# Amendments to SEC Custody Rule 206(4)-2 Will Affect All Investment Advisers

*By Paul B. Uhlenhop*

## I. Introduction

The SEC has promulgated final amendments to its investment adviser custody Rule 206(4)-2.[1] The effective date of the amended rule is November 5, 2003, but advisers have until April 1, 2004 to change their procedures, policies and client arrangements.[2] The amended rule has a number of key changes discussed in further detail below including the following:

- *Deduction of client fees from the client account will constitute custody* and advisers will be required to comply with the new custody provisions discussed below.
- The rules codify a number of staff interpretations regarding inadvertent receipt of funds, checks and securities.
- The amendments provide two methodologies for compliance with the custody provisions.
- The amendments clarify the custody treatment of privately placed securities and mutual funds.

The revocation of the no-action letters that permitted client fee deduction without complying with the custody provisions of old Rule 206(4)-2 means that most advisers will have custody. Fortunately, the Amending Release provides that even though a client fee deduction is technical custody the adviser may continue to deduct fees if an adviser complies with the other provisions of the new custody rule in subsection (a). The new rule will require all advisers to "maintain" all customer funds and assets at all times with a "qualified custodian." Further, customers must receive quarterly account statements either from the adviser or from the custodian. If quarterly account statements are sent by the adviser, the adviser must be subject to a surprise audit. The expanded definition of "custody" and the new requirements for "qualified custodian" and other statements to customers and audits under certain circumstances are discussed below.

## II. Custody As Defined By The Amended Rule

The amended Rule 206(4)-2(c)(1) defines "custody" as follows:

> "Custody" means holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. Custody includes – (i) Possession of client funds or securities, (but not of checks drawn by clients and made payable to third parties,) unless you receive them inadvertently and you return them to the sender promptly but in any case within three business days of receiving them;
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> (ii) Any arrangement (including a 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; and
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> (iii) Any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives you or your supervised person legal ownership of or access to client funds or securities.[3]

With respect to possession in item (i), the SEC's Amending Release provides that any possession, *even temporarily* of client funds or securities constitutes custody. If securities or funds are inadvertently received by the adviser, the amended rule permits return of client funds or securities as long as the funds or securities are *returned to the client* within three business days of receiving them. The rule specifically does not allow advisers to forward clients' funds or securities to a custodian or elsewhere.[4] This is particularly difficult, for example, when the adviser has an elderly individual who asks the adviser to transmit a client's securities from a lock box to a custodian. The best practice is for an adviser to assist the client by providing envelopes addressed to the custodian, with postage, and even assisting the client with a cover letter addressed to the custodian.[5] Advisers may meet with clients to assist the client in forwarding funds or securities to a custodian. If the adviser takes the securities into possession even temporarily, the adviser may violate the rule even though it complies with subsection (a) because all client funds and securities would not be maintained at a "qualified custodian," as discussed below in Sections III and VI.

With respect to checks, the Amending Release clarifies an area that SEC inspection staff had taken different positions in the past. An adviser's possession of a check drawn by a client and made payable to a third party is not possession of client funds.[6] The Amending Release in footnote 4 makes clear that access and custody could arise through an affiliate of an adviser if the adviser has access.[7] However, if an affiliate is a "qualified custodian," the adviser would not have access to funds and securities maintained at the qualified custodian.[8]

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Item (ii) provides that if an adviser has authority to withdraw funds or securities from a customer's account, the adviser has custody.[9] The Amending Release specifically states that if a client has authority to deduct advisory fees or other expenses directly from a client's account, the adviser has custody.[10] Further, the Amending Release states that the staff has specifically withdrawn its prior no-action letters with respect to fee deduction.[11] Although an adviser will have custody, an adviser apparently is still permitted to deduct its advisory fees with client written consent by direction to a "qualified custodian" holding customer assets provided the adviser complies with the provisions discussed below in Section III.[12] If the adviser has a power of attorney to sign checks, is on a joint account with the client, can sign checks, or has wire transfer authority or similar authority, the adviser also has custody and would not be able to comply with the custody rule.

