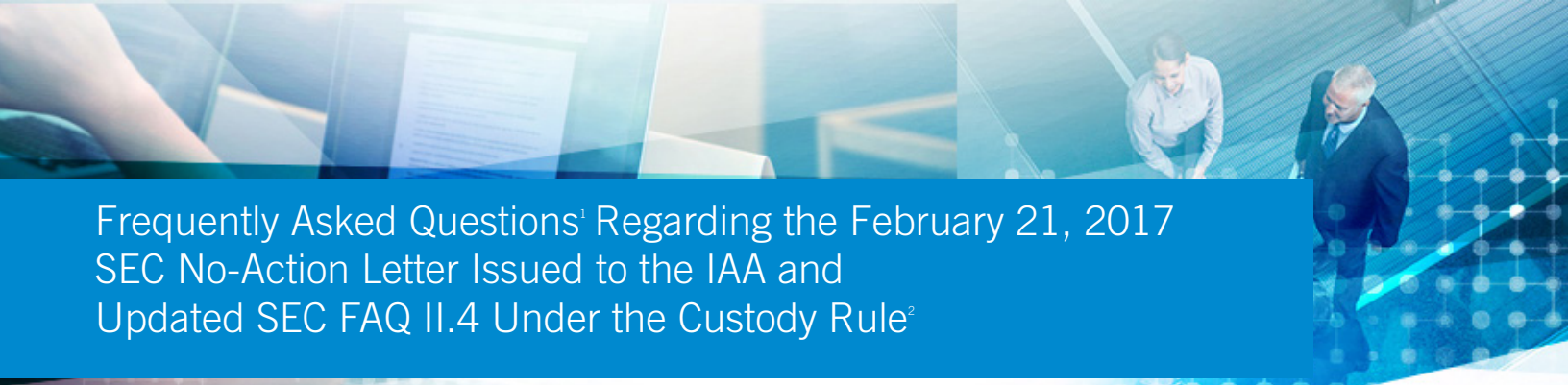

Frequently Asked Questions[1] Regarding the February 21, 2017 SEC No-Action Letter Issued to the IAA and Updated SEC FAQ II.4 Under the Custody Rule[2]

May 1, 2019

A. Standing Letters of Authorization (SLOAs)

1. Why did the IAA ask for this no-action letter?

The SEC staff's FAQs about the Custody Rule do not specifically address whether SLOAs with client-designated third party transferees result in custody in all circumstances. As a result, there has been widespread confusion and uncertainty among investment advisers, custodians, broker-dealers, compliance professionals and legal counsel as to whether SLOAs constitute custody. This uncertainty became more acute following the 2009 amendments to the Custody Rule, when obtaining a surprise exam became one of the consequences of having custody. IAA members requested that the IAA approach the SEC staff to obtain clarification to help advisers understand their obligations under the Custody Rule.

2. What is an SLOA for purposes of the no-action letter?

An SLOA is a standing letter of instruction or other similar asset transfer authorization arrangement established by a client with a qualified custodian. The client instructs the qualified custodian that maintains the client's account to transfer assets, either on a specified schedule or from time to time, to a designated third party upon the future request of the client's authorized adviser in accordance with the limited authority the client grants to the adviser. Such disbursements can be made by any method, such as wires, checks, or electronic funds transfers (ACH).

For purposes of the no-action letter, an SLOA involves a transfer to a *third party*. See Section B below for FAQs on first-party transfers (where a client grants an adviser the authority to move money between the *client's own accounts*).

3. Prior to the no-action letter, was it clear that SLOAs confer custody on advisers?

No, at least not in every situation. As we indicated in the letter to the SEC, in our view, an adviser simply following a client's instruction to transfer assets pursuant to an SLOA does not result in an adviser "holding" client funds, give an adviser "authority to obtain possession" of client funds, or authorize an adviser to "withdraw client funds" as contemplated by the Custody Rule. We requested the SEC staff's confirmation to that effect, given that many in the industry historically have interpreted the Custody Rule in that same way. The SEC staff disagreed, stating that "a letter of instruction or other similar asset transfer authorization arrangement established by a client with a qualified custodian would constitute an arrangement under which an investment adviser is authorized to withdraw client funds or securities maintained with a qualified custodian upon its instruction to the qualified custodian. An investment adviser that enters into such an arrangement with its client would therefore have custody of client assets and would be required to comply with the Custody Rule."

