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IN THIS ISSUE

Custody: New SEC guidance creates more clarity for advisors

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I. Introduction

On February 21, 2017, the staff ("Staff") of the Division of Investment Management of the Securities and Exchange Commission ("SEC") released guidance (the "SEC Guidance") that provided more clarity on the topic of the "Custody Rule"[1] for independent SEC-registered investment advisors ("Advisors"). The SEC Guidance includes, as discussed in a later section: (i) a no-action letter (the "IAA Letter") to the Investment Adviser Association ("IAA"),[2] providing relief from part of the Custody Rule with respect to certain standing letters of authorization ("SLOAs") and similar arrangements, (ii) an update to Question II.4 of the Staff's Frequently Asked Questions about the Custody Rule ("FAQ II.4"),[3] which expands on prior guidance regarding transfers among multiple accounts of a single client, and (iii) a Guidance Update from the Division of Investment Management ("IM Guidance"),[4] detailing when certain custody agreement provisions may inadvertently cause an Advisor to have custody and providing a potential solution to that problem.

This white paper is designed to summarize the SEC Guidance and the Custody Rule and to outline concrete steps you can take to review, consider, and solve custody issues. For Advisors unfamiliar with the Custody Rule, the white paper begins in Section II with a review of the definition of *custody* and common arrangements deemed to give an Advisor custody. For Advisors familiar with the Custody Rule, please see Section III for the discussion of the SEC Guidance. Section IV of this white paper covers compliance requirements for Advisors that have custody.

II. Custody Rule overview

The Custody Rule has proved to be difficult to parse, and it leaves many Advisors uncertain if they would be deemed to have custody.[5] Most Advisors' clients' assets are held in accounts at broker-dealers and banks, but even so, the Advisor can still be deemed to have "custody" depending on the type of authority the Advisor has over the movement of assets from the account. In addition, whether there is custody can depend on client relationship documents,

[1] Rule 206(4)-2 under the U.S. Investment Advisers Act of 1940 ("Advisers Act").

[2] Investment Adviser Association, SEC Staff No-Action Letter (February 21, 2017).

[3] U.S. Securities and Exchange Commission, Question II.4, "Staff Responses to Questions About the Custody Rule," updated as of February 21, 2017 ("SEC FAQs").

[4] U.S. Securities and Exchange Commission Division of Investment Management, "Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority," IM Guidance Update (February 21, 2017).

[5] The SEC's Office of Compliance Inspections and Examinations ("OCIE") has at least twice warned Advisors about the possibility of having custody and not knowing it. First, in a Risk Alert from March 4, 2013, entitled "Significant Deficiencies Involving Adviser Custody and Safety of Client Assets" ("March 2013 Risk Alert"), the OCIE Staff cited a variety of "situations where an adviser failed to recognize that it has custody under the rule." Second, earlier this year, in a Risk Alert entitled, "The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers" ("February 2017 Risk Alert"), the Staff noted that Advisors continue to not "recognize that they may have custody as a result of certain authority over client accounts."

including advisory contracts, and on documents to which the Advisor is not a party, such as agreements between clients and certain custodians.

Custody is defined in the Custody Rule as "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them." This is a broad and technical definition that extends beyond the intuitive meaning of direct control and includes authority that may be indirect and conditional. The Custody Rule provides three examples of arrangements that constitute custody, outlined next.

Possession of client funds or securities

The Custody Rule states that custody includes "possession of client funds or securities" with certain exceptions. Typically, Advisors never have physical "possession" of securities. Most securities trades are not physical exchanges (e.g., handing over a paper stock certificate to another person in exchange for cash). Instead, most securities are permanently held by banks or central depositories like the Depository Trust and Clearing Corporation ("DTCC") and exchanged using a book-entry system.[6] But an Advisor may occasionally receive client assets, and unless the Advisor handles the situation carefully, it will be deemed to have custody and possibly to have violated the Custody Rule's requirement that client assets be maintained with a qualified custodian. For example, the Advisor's client might send the Advisor funds or securities by mistake. An Advisor that receives client securities or funds inadvertently will not be deemed to have custody if the Advisor returns the securities or funds *to the sender* within three business days of receipt. Note that the Custody Rule does *not* permit an Advisor who has inadvertently received client assets to forward the securities or funds to the qualified custodian,[7] except in certain very limited circumstances.[8]