Item (iii) of the examples provides that legal capacity will result in legal custody. For example, a general partner of a limited partnership, a managing member of a limited liability company, a trustee of a trust or a manager of any similar type of investment pool under the rule constitutes legal custody. This means that if an adviser is a managing member of an investment pool or the trustee of an investment pool or a general partner of a limited partnership or any similar pooled investment arrangement, the adviser will be deemed to have custody as a matter of law unless the pool's assets are held at a "qualified custodian" and the other requirements of subsection (a) of the rule discussed in Section III are observed. Footnote 15 of the Amending Release provides an exception where, because of family or personal relationship with a decedent beneficiary or grantor an employee of the adviser serves as trustee, conservatorship or administrator. This brief footnote is not particularly clear about whether it applies or not where the employee's investment adviser also acts as investment adviser to the trust or conservatorship or administrator.[13] Based on past positions of the staff, it probably does apply if the investment adviser receives any sort of compensation for managing the assets.

As discussed below, advisers have various alternatives by which they can comply with the requirements of the amended rule.

**III. Custody: Alternative Methods of Compliance**

A. Alternative I

*1. Securities and Funds Held at "Qualified Custodian"*

Under the first alternative, as also under the second alternative discussed below in Section III.B., all client funds and securities must be maintained by one or more "qualified custodians" in:

- A separate account for each client under the client's name;
- In accounts that contain only client funds and securities under the adviser's name as agent or trustee for the clients.[14]

The adviser may not have possession of, access to, or legal entitlement of client funds and securities because all funds and securities must at all times be maintained at a "qualified custodian." However, as noted above, footnote 8 states that checks payable to the adviser for payment of advisory or similar fees or expenses do not represent client funds, but a check made payable to the adviser to pass on to a custodian or to a third party would constitute client funds that need to be held by a "qualified custodian."[15]

A "qualified custodian" is defined in Rule 206(4)-2 as:

- A bank or a savings association that has deposits insured under the Federal Deposit Insurance Act; or
- A registered broker-dealer; or
- A futures commission merchant holding client funds and security futures or other securities incidental to transactions for futures and options on futures; or
- A foreign financial institution that customarily holds financial assets for customers provided the assets are kept in segregated accounts separate from proprietary assets. [16]

Registered broker-dealers or banks are "qualified custodians" under the amended rule and, if they are also an investment adviser, may custody their own clients' funds and securities.[17]

Each adviser that opens an account with a "qualified custodian," either in its own name on behalf of clients or in the client's own name, must notify the client in writing of the custodian's name, address and the manner in which the funds or securities are maintained when such account is opened and also following any changes with respect to the custodian for the account.[18]

*2. Account Statements From Qualified Custodians to Clients*

The adviser must have a reasonable basis to believe that the "qualified custodian" sends account statements at least quarterly directly to each of the adviser's clients for which it maintains funds or securities. The account statements must identify the amount of funds and each security in the account at the

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end of the period and set forth all transactions in the period. Many investment advisers will wish to obtain a representation or agreement from the "qualified custodian" that monthly or quarterly account statements will be sent to clients identifying the amount of funds and securities at the end of each period and setting forth all of the transactions.

If the adviser is a general partner of a limited partnership or managing member of a limited liability company or has a similar position with any type of investment pool vehicle, the *account statements* must be sent by the custodian *to each participant in the pool.*[20] However, there is an exception from this requirement if the pool is audited on an annual basis and copies of that and certain other information are sent to pool participants within 120 days of the pool's fiscal year end.[21] An adviser that provides investment services to trusts must also ensure that account statements are delivered to the trustees, co-trustees, beneficiaries and grantors or an independent representative if the adviser or employee acts as trustee or co-trustee.