4. What if this means I have custody for the first time?

If an adviser determines that its (or its affiliates') arrangements confer custody, an adviser should develop policies and procedures to comply with the Custody Rule. In general, these would address the placement of client assets with a "qualified custodian," the delivery to clients of certain account statements by the qualified custodian, and monitoring and testing pertaining to the safeguarding and custody of client assets.

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[1] These Frequently Asked Questions are provided as a service to members. They are not intended as legal advice, and they are not a substitute for legal counsel. We undertake no duty to update them.

[2] Rule 206(4)-2 under the Investment Advisers Act of 1940. *See Final Rule: Custody of Funds or Securities of Clients by Investment Advisers*; Rel. No. IA-2968 (December 30, 2009) (adopting release for the most recent amendments to the rule) http://www.sec.gov/rules/final/2009/ia-2968.pdf.

If an adviser has not done so already, it will also need to include client assets that are subject to an SLOA in its response to Item 9 of Form ADV, to the extent that the SLOA results in custody (see Question 20 below).

Please refer to the IAA Compliance Guide for more detailed information regarding the Custody Rule and its requirements. *See* Compliance Control: Custody and Safeguarding of Client Assets.

5. What relief does the no-action letter provide?

Notwithstanding the SEC staff's view that SLOAs might give advisers custody, the staff agrees not to recommend enforcement action if an adviser acts pursuant to an SLOA without obtaining an annual surprise exam, as long as the representations outlined in the letter are met.

6. Can the client's instruction to the custodian be electronic?

So long as the client signs the instruction (with a wet or electronic signature) and it contains the required information, it may be sent to the custodian electronically, and will be considered to be "in writing." *(Representation #1)*

7. Can the identity of the third party be open-ended?

No. The client must designate a specific third party. The client must specify (i) the third party's name and (ii) either the third party's address or the third party's account number. *(Representation #1)*

8. Can the timing and/or amount of transfers under an SLOA be open-ended?

Yes. Although the authorization must be specific as to the third party, the no-action letter's relief allows the client to authorize the adviser to determine the timing and/or amount. *(Representation #2)*

9. If an SLOA provides for a transfer where the amount, timing and payee are fixed (the adviser has no discretion), does an adviser have custody?

No. An arrangement that is structured so that the investment adviser does not have discretion as to the amount, payee, and timing of transfers under an SLOA would not implicate the Custody Rule. *(Footnote 1)* This is distinguishable from the types of SLOAs that are the primary focus of the no-action letter, which implicate the Custody Rule and thus may benefit from relief from the annual surprise exam requirement.

10. Does the client have to use a particular form to give the adviser authorization to act pursuant to an SLOA?

No. Check with the custodian on its procedures, but the authorization can be given on the custodian's own form or by some other writing. Some custodians may require a particular form for operational reasons. *(Representation #2)*

11. What kind of verification of the client's instruction must the custodian perform?

There is some flexibility here. The no-action letter highlights signature review as one acceptable form of verification, but does not foreclose other methods to verify the client's authorization. *(Representation #3)*

12. How "promptly" must a custodian send a transfer of funds notice to the client after each transfer?

Although the term "promptly" is not defined, we understand that in practice, a custodian typically sends notice within one to two business days. *(Representation #3)*

13. If the client wants to terminate the instruction, must he or she do so in writing?

No, but for operational and security reasons, some custodians may have particular protocols to follow. *(Representation #4)*

14. If the client wants to change the instruction, must he or she do so in writing?

The "instruction", which must be in writing (either paper or electronic), must include the third party's name, and either the third party's address or account number at a custodian. *(Representation #1)* It follows that if a client changes the third party's name, address or account number, the change needs to be in writing and include the client's signature. Also, some custodians may require a new SLOA in order to effect any changes.

