualified custodian" under the amended rule includes banks and savings associations, registered broker-dealers, registered futures commission merchants (for advisers offering futures advice), and foreign financial institutions that customarily hold financial assets for their customers, provided

⁴ In the Matter of Gofen and Glossberg, Inc., Investment Advisers Act Release No. 1400 (Jan. 11, 1994).

that the foreign financial institution keeps advisory clients' assets in customer accounts segregated from its proprietary assets. Advisers meeting the definition of qualified custodian may hold client assets themselves, provided they comply with the account statement requirements and any "custody rules imposed by the regulators of the advisers' custodial functions." Additionally, Advisers may also maintain client assets with affiliates that are qualified custodians.

The amended rule contains special provisions for two types of securities: mutual fund shares and private issues.

Mutual Fund Transfer Agents

Under certain circumstances, a client or adviser may purchase shares of a mutual fund directly from the fund's transfer agent rather than through another intermediary such as a broker-dealer. In these cases, the mutual fund's transfer agent maintains the securities for the client on the mutual fund's books, while the adviser may also have custody through check-writing or fee-deduction authority over the advisory client's assets. The amended rule allows an adviser to use the mutual fund transfer agent in lieu of a qualified custodian with respect to those shares.

Privately Offered Securities

Advisory clients who purchase privately-offered securities may pose certain difficulties in maintaining client assets with a qualified custodian because the client's ownership of the security is recorded on the books of the issuer. Therefore, the amended rule does not apply to advisers with respect to privately-offered securities in their clients' accounts, if ownership of the securities is recorded only on the books of the issuer or its transfer agent, in the name of the client, and transfer of ownership is subject to prior approval of the issuer or holders of the issuer's outstanding securities.

However, in the case of limited partnerships or other pooled investment vehicles where the private securities are held in the name of the

limited partnership and the adviser acts for the partnership, the adviser may have apparent authority to arrange transfers that would be recognized by the issuer of the securities. Therefore, to impose additional safeguards against abuse, an adviser may use the exception for private securities with respect to the account of a limited partnership only if the limited partnership is audited annually, and the audited financial statements are distributed in accordance with 206(4)-2(b)(3) as amended.

Delivery of Account Statements to Clients

The amended rule requires advisers that maintain custody of customer funds or securities to have a reasonable belief that the qualified custodian holding the assets is providing account statements to those clients on a quarterly basis.⁵ Additionally, the qualified custodian must deliver the account statements *directly* to advisory clients as opposed to going *through* the adviser. The direct delivery method was designed to ensure integrity of the account statement information as well as allow the advisory client to easily identify any unauthorized transactions or withdrawals by an adviser.

However, in the event that a client does not receive account statements directly from the qualified custodian, the adviser must continue sending quarterly account statements to that client and to undergo an annual surprise examination by an independent public accountant to verify the funds and securities of that client.

In other circumstances, some advisory clients may not wish to receive custodial reports. In this case, clients can choose to have an independent representative receive account statements on their behalf. An "independent representative" is a person that (i) acts as agent for an advisory client and by law or contract is obligated to act in the best interest of the advisory client; (ii) does not control, is not controlled by, and is not under common control with the adviser; and (iii) does not have, and has not had within the past two years a material business relationship with the adviser.⁶

⁵ Amended SEC Rule 206(4)-2(a)(3)(i).

⁶ Amended SEC Rule 206(4)-2(c)(2).

Pooled Investment Vehicles

In some circumstances, advisers may take legal title to the client assets they manage, such as in the case of advisers that also serve as general partner to investment pools. Under these circumstances, the final amended rule contains a special provision clarifying that account statements (whether delivered by the qualified custodian or the adviser) must be sent directly to the investors in the pool if the adviser to the pool also acts as its general partner, managing member, or in a similar capacity and has custody of client funds or securities.

Trusts

In the event that an adviser acts as trustee for its client's trust, the adviser must ensure that account statements are delivered to their clients. These advisers are often acting in a capacity that gives them legal ownership, and therefore custody, of the client assets. In many cases, the advisory client is also the trust grantor and beneficiary. In other circumstances, the adviser may need to have quarterly statements delivered to an independent representative who may be a co-trustee, lead beneficiary, trust attorney, executor, or, in the case of court-supervised trusts, the court.

Exemptions from the Amended Rule

The three available exemptions from the amended rule apply to registered investment companies, pooled investment vehicles and registered broker/dealers.

Registered Investment Companies

Advisers are not required to comply with the amended rule with respect to clients that are registered investment companies. Registered investment companies and their advisers must comply with the strict requirements of section 17(f) of the Investment Company Act of 1940 and the corresponding custody rules therein.

Pooled Investment Vehicles

Advisers are not required to comply with the reporting requirements of the rule with respect to pooled investment vehicles, such as limited partnerships or limited liability companies, if the pooled investment vehicle (i) receives an annual audit; and (ii) distributes its audited financial statements prepared in accordance with GAAP to all limited partners (or members or other beneficial owners) within 120 days of the end of its fiscal year.

Registered Broker-Dealers

The amended rule eliminates the exemption for advisers that are also registered broker/dealers, which are qualified custodians under the rule.

Amendments to Form ADV

Part 1A- Item 9 of Form ADV

Item 9 of Part 1A of Form ADV asks whether an adviser has custody of client funds or securities. As a result of this question, many advisers that deduct their fees directly from client accounts and therefore have custody, have previously answered "no" to Item 9 in reliance on previous SEC issued no-action letters.⁷ However, as a result of the amended rule, Item 9 of Part 1A of Form ADV will be revised to include new instructions which clarify that advisers that have custody *only* because they deduct fees may answer "no" to Item 9 in compliance with the amended rule.

Part II- Item 14 of Form ADV

As part of the old Custody Rule, Item 14 of Part II of Form ADV requires an adviser that maintains custody of customer funds or securities to include an audited balance sheet by an independent accountant along with Part II of Form ADV. However, as a result of the amended rule, the Form ADV was amended to eliminate the requirement for an adviser to include an audited balance sheet in their disclosure statements sent to clients.

⁷ Investment Counsel Association of America, Inc., SEC Staff Letter (June 9, 1982); John B. Kennedy, SEC Staff Letter (June 5, 1996); and Securities America Advisers Inc., SEC Staff Letter (Apr. 4, 1997)

The text of the amended Form ADV limits this relief to federally covered advisers who are registering or registered only with the SEC. As a result, state regulatory agencies may continue to require advisers registered with them to provide a balance sheet.

Effective Date of the Amended Rule

The effective date of the amended rule is November 5, 2003. However, advisers must comply with the amended rule by April 1, 2004, by ensuring that clients' assets are kept in accounts with qualified custodians and that each adviser has a reasonable belief that the qualified custodians are sending quarterly account statements directly to their advisory clients or to their independent representatives.

However, as an alternative, advisers may follow the requirements of sending quarterly statements so long as they undergo an annual surprise examination. Additionally, advisers to limited partnerships that are not currently subject to the annual audit requirement must ensure that those partnerships are prepared to undergo an annual audit if the adviser intends to rely on any exceptions to the amended rule.

Mr. Tarra is a Managing Principal with Financial Registrations, Inc., a compliance management consulting firm providing registration and compliance advisory services to securities broker/dealers and registered investment advisers. For more information on this topic or other compliance related matters, please contact:

Scott P. Tarra
Managing Principal
starra@financialreg.com

Financial Registrations, Inc.
25602 Alicia Parkway #107
Laguna Hills, CA 92653
www.financialregistrations.com

Toll-free (800) 641-1818
Direct (949) 770-6154
Fax (949) 770-6198