*3. Independent Representative*

A client may designate an independent representative as defined in the rule to receive on behalf of the client notices and account statements that are required. "Independent representative" means the following:

"Independent representative" means a person that:

> (i) Acts as agent for an advisory client, including in the case of a pooled investment vehicle, for limited partners of a limited partnership (or members of a limited liability company, or other beneficial owners of another type of pooled investment vehicle) and by law or contract is obliged to act in the best interest of the advisory client or the limited partners (or members, or other beneficial owners);
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> (ii) Does not control, is not controlled by, and is not under common control with you [the adviser]; and
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> (iii) Does not have, and has not had within the past two years, a material business relationship with you.[22]

In many cases, wealthy clients who travel or do not have investment sophistication rely on lawyers, accountants and others to review client notices and account statements. This practical provision of the independent representative will facilitate and accommodate clients.

*4. Commentary on Alternative I*

Most custodians currently send account statements at least quarterly. In such case, the adviser under the amended rule will need to make arrangements with custodians to make certain that statements are sent at least quarterly. However, in some cases the adviser itself sends account statements to clients. In such case, the adviser may wish to use Alternative II, which permits the adviser to send statements directly to the client but which also has a number of aspects similar to the old Rule 206(4)-2 requirements if an adviser has custody.

B. Alternative II

*1. Qualified Custodians for Client Funds and Securities*

The second alternative has the same requirement as Alternative I for a "qualified custodian" and notice to clients about qualified custodians. It should be noted that the Amending Release permits *but does not require* an omnibus account with a "qualified custodian" under Alternative II. An omnibus account is an account in which funds and securities are held at a "qualified custodian" in the name of the investment adviser as agent for the exclusive benefit and interest of its clients. However, the names and addresses of clients and individual holdings are not provided to the qualified custodian.[23] Under Alternative II, an adviser need not use an omnibus account at a "qualified custodian" but may elect to have a "qualified custodian" hold client funds and securities in the names of individual account holders. The investment adviser must be certain that an omnibus account held in the name of the investment adviser as agent must be for the exclusive benefit and interest of its clients. More importantly, an investment adviser as a fiduciary should obtain from an omnibus qualified custodian an agreement similar to the one obtained for broker-dealer special reserve accounts.[24] Rule 15c3-3(f) requires each bank to agree that the bank was informed that all cash and qualified securities deposited in the account are being held by the bank for the exclusive benefit of customers of the broker-dealer and are being kept separate from any other accounts maintained by the broker-dealer with the bank and provides that the cash and/or qualified securities shall at no time be used directly or indirectly as security for a loan to the broker-dealer by the bank and shall be subject to no right, charge, security interest, lien or claim of any kind in favor of the bank or any person claiming through the bank. It is recommended that investment advisers obtain a similar letter agreement from any qualified custodian holding an omnibus account for an investment adviser's clients' funds and securities.

*2. Account Statements from Adviser to Clients*

Under the second alternative, the adviser may send (in lieu of the custodian sending) quarterly account statements provided they are sent directly to each client for which the adviser has custody of funds or securities, identifying the funds and securities of which the adviser has custody at the end of the period and setting forth all transactions during the period.[25]

*3. Surprise Audit*

Under this second alternative, however, there are *additional requirements.* Like the old custody rule, an independent public accountant must verify by actual examination and surprise audit all funds and

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securities at least once during each calendar year at a time chosen by the accountant that is irregular from year to year.[26] Furthermore, the accountant must file a certificate on Form ADV E with the SEC within thirty days after completion of the surprise examination stating that the accountant has examined the funds and securities of the adviser and specifying the nature and the extent of the examination by the independent public accountant. Further, the independent public accountant, if it finds any material discrepancies during the examination, must notify the Commission within one business day by fax or electronic mail following by first class mail.[27] Footnote 33 of the Amending Release provides that the audit must be in accordance as follows:

- The Audit and Accounting Guide for Audits of Investment Companies, §11.12(202).
- The statement of SEC describing nature of the examination to be made of all funds and securities held by investment advisers and the content and related accountant's certificate IA Release No. 201, 31 F.R. 7821 (May 26, 1966).[28]

Audited financial statements for an investment adviser operating offshore may be prepared in accordance with the International Accounting Statements if funds or securities are held in custody offshore.[29]