An Advisor who opens an envelope in the mail to discover a client's check may be surprised but cannot be complacent. An Advisor taking possession of checks can, but does not always, result in custody. It depends on the particular check and what the Advisor does with it. If an Advisor receives a check from its client that is payable to a third party (such as a check payable to the custodian for deposit into the client's account), possessing that check is not deemed to be custody. But other scenarios involving an Advisor's receipt of checks are more complicated.[9]

Authorized or permitted to withdraw client funds or securities

The Custody Rule states that "custody" applies to "any arrangement (including general power of attorney) under which you are authorized or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian." An Advisor who has authority to disperse money to itself or third parties from a client's account is deemed to have custody. For example, this applies to an Advisor who has authority to deduct its fees from the client's account,[10] sign checks on a client's behalf, make transfers to other accounts not in the client's name, or provides a bill-paying service for clients. The form of authority is generally irrelevant for purposes of this test, including authority granted to the Advisor through a signed power of attorney, authority granted by an election made by the client in the brokerage account agreement or other agreement with the custodian, or a SLOA, as discussed in detail in Section III covering the SEC Guidance. Possession of the username and password to a client's custodial account is also considered custody, if such access to the account permits withdrawal or transfer of assets to an account not in the client's name.[11]

Most Advisors' clients' assets are held in accounts at broker-dealers and banks, but even so, the Advisor can still be deemed to have "custody" depending on the type of authority the Advisor has over the movement of assets from the account.

The type of authority available to an Advisor matters. Not every "authority" constitutes authority to "withdraw" client funds or securities. For example, an Advisor's authority to trade the client's account and have assets from the account to settle trades via "delivery vs. payment" is not considered

[6] However, certain investments in private offerings for clients may involve certificated securities, which may come into the Advisor's possession.

[7] SEC FAQs, Question II.1.

[8] An Advisor that receives a check (or in some cases stock certificates, dividends, or evidence of new debt) payable to the client from a class-action administrator distributing settlement proceeds or from a tax authority distributing a tax refund may, subject to certain conditions, forward the check to the custodian for deposit in the client's account. Investment Adviser Association, SEC Staff No-Action Letter (September 20, 2007).

[9] See Schwab's frequently asked questions about check deposits for a helpful review of different check scenarios (refer to the "Custody Rule" section of these FAQs). You may also access these via schwabadvisorcenter.com.

[10] But if fee deduction authority is the sole reason the Advisor has custody, then it need not disclose custody in its Form ADV and the annual surprise exam requirement (discussed in Section III of this white paper) does not apply. In contrast, deduction of advisory fees where the client instructs the custodian to determine the amount of the fee (as opposed to merely deducting the amount stated by the Advisor) and the custodian calculates the fee before deducting it and paying it to the Advisor is not considered custody. SEC FAQs, Question III.1.

[11] SEC FAQs, Question II.6.

to be custody. Similarly, an Advisor with authority to make transfers between two accounts held by the same client or to instruct a custodian to remit funds or securities to the client is generally not "custody" pursuant to Staff guidance, provided that the conditions in updated FAQ II.4 are met.[12]

Capacity that gives ownership or access to client funds or securities

The Custody Rule states that custody includes "[a]ny capacity…that gives you or your supervised person legal ownership of or access to client funds or securities."

Under this test, if the Advisor acts as a trustee of a trust, or as executor of a client's estate, and provides advisory services to the trust or estate, then the Advisor has custody. An Advisor also has custody if it acts as a general partner of a limited partnership, as managing member of a limited liability company, or in a comparable position for a pooled investment vehicle.

Case study

In 2013, the SEC brought an enforcement action against an Advisor that maintained blank letters of authorization that the firm filled out on its own (sometimes copying client signatures) when necessary to transfer client funds. In addition, according to the SEC, the Advisor held login information and passwords for outside accounts (e.g., third-party retirement and brokerage accounts) and authority to write checks on certain clients' behalf. These practices, according to the SEC, gave the Advisor custody of those client assets, but the Advisor had not, among other things, obtained an annual surprise examination to verify those assets, maintained adequate policies and procedures, or retained sufficient books and records, and the SEC brought an enforcement action against this Advisor for violating these requirements.[13]

III. SEC Guidance

Being deemed to have "custody" presents a number of challenges for Advisors. An Advisor that is deemed to have custody generally, unless qualifying for an exemption or applicable relief, must (i) confirm that custodians are "qualified," (ii) conduct "due inquiry" into whether the custodians are sending account statements to clients, (iii) in some cases notify clients of arrangements made with custodians, and (iv) hire an accounting firm to conduct an annual surprise exam. Advisors with custody also must update their compliance policies and procedures, provide proper Form ADV disclosures, and ensure they capture appropriate books and records regarding custody.