15. What kinds of records can an adviser maintain to show that the third party is not a related party or located at the same address *(Representation #6)*?

The relief that the no-action letter provides is not available for transfers to third parties that are related to the adviser or that are at the same address as the adviser. Although the no-action letter does not specify the form of records that an adviser must maintain, we would anticipate that an acknowledgment by the client or a memo to the file explaining the adviser's basis for determining that the third party is not a related party or located at the same address may satisfy this representation.

16. How soon after the SLOA is established must the custodian send the client an initial notice confirming it?

The timing of the initial notice is not specified. *(Representation #7)* We believe that, in general, the custodian would send the initial confirming notice to the client promptly.

17. When must the annual notice reconfirming the instruction be sent?

The timing of the annual notice is not specified. *(Representation #7)* This gives custodians some flexibility to use a rolling schedule, combine the annual notice with other client communications, or adopt other processes that maximize the efficiency of delivering the notice.

18. How can an adviser document that the custodian has complied with the Representations?

Some custodians may make a letter or other form of certification available to all advisers on their website, which an adviser can periodically download or print and maintain in its records as due inquiry. Others may not. Advisers should develop documentation that reflects their custodians' practices.

19. How long does an adviser have to start complying with the Representations?

The IAA noted in its incoming letter that implementation of the Representations will take at least six months, as it involves a number of steps, including some that require investment advisers and custodians to work in good faith to ensure that these protocols are met. During discussions with the SEC staff about timing, the staff suggested six months from the date of the no-action letter. The SEC staff subsequently acknowledged, however, that a one-size-fits-all approach may not be workable. Some advisers many need more time, while others may not. The SEC staff acknowledged in the letter that investment advisers, qualified custodians and their clients will require a "reasonable period of time" to implement the processes and procedures necessary to comply with the no-action letter's relief. The adviser should make a good faith effort to comply with the Representations in six months, with the understanding that the staff views this timeframe with some flexibility.

20. Does an adviser need to include client assets that are subject to an SLOA in its response to Item 9 of Form ADV?

Yes, to the extent that the SLOA results in custody, to reflect custody by your firm (Item 9.A) and/or custody by your affiliate that uses an SLOA (Item 9.B).

As noted in Question 9 above, not all SLOAs confer custody. For example, an arrangement that is structured so that the investment adviser does not have discretion as to the amount, payee, and timing of transfers under an SLOA would not implicate the Custody Rule. *(Footnote 1)* An adviser would not need to include client assets that are subject to such an arrangement in its response to Item 9 of Form ADV.

21. By when must an adviser amend its Form ADV to include client assets that are subject to an SLOA?

This is not a change that requires an other-than-annual amendment, so an adviser may wait until its next annual updating amendment filed after October 1, 2017.

22. How should an adviser handle what could be perceived as a discrepancy between (i) the dollar amount and number of clients for which it reports having custody in Item 9 of Form ADV and (ii) the independent public accountant's Form ADV-E filing?

An adviser needs to include client assets that are subject to an SLOA in its response to Item 9 of Form ADV, to the extent that the SLOA results in custody. However, the independent public accountant's Form ADV-E filing may not match because the adviser does not need a surprise exam for those assets. An adviser could explain the discrepancy in the Miscellaneous Section at the end of Schedule D of Form ADV. Alternatively, an adviser could document which accounts are subject to an SLOA in its internal records, and then explain the situation should questions arise during an SEC exam.

23. Does the letter cover bill-paying authority and the like?

It depends on the scope of the authority. The letter applies to situations in which an adviser has *limited* authority under an SLOA. This would include bill-paying arrangements where the third-party destination account is fixed and the client's instruction makes it clear that the client authorized the adviser to pay the bill, even if the timing and amount are open-ended. The letter does **not** cover *general* bill-paying or check-writing authority, or other cases where an adviser has *full* power of attorney or *broad* discretionary authority to withdraw client funds at the adviser's discretion and make disbursements to any third party on behalf of the client.