*4. Commentary on Alternative II*

Alternative II presents an alternative that many advisers may find attractive although it involves the cost of a surprise audit. A number of advisers at the present time operate under and comply with the old custody rule by having a surprise audit and sending quarterly statements from the adviser to its clients. Some advisers follow this alternative because they do not wish to disclose names and addresses of their clients to a qualified custodian that is a competing institution. In other cases, the custody audit alternative has been followed by advisers to avoid inadvertent custody and to provide the convenience of handling certain customer funds and securities. Under the amended rule, an adviser will no longer be able to avoid inadvertent custody by following the audit provisions of the old rule. However, as noted above, the Amending Release specifically permits investment advisers to hold client funds and securities with a "qualified custodian" in an omnibus account.[30]

C. Combination of Alternative I and Alternative II

The Amending Release also provides for a combination of Alternative I and Alternative II. Footnote 33 of the Amending Release specifically provides that a "qualified custodian" may deliver account statements directly to some, but not all, of the adviser's clients provided the adviser delivers quarterly statements to the remaining clients.[31] However, the footnote notes that if an adviser selects this alternative there would have to be a surprise audit meeting the requirements of Alternative II with respect to funds and securities for clients to whom the adviser directly sends statements.

**IV. Special Rules and Exceptions**

A. Shares in Mutual Funds

In lieu of a "qualified custodian," mutual funds may be held with a transfer agent.[32] The transfer agent must send the statements directly to the client and comply with the other provisions dealing with custody.[33]

B. Privately Offered Securities

If an adviser holds privately placed securities that meet certain conditions, they are excepted from the custody provisions. The privately placed securities must meet the following requirements:

- They must be acquired from the issuer in a transaction or chain of transactions not involving any public offering.
- They must be uncertified and ownership recorded only on the books of the issuer or its transfer agent in the name of the client.
- The securities are transferable only on the consent of the issuers or alternatively holders of outstanding securities.[34]

Although the rule itself states that the securities are transferable only on the consent of the issuer or alternatively holders of the outstanding securities, footnote 21 indicates that the specific number or percentage of securities' holders need not be unanimous but only the amount required under the applicable agreement or otherwise by law.[35] The privately placed securities exception does not apply to securities held for the account of a limited partnership or other type of pool vehicle unless the pooled vehicle is audited and the annual audited financial statements are distributed within 120 days of the end of its fiscal year to all participating members of the pool or other beneficial owners.[36]

C. Registered Investment Companies

The custody rule does not apply with respect to the account of an investment company registered under the Investment Company Act of 1940. This is because there is substantive regulation of such activities outside of the Investment Advisers Act.[37]

**V. Form ADV Changes**

The Amending Release also amends Form ADV. The SEC eliminated the requirement in Part II, item 14 of Form ADV that advisers with custody including ADV Part II or its brochure or a balance sheet audited by an independent public accountant.[37] In addition, firms that have previously stated that they do not have custody in Item 9 of ADV by checking the box "no" may continue to do so, *but only if the adviser has custody solely because it deducts fees from client accounts.*[39]

**VI. The Possible Unstated Trap For The Unwary in The Amended Rule**

As discussed above, the amended rules' definition of "custody" is very broad and codifies a number of prior staff interpretations. The amended rule specifically states that a registered adviser is engaged "in a deceptive, manipulative act, practice

