Anchin Alert

Anchin, Block & Anchin LLP
Accountants and Advisors

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SEC Clarifies Three Confusing Situations For The Custody Rule

The SEC's Custody Rule continues to be a headache for registered investment advisers. The conditions are so unclear, it's easy to inadvertently trigger custody rule violations. To help advisers adjust, the SEC recently issued clarification for three confusing situations under the rule.

1 - Distributing Funds/Securities To A Third Party
On February 21st, 2017 the SEC responded to an inquiry from the Investment Adviser Association. The Association wanted the SEC's opinion on what happens when a client grants their adviser the power to distribute assets from a custodian to a third party.

The Investment Adviser Association thought this would not be deemed as custody under the rule because the adviser only acts according to the strict instructions of the client.

However, the SEC disagreed. They believe that any time an adviser has the ability to dispose of client funds or securities, for any reason besides authorized trading, they have access to client funds and thus fall under the definition of custody.

When The SEC Will Not Recommend Enforcement
Despite the SEC's strict definition, they laid out conditions for situations where they would not recommend enforcement, even if the adviser technically has custody but is not otherwise complying with the rule (e.g. timely issuance of GAAP basis financial statements or subjecting themselves to advance surprise examinations). According to the SEC, they will not recommend enforcement 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 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.

2 - Trouble With Custodial Agreements

An SEC guidance update identified another trouble area: when the client signs a custodial agreement that gives the adviser more authority than they realize, like the ability to receive client assets or make decisions on behalf of the client.

These conditions give the adviser unintended custody which they might not realize it if they don't carefully read and understand the custodial agreement.

The SEC suggests that advisers avoid this situation, by drafting a letter to the custodian requesting the adviser's authority be limited to "delivery versus payment," despite terms of the custodial agreement.

3 - Transfers Between Client Accounts

In a recent staff response, the SEC cleared up one more confusing situation: when an adviser has authority to transfer assets between a client's accounts at a custodian or between two different qualified custodians. The SEC says this does not establish custody so long as the client gave the adviser written permission to transfer securities and funds between their accounts.

To stay compliant, advisers must be cognizant of when the Custody Rule applies. We will keep you updated with the latest SEC notices as they clarify applications of this complicated rule.

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