24. How does the relief that the no-action letter provides interact with the exemption from the surprise exam that is available if an adviser has custody "solely" as a consequence of an adviser's authority to deduct advisory fees from client accounts?

The no-action letter was not intended to undermine the "solely" requirement of the fee deduction exception. Notwithstanding the word "solely" in Rule 206(4)-2(b)(3), an adviser that has custody both because it is authorized to deduct fees from client accounts, and because it uses SLOAs, can be relieved from the annual surprise exam requirement as long as it adopts appropriate policies and procedures that address the risk that the adviser or its personnel could deduct fees to which the adviser is not entitled under the terms of the advisory contract and the representations outlined in the no-action letter are met. (A similar analysis applies if (i) you have custody "solely" because a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services you provide to clients; and (ii) your related person is operationally independent of you.)

25. For arrangements where an adviser is authorized to initiate an ACH pull transaction at the receiving qualified custodian, can the receiving qualified custodian, as opposed to the sending qualified custodian, fulfill the applicable conditions set forth in the February 21, 2017 No-Action Letter such that the adviser can avoid the annual surprise exam? For example, if an accountholder has established standing authority at his/her brokerage firm for an adviser to pull funds via ACH from his/her bank checking account into his/her brokerage account, can the brokerage firm (the receiving qualified custodian) fulfill the applicable conditions?

Yes. The February 21, 2017 No Action-Letter states that an adviser can avoid the annual surprise exam if its "qualified custodian" meets certain conditions. Where an adviser is authorized to initiate an ACH transaction at the receiving qualified custodian which meets the conditions required by the "qualified custodian" in the No-Action Letter, the adviser can avoid the annual surprise exam.

26. May a broker-dealer that introduces customers on a fully disclosed basis (the "Introducing Broker-Dealer") to a clearing broker-dealer (the "Qualified Custodian") perform the applicable conditions set forth in the February 21, 2017 No-Action Letter that are the responsibility of the Qualified Custodian (the "Qualified Custodian Steps") despite the fact that the Introducing Broker-Dealer is not the customer's qualified custodian? (An Introducing Broker-Dealer's relationship with its clearing broker-dealer is governed by FINRA Rule 4311 and a detailed clearing agreement which sets forth the specific responsibilities of the Introducing Broker-Dealer and the clearing broker-dealer with respect to customers. The Introducing Broker-Dealer is responsible for managing the customer relationship, including interacting with the customer to satisfy his or her requests. The Introducing Broker-Dealer has the relationship with the customer, not the clearing broker-dealer. As a result, the clearing broker-dealer would not be in a position to perform the Qualified Custodian Steps because the clearing broker-dealer would not have the information necessary to perform those Steps.)

An Introducing Broker-Dealer may perform the Qualified Custodian Steps despite the fact that the Introducing Broker-Dealer is not the qualified custodian. Because the Introducing Broker-Dealer is stepping into the shoes of the Qualified Custodian for purposes of the letter, the adviser would need to obtain from the Introducing Broker-Dealer an internal controls report if the adviser is affiliated with the Introducing Broker-Dealer. The internal controls report would address the Introducing Broker-Dealer's controls over the performance of the Qualified Custodian Steps.

B. First-Person Transfers

1. What is a transfer "between two or more of a client's accounts," often referred to as first-person transfers, for purposes of FAQ II.4?

A first-person transfer is a transfer between accounts owned by the same individual(s) or entity(ies). A good rule of thumb is to consider whether both accounts are associated with the same taxpayer ID number(s). Following are several examples of first-person transfers:

- A transfer between an individual's account and his/her IRA account.
- A transfer between an individual's account and his/her revocable living trust.
- A transfer between a husband/wife's joint account and the same husband/wife's community property account.

Check with your custodian(s), because custodian practices may vary relating to forms and what might be considered first- or third-party transfers.