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or course of business" within the meaning of Section 206(4) if it has "custody of a client's funds or securities unless" and then it sets forth a number of requirements in subsection (a). On its face, the rule would lead one to believe that if an adviser complies with the provisions of subsection (a), it will not violate the rule even if the adviser has custody within the new meaning of the defined term "custody." However, a very different interpretation is possible and will likely be the SEC's staff interpretation. The different interpretation in essence seems to be that if an adviser has "custody" by reason of *temporary possession* of client funds or assets, then the adviser is in violation of the amended rule because all client assets and funds would not be "maintained" at a "qualified custodian." Nowhere in the Amending Release does it state that temporary physical possession means that a qualified custodian will not be maintaining client funds or securities. Nowhere does the Amending Release explicitly explain this result although it could be inferred. This interpretation is even more confusing because even though the deduction of fees by an adviser results in custody, an adviser does not violate the rule if it complies with subsection (a).[40] Likewise, with respect to the definition of "custody" in subsection (c)(1)(iii), the Amending Release is clear that custody by capacity, such as a general partner of a limited partnership or trustee of a trust, would not violate the rule if all of the provisions of subsection (a) are otherwise followed. The Amending Release takes a similar position with respect to custody by legal right in subsection (c)(1)(ii). If an adviser has deemed custody by reason of deduction of fees or deemed custody by reason of (c)(1)(ii) or (iii), why does compliance with subsection (a) not work for deemed custody by physical possession within the meaning of (c)(1)(i) of the rule? The explanation for this seemingly contradictory position is that temporary physical possession of customer funds or securities means that not all customer funds and assets would be "maintained" at a qualified custodian. Although this emerging interpretation may be good policy, the amended rule's distinction between custody under example (i) (physical possession) and examples (ii) and (iii) (legal access or legal capacity) will be very confusing to clients and to attorneys. The SEC staff would be well advised to promptly issue a clarifying release to clear up this critical point and the inconsistent treatment.

**VII. The Questionable Legal Basis For Custody Regulation Under The Anti-Fraud Provisions**

Rule 206(4)-2 is promulgated under Section 206(4),[41] which permits the SEC to promulgate regulations that define and describe means reasonably designed to prevent fraudulent, deceptive or manipulative practices in the course of business. If an adviser has custody, the custody is in and of itself certainly not manipulative or fraudulent and whether custody is itself, without other conduct, deceptive, is very questionable. Thus, the SEC authority to promulgate the custody rule under Section 206(4) is somewhat dubious. It is obvious that the SEC has promulgated the rule under Section 206(4) because it has no other authority under the Investment Advisers Act to promulgate such a rule (other than possibly under Section 204[42] the books and records section). However, to date, the Commission's authority has not been seriously challenged, although it has been questioned from time to time.

**VIII. Summary and Conclusion**

Although the amended rule is somewhat complex, confusing and inconsistent, it simplifies a number of confusing former staff interpretations and no-action letters regarding custody. It sets forth relatively clear rules in a number of areas, such as inadvertent receipt of funds and securities, third party checks, and a number of other situations involving pooled vehicles, trusts, family partnerships and similar arrangements. In the past, the staff, particularly the examination staff, has taken different views on these issues.

With respect to fee and expense deduction, the prior SEC staff no-action letters always stated that although a no-action position was being granted, the adviser in fact had custody. While on the face of it, the revocation of the prior no-action letters affects numerous investment advisers, the alternatives presented by the rule, including the mixed alternative, provide some flexibility to most investment advisers.

Unfortunately, the Amending Release does not discuss that anything defined as possession of client funds and securities in subsection (c)(1)(i) would violate the rule because all client funds and securities would not be *physically maintained* at a qualified custodian as required by subsection (a) of the rule. However, custody by reason of (c)(1)(ii) or (iii) would not violate the rule if the adviser otherwise complies with subsection (a).

Compliance with the new custody model will take some planning and compliance. The first project is for an investment adviser to survey how customer funds and securities are held and the procedures of its custodians with respect to sending account statements to clients and the information contained in such account statements. This should not be too difficult because most investment advisers currently have all of their customers' funds and securities at qualified custodians that send quarterly statements directly to the clients with the required information when a client opens an account at an adviser. The adviser will need compliance procedures to verify custody and the statements to be sent by the custodian.

For advisers who do not prefer to have a custodian have the names and addresses of its clients, or for other reasons prefer to send quarterly statements directly to clients, the adviser

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has the option of sending its own statements and maintaining the clients' securities and funds with a "qualified custodian." The funds and securities of clients may be maintained with the qualified custodian in the client's name or in an omnibus account in the name of the investment adviser for the exclusive benefit of its clients or a combination of the two. In such case the adviser must comply with the surprise audit provision. However, today, many advisers for a variety of reasons comply with the surprise audit provisions of the old rule. Many advisers find that this surprise audit is not much of a burden and is relatively inexpensive. Under the amended rule, however, as explained above, the staff is of the view that subsection (a) requires that the adviser not have any *physical* custody of client funds or securities. As a consequence, advisers will no longer be able to use the Alternative II to avoid inadvertent *physical* custody of client funds or securities.