The requirements of the Custody Rule can make it more difficult or expensive for Advisors to offer their clients services that involve money movement, such as paying their clients' bills out of managed assets, making tuition payments or tax payments, making charitable contributions, and executing documents for or making required payments to private funds in connection with the private fund's subscriptions or capital calls. Advisors often want to offer these services, and many custodians offer platforms to enable Advisors to do so, but implementing these arrangements has been a source of frequent confusion and compliance deficiencies.[14]

In response to these concerns from Advisors, two years ago the IAA, working with Schwab and other custodians, began asking the Staff to provide the industry with clearer guidance on when it is or is not custody where an Advisor has authority to move money to third-party accounts. While those discussions were occurring, the SEC exam staff also began writing up Advisors for deficiencies in certain cases where the Advisor had authority to move money to *first*-party accounts (meaning to and from the same client's accounts). On February 21, 2017, the Staff responded to issues raised by the industry concerning both third-party and first-party money movement authority by issuing three different sets of regulatory guidance, discussed in detail next.

FAQs provided by Schwab and the IAA

Advisors may find helpful as a continuing reference on the SEC Guidance the Frequently Asked Questions published by Schwab and the IAA.

- From Schwab: "SEC Custody Rule 'No-Action' Letter and Additional Guidance—Frequently Asked Questions" (February 21, 2017)[15]
- From IAA: "Supplement to Frequently Asked Questions Regarding the SEC's Custody Rule and the February 21, 2017 SEC No-Action Letter Issued to the IAA and Updated SEC FAQ II.4" (February 21, 2017)[16]

Both Schwab and the IAA expect to update their respective Frequently Asked Questions as additional guidance emerges. These resources can also be accessed by visiting schwabadvisorcenter.com.

[12] See the discussion within Section III. SEC Guidance, Updated FAQ II.4.

[13] U.S. Securities and Exchange Commission, *In the Matter of GW & Wade, LLC*, Administrative Proceeding, No. 3-15589 (October 28, 2013).

[14] See OCIE's March 2013 Risk Alert and February 2017 Risk Alert.

[15] Schwab Advisor Services, "SEC Custody Rule 'No-Action' Letter and Additional Guidance–Frequently Asked Questions" (February 21, 2017).

[16] Investment Adviser Association, "Supplement to Frequently Asked Questions Regarding the SEC's Custody Rule and the February 21, 2017 SEC No-Action Letter Issued to the IAA and Updated SEC FAQ II.4" (February 21, 2017).

IAA, SEC no-action letter (February 21, 2017)

The IAA received a no-action letter clarifying when an Advisor has custody if it acts pursuant to a SLOA or other similar arrangement established by a client with a qualified custodian and authorizing the Advisor to transfer client assets to a third party. The no-action letter provided assurance that the Staff would not recommend enforcement action if an Advisor with a SLOA arrangement were to forego the annual surprise exam requirement of the Custody Rule, provided that the seven conditions detailed below are in place.

Although the IAA argued that an Advisor, relying only on a limited SLOA approved by the client and making a corresponding direction to the qualified custodian pursuant to a SLOA, was outside the definition of custody completely, the Staff disagreed and stated that a SLOA would constitute custody under the Custody Rule, but the Staff would not recommend an enforcement action if an Advisor did not obtain the annual surprise examination if:

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 Advisor, 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 Advisor 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 Advisor maintains records showing that the third party is not a related party of the Advisor or located at the same address as the Advisor.

7. The client's qualified custodian sends the client, in writing, an initial notice confirming the instruction and an annual notice reconfirming the instruction.

It's worth noting that six of the seven conditions necessitate an Advisor's reliance on the custodian, at least in part. Thus, Advisors will want to determine whether and how their custodians help them meet these conditions.[17]

There is no standardized format for a SLOA, so Advisors may continue to use their current authorization and documentation, as long as they are consistent with the Custody Rule. However, many custodians have particular forms they ask Advisors and their clients to use to facilitate orderly processing at the custodian, and if the Advisor desires to forego the annual surprise examination requirement in reliance on the IAA Letter, the SLOA and processes at the custodian must in substance meet the seven conditions listed previously.