2. Why did the SEC staff update FAQ II.4?

OCIE has sometimes cited advisers for deficiencies when having the authority to initiate first-person transfers where the client's authorization generally applied or referred to "all my accounts" and did not include the specific account number at the receiving custodian. The updated FAQ II.4 clarifies what "specifying" the client accounts means.

3. What does "client account" mean?

FAQ II.4 applies to transfers between the same client's own accounts. Generally, this means the client should be named account holder on the sending and receiving accounts for it to be considered a first-party transfer.

4. For transfers that will be made between unaffiliated custodians, what happens if a client adds an account, or otherwise changes account numbers to which the authorization applies?

The adviser would need to consider having the client update the authorization in writing with the new specified account number in order to avoid having custody. The sending qualified custodian may also require such authorization to be updated.

5. The FAQ says a copy of the authorization is provided to the "qualified custodians." Does the client's authorization have to be sent to both the sending and receiving custodians?

No. The updated FAQ states that the authorization does not need to be provided to the receiving custodian. This means that the authorization only has to be provided to the sending custodian (which may be transmitted through the adviser).

6. Does FAQ II.4 apply to transfers between the client's own accounts within the same qualified custodian (or between affiliated custodians)? In other words, do names and account numbers have to be specified for first-party journal entries?

No. A journal, in this case, is a transfer between two accounts owned by the same client at the same qualified custodian or at two affiliated qualified custodians. An adviser's authority to transfer client assets between the client's accounts at the same qualified custodian or at 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, such as name/account numbers, in the authorization.

7. Does FAQ II.4 apply to an adviser's authority to instruct the custodian to write a check to a client on the account that is sent to the client's address on record with the custodian?

This situation is also governed by the SEC's Staff Responses to Questions About the Custody Rule (FAQ II.5.A). The authority to instruct the custodian to perform check-writing to the client's address of record does not confer custody on the adviser, subject to the conditions in FAQ II.5.A, namely that (1) the client has granted such authority to the adviser in writing and a copy of that authorization is provided to the qualified custodian, (2) the adviser has no authority to open an account on behalf of the client; and (3) the adviser has no authority to designate or change the client's address of record with the qualified custodian. FAQ II.5.B, which covers an adviser's authorization to change a client's address, would also be applicable.

8. A client granted the adviser certain authority as reflected in the custodian's forms. How does that authority affect the analysis under FAQ II.4?

Each custodian's forms might allow advisers and their clients to select different levels of authority, and these levels might affect whether the adviser has custody. We suggest that you review your arrangements with your clients, and review the forms they executed with particular custodians to determine if you need to make any adjustments as a result of this updated FAQ. We understand that some custodians may be in the process of updating their forms during the implementation period noted below.

9. How long does an adviser have to start complying with the clarification?

Although the FAQ does not specify a deadline, based on our discussions with SEC staff, the staff understands that investment advisers will require a reasonable period of time to implement the processes and procedures necessary to comply with the clarification. Our initial conversations with the staff suggested that six to 12 months may be necessary. Subsequently, the industry and the staff came to realize that it may take some firms (advisers and custodians) longer based upon their own facts and circumstances. As with SLOAs, the adviser should make a good faith effort to comply with updated FAQ II.4, with the understanding that the staff views implementation timing with some flexibility.

10. What options does an adviser have?

We believe that the majority of advisers with individual clients will want to take some affirmative action in light of the new guidance. They may choose to "repaper" their letters of authorization, adding the required specificity with respect to account numbers. Or they may choose to accept custody and subject their accounts to the surprise examination. Or they may choose to forego offering clients assistance in managing transfers among their accounts.

11. For arrangements where an adviser is authorized to initiate an ACH pull transaction at the receiving qualified custodian, can the client "specify" the sending and receiving accounts in compliance with FAQ II.4 by providing a written authorization signed by the client to the receiving qualified custodian, as opposed to the sending qualified custodian, stating 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)? For example, if an accountholder gives standing authority to his/her adviser to initiate a first-party transfer from his/her bank checking account via ACH into his/her brokerage account, can the accountholder provide the signed written authorization required in FAQ II.4 to the receiving brokerage firm instead of the sending bank?

Yes.