Importantly, the SEC has provided a third alternative although not expressly stated in the rule but referred to in footnote 33 which allows an adviser to use both alternatives – some clients under Alternative I and other clients under Alterative II.

With respect to pooled entities in which the adviser is a manager or participant, the proposed rule provides a practical solution in providing that statements do not have to be directly sent to pool participants as long as the pool is audited and the audited financial statements are distributed to pool participants.

Also importantly for some advisers that are involved with privately placed securities, the clarification with respect to custody of privately placed securities which are uncertificated and codifies a number of sometimes conflicting SEC interpretations and no-action letters. The provision with respect to mutual funds being held at transfer agents will also be important to many small investment advisers whose activities are exclusively or largely involved with mutual funds.

In summary, the rule requires some work, some expense, and some changes. ❑

1. 17 C.F.R. 275.206(4)-2.
2. Custody of Funds or Securities of Clients by Investment Advisers, IA Release No. 2176 at p. 1, (Sept. 25, 2003), (the "Amending Release").
3. Rule 206(4)-2(c)(1); 17 C.F.R. 275.206(4)-2(c)(1).
4. Amending Release, p. 3.
5. *Id.*, at fn. 7.
6. *Id.*, at p. 3.
7. *Id.*, at fn. 4.
8. *Id.*, at fn. 49.
9. *Id.*, at p. 3.
10. *Id.*, at p. 3.
11. *Id.*, at fn. 11.
12. *Id.*, p. 3, fn. 12 & fn. 13.
13. *Id.*, at fn. 15.
14. Rule 206(4)-2(a)(1); 17 C.F.R. 275.206(4)-2(a)(1).
15. Amending Release, fn. 8.
16. Rule 206(4)-2(c)(3); 17 C.F.R. 275.206(4)-2(c)(3).
17. Amending Release, fn. 49.
18. Rule 206(4)-2(a)(2); 17 C.F.R. 275.206(4)-2(a)(2).
19. Rule 206(4)-2(a)(3)(i); 17 C.F.R. 275.206(4)-2(a)(3)(i).
20. Rule 206(4)-2(a)(3)(iii); 17 C.F.R. 275.206(4)-2(a)(3)(iii).
21. Rule 206(4)-2(b)(3); 17 C.F.R. 275-206(4)-2(b)(3).
22. Rule 206(4)-2(a)(4); 17 C.F.R. 275.206(4)-2(a)(4).
23. Amending Release, p. 3.
24. SEC Rule 15c3-3(f); 17 C.F.R. 240.15c3-3(f).
25. Rule 206(4)-2(a)(3)(ii)(A); 17 C.F.R. 275.206(4)-2(a)(3)(ii)(A).
26. Rule 206(4)-2(a)(3)(ii)(B); 17 C.F.R. 275.206(4)-2(a)(3)(ii)(B).
27. Rule 206(4)-2(a)(3)(ii)(C); 17 C.F.R. 275.206(4)-2(a)(3)(ii)(C).
28. Amending Release, fn. 33.
29. *Id.*, at fn. 41.
30. *Id.*, at p. 3.
31. *Id.*, at fn. 33.
32. Rule 206(4)-2(b)(1); 17 C.F.R. 275.206(4)-2(b)(1).
33. Amending Release, fn. 25.
34. Rule 206(4)-2(b)(2); 17 C.F.R. 275.206(4)-2(b)(2).
35. Amending Release, fn. 21.
36. Rule 206(4)-2(b)(2)(i) & (ii); 17 C.F.R. 275.206(4)-2(b)(2)(i) & (ii).
37. Rule 206(4)-2(b)(4); 17 C.F.R. 275.206(4)-2(b)(4).
38. Amending Release, p. 9.
39. *Id.*
40. Amending Release, p. 3.
41. 15 U.S.C. §80b-6(4).
42. 15 U.S.C. §80b-4.