The Staff recognized that it may take a certain period of time before Advisors and custodians will be able to revise their documentation and practices to conform to the IAA Letter. Although the Staff's IAA Letter did not expressly state how long, the IAA's request letter stated at least six months and in subsequent comments, members of the Staff have confirmed six months is the Staff's expectation, but a longer period might be reasonably justified by particular circumstances. Furthermore, members of the Staff have stated that Advisors are expected to be making good faith efforts to come into compliance during this period, as opposed to taking no action and then abandoning the existing SLOAs at the end of the six-month period. If an Advisor makes no good faith effort to conform SLOAs to the IAA Letter during these six months, then compliance deficiencies or other actions against the Advisor could result.

The IAA Letter also indicates that certain SLOAs might be structured to avoid the requirements of the Custody Rule altogether. The Staff stated as an example that "an arrangement that is structured so that the Advisor does not have discretion as to the amount, payee, or timing of transfers under a SLOA would not implicate the Custody Rule." Thus, arrangements that provide for payments made pursuant to a pre-established schedule, preset amounts, and designated payees could be structured to avoid the Custody Rule's requirements. Similarly, existing arrangements that require the Advisor to obtain client preauthorization before transferring funds or securities do not constitute custody and were not impacted by the Staff's relief. This makes sense because that type of authority essentially gives no discretion to the Advisor, so it is like a letter of instruction from the client to the custodian that the Advisor is simply transmitting on the client's behalf.

The Staff stated that Advisors that maintain custody of client assets pursuant to a SLOA, even if able to skip

[17] For what Schwab is doing, see Schwab Advisor Services "SEC 'No-Action' Relief Conditions and How Schwab Helps You Satisfy Them" (February 21, 2017), as well as the Schwab FAQs.

the annual surprise examination in reliance on the IAA Letter, should include those client assets in the Advisor's response to Item 9 of Part 1A of Form ADV in their annual ADV update amendment beginning on October 1, 2017. Practically speaking, because most Advisors follow a calendar year cycle to update their ADVs, this means that most Advisors will need to comply with this requirement in their annual updating amendment to be filed during the first quarter of 2018.

With the relief provided by the IAA Letter, Advisors that wish to offer their clients less paperwork by establishing SLOAs authorizing payment to third parties would still, at a minimum, need to ensure client assets are maintained with a qualified custodian, that clients are promptly notified of custodial arrangements if applicable, and have a reasonable basis to believe custodians are sending quarterly account statements to clients. However, so long as they comply with the terms of the IAA Letter, Advisors would be relieved from the requirement of retaining a public accounting firm to conduct a surprise examination annually with respect to those accounts. This should simplify, and reduce the cost of, compliance with the Custody Rule.

Updated FAQ II.4

In the second piece of the SEC Guidance, the Staff updated its FAQ II.4 on transfers between two accounts owned by the same client ("first-person transfers") at different or unaffiliated qualified custodians. Previously, the FAQ stated that an Advisor with authorization to make transfers between two accounts owned by the same client would not be deemed to have custody if the client has provided written authorization to the Advisor and a copy of the authorization is provided to the qualified custodian "specifying the client accounts maintained by the qualified custodian." Industry practice has varied on the level of specificity included in written authorizations, and an indication of authority to send money to any and all of a client's accounts without more documentation of the receiving accounts was customary. According to the IAA and industry reports, the SEC's examination staff began sending deficiency letters to Advisors, citing them for client authorizations that were not specific enough.

In the updated FAQ II.4, the Staff explains that "specifying" client accounts means "stat[ing] 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)." The authorization does not need to be provided to the receiving custodian. Additionally, updated FAQ II.4 provides that an Advisor'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" does not constitute custody and accordingly does not require specification of client accounts.

SEC Staff Responses to Questions About the Custody Rule (Updated FAQ II.4)

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.)

For most Advisors, the updated FAQ II.4 and its requirement that clients must list the sending and receiving account numbers impacts "first-party"[18] *wire* transfers. Account numbers are not needed for journal transfers between a client's accounts at a single custodian (or affiliated custodians) or for checks payable to the client and sent to the client's address of record. In addition, electronic ACH transfers already typically require listing the account numbers of the sending and receiving accounts. This leaves the Advisor with the following possibilities for first-party wires and their status under the Custody Rule:

First-party wire transfer initiated by Advisor	Custody?	Annual surprise exam required?
Receiving/destination account number is NOT supplied by account holder when authorization granted	Yes	Yes
Receiving/destination account number IS supplied by account holder when authorization granted	No	No

One way to think about how to synthesize the no-action relief on SLOAs for money movement authority to third-party accounts (the IAA Letter) and the clarification on money movement authority to first-party accounts (updated FAQ II.4) is as follows:

- Do you have standing (i.e., ongoing) authority to move money out of your client's account without getting your client's signature each time?
- If so, do you want or need to continue having this authority?
- If so, are the receiving accounts third-party accounts or are they first-party accounts?
- If third-party, you have custody and need to report those accounts on your Form ADV, Part 1A, Item 9. Consider whether you want or can take advantage of the relief under the IAA Letter when it comes to the annual surprise accountant's exam.
- If first-party, what method do you use to move money to your client's accounts? If an internal journal, by check to the client's address of record at the custodian, or by ACH electronic funds transfer, you likely do not need to do anything. If by wire, decide whether destination account information should be supplied by the account holder when authorization is granted to establish standing first-party wire instructions.

Reference the supplement to this white paper entitled "Standing Money Movement Authority and Custody Implications for Advisors" for further detail contained in a helpful decision tree format.

Look for future communications from Schwab

Many Advisors have first-party wire authority over their clients' accounts, which under some custodians' forms (including Schwab's current forms) is merged together with the same authority for checks and journals. Custodians may each be a little different in how this authority is included in their forms and what options they will make available to Advisors to deal with that existing authority in light of updated FAQ II.4. Schwab will be communicating options available for Advisors in the upcoming months. Advisors should check with their other custodians as well.

Informally, the Staff had indicated its expectation that Advisors and their custodians should have a reasonable time period to make the necessary adjustments, and the Staff has indicated that this means six to 12 months.[19]

IM Guidance Update

The third piece of guidance released by the Staff was the IM Guidance, in which the Staff announced that it takes the position that an Advisor can inadvertently have custody because of disbursement authority provided to the Advisor in the terms of a custody agreement between the Advisor's client and its custodian. To be clear, the IM Guidance was directed primarily at custodial agreements that provide, as their standard language, automatic disbursement authority to the Advisor. It was generally not directed at custodial agreements that have disbursement authority presented as an option that a client can choose to grant and/or confirm by checking a box or initialing an optional provision to make such authority apply.[20] But the IM Guidance puts the burden on Advisors if this authority is automatically included in the standard custodial agreement, even if the Advisor did not intend to have this authority and explicitly disclaimed it in the advisory agreement with its clients. This

[18] The limits of what constitutes a "first-party" transfer are expected to merit additional guidance from the SEC. For example, is a transfer from an individual account to a joint account with the individual's spouse a first-party transfer?

[19] See the discussion regarding the compliance transition period for implementing the conditions of the IAA Letter, which should also apply to FAQ II.4.

[20] Schwab's account agreements do not automatically confer this type of authority on an Advisor. They give the Advisor's clients the option to select whether their Advisor will have money movement authority.

problem is more often found in the custody agreements banks have with their institutional clients, and where many Advisors have limited, if any, influence or control over the terms of custody agreements. It may be difficult or practically impossible for the Advisor (who is not a party to such agreement) to have access to or receive a copy of the agreement to review it for the existence of authority conferring custody.

For custody agreements that automatically include disbursement authority and thus inadvertently confer custody on the Advisor, the Staff stated in the IM Guidance that the Advisor may fix the problem by sending a letter to the custodian that limits the Advisor's authority to "delivery versus payment" (i.e., trading authority) and disclaims the Advisor's authority notwithstanding the wording of the custodial agreement and "hav[ing] the client and custodian provide written consent to acknowledge the new arrangement."

"Inadvertent custody" vs. Intentional authority

Note that if you want and have the authority to move money out of your clients' accounts, it is not "inadvertent custody." For example, many custodians such as Schwab require the client to indicate on the account application or other form whether the client has granted money movement authority to the Advisor. This is intentional authority, and you have custody if it is a SLOA to move money to third-party accounts and should look to the IAA Letter to get relief from the surprise accountant's exam. If it is standing authority to move money to first-party accounts, follow FAQ II.4 and the relevant guidance to determine whether you have or can avoid custody.

IV. You have custody. Now what?

With the new SEC Staff clarifications, some Advisors may discover that they have custody for the first time. If you are deemed to have custody, you are subject to a number of requirements described generally within this section. Before reviewing these requirements, let's recap the SEC Guidance as background for when and how the requirements apply. First, SLOAs conforming to the seven conditions in the IAA Letter are custody, but the annual surprise examination is not required. Second, first-party money movement authority through wire transfers without supplying the receiving/destination account number is custody, but if conforming to updated FAQ II.4 is not custody. Third, standard custody agreements that have built-in automatic disbursement authority inadvertently give the Advisor custody, but the Advisor may avoid custody by disavowing the authority in writing and getting that confirmed by the client and the custodian.

