SHARTSIS FRIESE LLP
INVESTMENT FUNDS & ADVISERS REGULATORY ALERT

Inadvertent Custody

The SEC recently clarified when an investment adviser will be deemed to have custody of client assets in certain separate account situations, through a No-Action Letter and IM Guidance Update.

In the recent Investment Advisers Association No-Action Letter, the SEC staff stated that an adviser is deemed to have custody of a client's account under Rule 206(4)-2 if the client has provided to the client's custodian a standing letter of authorization or instruction (SLOA) or other similar arrangement that allows the adviser to direct the disbursement of funds to one or more third parties designated by the client. As a consequence of this deemed custody, SEC-registered advisers will need to amend Item 9 of Form ADV to include accounts that are subject to SLOAs and may need to arrange for a surprise custody examination under Rule 206(4)-2. The ADV change is required at the next annual update after October 1, 2017 (for most advisers, early 2018).

The SEC staff stated, however, that it would not recommend enforcement action if an adviser that is deemed to have custody under an SLOA does not obtain the surprise custody examination if the SLOA meets seven specific requirements, including, among other things, that the SLOA is signed by the client, the custodian verifies the instruction and notifies the client of each transfer, and the adviser maintains records showing that third party is not a related party of the adviser. Several of the requirements are duties the custodian of the account must agree to perform, so advance planning is essential. Advisers that disburse client funds under an SLOA should review all seven of these conditions carefully and modify their documents accordingly to avoid a surprise custody examination requirement.

Consistent with the above, in IM Guidance Update No. 2017-01, the SEC Division of Investment Management warned advisers that they may inadvertently have custody of client assets if language in agreements between their clients and their clients' custodians authorizes the adviser to instruct the custodian to disburse funds or securities, even if the adviser is prohibited from doing so in its agreements with clients.

If you have any questions or comments regarding custody issues, please contact one of the attorneys in the Investment Funds & Advisers Group at Shartsis Friese LLP: John Broadhurst, Geoff Haynes, Chris Rupright, Carolyn Reiser, Neil Koren, Jim Frolik, Christina Hamilton, Joan Grant, Lyn Roberts, Anthony Caldwell, David Suozzi or Kathryn Miller.