Qualified custodian

If an Advisor has custody, client funds and securities must, with limited exceptions, be maintained with a "qualified custodian." A qualified custodian includes U.S. broker-dealers and banks, U.S.-registered futures commission merchants (but only with respect to client funds and securities related to futures activities), and foreign financial institutions that customarily hold client assets subject to certain conditions.[21]

Certain types of securities held on behalf of certain clients are exempt from the requirement to use a "qualified custodian." Mutual fund shares issued to investors may be held by the mutual fund's transfer agent in lieu of a qualified custodian. Similarly, certain privately offered securities may be held away from a qualified custodian, subject to conditions.

Qualified custodians need not be independent from the Advisor, but Advisors using an affiliated custodian must obtain an internal control report from an accounting firm registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB firm"). Additionally, unless the affiliated custodian is "operationally independent,"[22] the surprise "independent verification," described later, must be performed by an accounting firm registered with the PCAOB.

Notice requirement

Second, for those Advisors that choose to open up an account with a custodian on their client's behalf (meaning, unlike accounts at Schwab, the client does not sign the account agreement), the Custody Rule requires the Advisor to notify the client in writing of the custodian's name, address, and the manner in which the funds or securities are maintained. This notice must be made promptly when

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[21] For example, such institution must keep client assets in a separate account for the customer that is segregated from the institution's own assets. Advisors should have a "reasonable basis" for believing that a non-U.S. institution will provide a level of safety for client assets similar to that which would be provided by a "qualified custodian" in the United States.

[22] Rule 206(4)-2(d)(5) sets forth the test for operational independence.

the account is opened and promptly after any changes to such information are made. In addition, if the Advisor sends account statements to its client, it must include a statement urging the client to compare Advisor account statements with account statements of the custodian.

Account statements

Advisors that have custody must have a "reasonable belief" based on due inquiry that the qualified custodian sends account statements[23] to the relevant clients at least quarterly. The most common method of due inquiry is getting duplicate statements, but an Advisor could also satisfy the due inquiry requirement if the qualified custodian confirms in writing that it has sent account statements to the Advisor's clients each quarter.[24] The account statements must identify (i) the amount of funds and amount of each security at the end of each statement period and (ii) all transactions in the account during that period. A client may designate an independent representative to receive such notices and account statements. The independent representative for the Advisor's client (i) must be an agent for the client who by law or contract is obliged to act in the best interest of the client, (ii) cannot control, is not controlled by, and is not under common control with the Advisor, and (iii) cannot have had a material business relationship with the Advisor within the past two years.

If the Advisor or a related person is a general partner of a limited partnership (or managing member of a limited liability company), the account statements must be sent to each limited partner (or member or other beneficial owner). For Advisors that act as their own qualified custodian, there are certain additional requirements.

Independent verification (annual surprise exam)

The fourth requirement under the Custody Rule is to obtain an independent verification of client funds and securities by an independent public accountant. The independent verification must be done at least once per year, and at a time chosen by the accountant, without prior notice. This is also known as the annual surprise exam. The engagement of the independent public accountant must be done pursuant to a written agreement, and such agreement must (i) provide for the first examination to occur no later than six months (following the engagement), (ii) require the accountant to file a certificate on Form ADV-E within 120 days of the time chosen by the accountant, stating that the accountant has examined the funds and securities and describing the nature and extent of the examination, and (iii) provide that upon finding any material discrepancies during the course of the examination, the accountant must notify the SEC within one business day and upon resignation, dismissal, or termination of the accountant's engagement, the accountant must file Form ADV-E within four business days. With the definition of custody sometimes difficult to apply, if an Advisor fails to recognize that it has custody with respect to a client account for which there is no exception to the surprise exam requirement, the Advisor could easily fail to include all required accounts within the scope of the annual surprise exam. The SEC has gone beyond citing this as a deficiency in inspections and has taken enforcement action against Advisors for this compliance failure.[25]

As noted previously, an Advisor can forego the surprise exam if it has custody (i) solely as a consequence of its authority to make withdrawals from client accounts to pay its advisory fees, (ii) with respect to SLOAs conforming to the IAA Letter, as discussed in Section III of this paper, or (iii) solely because a related person serves as the qualified custodian but is operationally independent from the Advisor (although it must still obtain the internal control report).

With respect to certain private funds, Advisors may provide fund investors with financial statements of the fund audited in accordance with GAAP in lieu of obtaining the annual surprise exam, account statement delivery, and custody notices.[26]

Policies and procedures

Under Advisers Act Rule 206(4)-7, an Advisor is required to adopt and implement policies and procedures reasonably designed to prevent violation, by the Advisor and its supervised persons, of the Advisers Act and the rules thereunder. In 2009, the SEC provided guidance on compliance policies and procedures related to custody.[27] Although Advisors with custody must have appropriate custody procedures, the SEC's guidance did not say what particular procedures are appropriate for any particular Advisor.

Among the procedures recommended are (i) background checks on employees with access to client assets, (ii) a two-signature requirement for disbursement authorization,

[23] Electronic delivery complying with SEC interpretive guidance is permissible.

[24] Schwab makes available an alert on schwabadvisorcenter.com for this purpose.

[25] See, e.g., U.S. Securities and Exchange Commission, *In the Matter of Morgan Stanley Smith Barney, LLC,* Administrative Proceeding, No. 3-17773 (January 13, 2017). The SEC's order found that Morgan Stanley failed to comply with the annual surprise custody examination requirements for two consecutive years when it did not provide its independent public accountant with an accurate or complete list of client funds and securities for examination.

[26] This "audit method" involves (i) the fund undergoing an annual audit by an independent PCAOB firm and (ii) distributing to investors audited GAAP annual financial statements within 120 days after the end of the pool's fiscal year (180 days for fund-of-funds). This replaces the custody notice requirement, account statement requirement, and surprise examination requirement. Advisors need to remember, however, to conduct a final audit on a liquidated pooled investment vehicle to comply with the rule in this circumstance.

[27] Custody of Funds or Securities of Clients by Investment Advisers, Advisers Act Release No. 2968 (December 30, 2009).

(iii) for Advisors with custody by virtue of their authority to deduct fees and expenses from client accounts, procedures to ensure the fee is accurately calculated and processed, reconciled with assets under management as reflected on statements of the custodian, and in accordance with advisory contracts and disclosures, (iv) procedures regarding the relationship with custodians, such as how the Advisor establishes a reasonable belief that the custodian is sending required account statements,[28] and (v) periodic testing of reconciliation of account statements and account information between Advisor and custodian.

Form ADV disclosure

Form ADV, Part 1A, Items 9A and B require information about (i) whether the Advisor or related person has custody of client assets, (ii) the total U.S. dollar amount of assets held in custody, and (iii) the number of clients for whose accounts the Advisor or related person has custody. Item 9C requires (i) verification of the Advisor's compliance with the account statement and audit or surprise exam or internal control report requirements and (ii) identification of the auditor used for the audit, surprise exam, or internal control report. Item 9E requires disclosure of the commencement date of the surprise exam. Form ADV, Part 1 disclosures related to custody are used by the SEC when identifying exam candidates through risk-based analysis, so having custody could result in more frequent examinations.

In Form ADV, Part 2A (the brochure), Item 15 requires the Advisor to explain, if a qualified custodian sends account statements to clients, that clients will receive and should carefully review such account statements. If clients also receive account statements directly from the Advisor, the Advisor must include a statement urging clients to compare account statements sent by the Advisor with those sent by the qualified custodian. If an Advisor or client uses a non-U.S. custodian, the Advisor should disclose material risks of the non-U.S. custodian. Some Advisors include additional disclosure in Item 15 including, where relevant, risks and conflicts associated with custody arrangements.

In 2016, the SEC adopted final rules amending Form ADV.[29] In the final rules, the SEC amended Section 9.C.3 of Schedule D that requires each Advisor to provide the PCAOB-assigned number of the independent public accountant used to perform the surprise examination. The final rules also clarified the language of Section 9.C.6 of Schedule D, which requires the Advisor to report whether all reports prepared by the independent public accountant since the last annual updating amendment contained unqualified opinions (previously, the language of Section 9.C.6 asked whether "any" report contained an unqualified opinion).

Books and records

Advisers Act Rule 204-2(b) requires Advisors with custody or possession of client funds to keep records of (i) all purchases, sales, receipts, and deliveries of client securities or funds, with a separate ledger account for each client, (ii) all confirmations of transactions affected by or for the account of clients, (iii) each security in which a client has a position, showing the name of each client having any interest, the amount of interest of each client, and the location of each security, and (iv) a memorandum providing a basis for establishing the operational independence of any related person(s).

Reference the road map to the Custody Rule on the next page to see how the compliance requirements discussed within this section (Section IV. You have custody. Now what?) apply to common arrangements that are deemed to give an Advisor custody.

V. Conclusion

The SEC Guidance provides welcome clarity for Advisors and custodians, and it may make it easier and less expensive for some Advisors to offer additional services to their clients. Given that custody arrangements continue to be a priority for the SEC and the Staff, the SEC Guidance also offers an opportunity for Advisors to review their custody arrangements with clients and custodians to avoid the potential pitfalls with the Custody Rule.

[28] The SEC also suggested that, if the custodian is a related person of the Advisor, the Advisor implement procedures to ensure the Advisor remains operationally independent of related person custodian.

[29] Form ADV and Investment Advisers Act Rules, Advisers Act Release No. 4509 (August 25, 2016).

The following chart shows the compliance requirements discussed within Section IV of this white paper as they apply to common arrangements that are deemed to give an Advisor custody.

A road map to the Custody Rule

Do I have custody?				
Arrangements that are "custody"[1]		**Fee deduction** Am I authorized to deduct my fees from a client's account?	**Disbursement authority** Do I have authority or permission to withdraw funds or securities from a client's account?	**Trustee; private fund sponsor** Do I (or a supervised person) serve in a capacity that gives me legal ownership or access to client funds or securities?
Examples		▪ Client confers fee payment authority in the advisory agreement or in the custodian's account application or separate limited power of attorney ("LPOA")	▪ Full (general) power of attorney ▪ Check-writing authority ▪ SLOA for disbursements to designated third parties ▪ First-party wire transfer authority if client does not supply destination account number[2]	▪ Trustee of client's trust[3] ▪ General partner of limited partnership, managing member of LLC, or comparable position for another type of pooled investment vehicle
What do I have to do to comply?		⇩	⇩	⇩
Core Custody Rule compliance requirements	**Qualified custodian** Use a qualified custodian to maintain client funds and securities.	✓	✓	✓
	Account statements Reasonable belief after due inquiry that qualified custodian sends account statements to clients.	✓	✓	✓[4]
	Independent verification Annual surprise examination by independent public accountant[5] to verify client assets.	Not applicable[6]	✓[7]	✓[4]
Possible additional Custody Rule compliance requirements	**Notice to clients** Of custodian's name, address, and manner in which assets are held (in client's name or your name as agent).	Did you open the account with the custodian on the client's behalf (client did not sign account agreement)? Yes ⇨ ✓[4] No ⇨ Not applicable		
	Internal control report Annual report by a PCAOB-registered independent public accountant on the custodian's safeguarding and related internal controls.	Do you or a related person serve as the qualified custodian? Yes ⇨ ✓ No ⇨ Not applicable		
Other compliance requirements	**ADV disclosure** Item 9 of Part 1 requires disclosure of whether you have custody and if so, describe why. Item 15 of Part 2A requires disclosure to clients that they should carefully review account statements sent to them by the qualified custodian.	Part 1, Item 9: Not applicable Part 2A, Item 15:✓	✓	✓
	Custody policies and procedures Rule 206(4)-7 requires Advisors with custody to adopt written policies and procedures designed to prevent Custody Rule violations.	✓	✓	✓

[1] The arrangements shown are the most common ones giving Advisors custody, but the list is not exclusive and other arrangements may also result in an Advisor having custody.
[2] Under updated SEC FAQ II.4, Advisor authority to initiate transfers from the client's account to another account of the client ("first-party" transfers) are not custody if the client specifies the account number of the client's destination account. This generally already occurs with electronic ACH transfers, but not wire transfers. Advisor-directed disbursements to the client via checks sent to the client's address of record are not custody, and journals between two accounts of the client at the same custodian are also not custody. Note that the limits of what constitutes a "first-party" transfer are not entirely clear and may merit additional guidance from the SEC staff.
[3] There is a very narrow exception for certain personal relationships.
[4] This requirement does not apply if the fund is annually audited by a PCAOB-registered independent public accountant and distributes its audited financial statements to beneficial owners.
[5] If you are, or a related person is, the qualified custodian, the independent public accountant must be PCAOB-registered.
[6] So long as the qualified custodian is not a related person or, if they are, they are operationally independent of you.
[7] The independent verification (i.e., annual surprise exam) requirement does not apply to third-party disbursement authority in SLOAs if the seven conditions of the February 2017 IAA SEC no-action letter are satisfied.

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