September 20, 2007
Our Ref. No. 20072131442
Investment Adviser Association
File No.132-3

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Your letter dated September 20, 2007 requests our assurance that we would not recommend enforcement action to the Securities and Exchange Commission (the "Commission") under Section 206(4) of the Investment Advisers Act of 1940 ("Advisers Act") and Rule 206(4)-2 thereunder ("Custody Rule") against any investment adviser ("adviser") that promptly forwards, to its client or a qualified custodian, certain client funds or securities (together, "client assets") that the adviser inadvertently receives in the situations and under the circumstances discussed below.

I. Facts

In your letter, you explain that your member advisers[1] from time to time receive certain client assets from non-clients. Specifically, you state that some advisers:

(1) provide administrative services to their clients in connection with tax filings made with the Internal Revenue Service, state and other governmental taxing authorities (together, "Tax Authorities"); those services include completing tax forms and filing them with the Tax Authorities. You state that the Tax Authorities sometimes send client tax refunds to the adviser's address;

(2) file proofs of claim for their clients and complete other documentation related to class action lawsuits and other legal actions. You state that the administrators of funds established to distribute the settlement proceeds of these actions ("administrators")[2] sometimes send client settlement assets to the advisers; and

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[1] You state that The Investment Adviser Association (formerly the Investment Counsel Association of America) is a non-profit organization whose members include nearly 500 investment advisory firms registered as investment advisers with the Commission ("member advisers").

[2] These include administrators of class action settlement accounts and Fair Funds accounts. A Fair Fund is a fund established pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002. That section authorizes the Commission to take civil penalties collected in enforcement cases against securities laws violators and to add them to disgorgement funds, creating a Fair Fund to be disbursed by the Commission for the benefit of the victims of the securities laws violations at issue. *See generally* the Commission's Rules of Practice on Fair Fund and Disgorgement Plans (Rules 1100 – 1106). *See, e.g.*, Morgan Stanley & Co. Incorporated, Exchange Act Release No. 55726 (May 9, 2007), http://www.sec.gov/litigation/admin/2007/34-55726.pdf; Banc of America Securities LLC, Exchange Act Release No. 55466 (Mar. 14, 2007),

(3) receive stock certificates or dividend checks in the name of their clients. You state that advisers also may receive stock certificates (or evidence of new debt) in a class action lawsuit involving bankruptcy where shares are issued in a newly organized entity, or as a result of a business reorganization.

We refer to the Tax Authorities, administrators and such issuers individually as "Third Party" and collectively as "Third Parties" for purposes of this letter.

You state that, in each of the three situations described above, your member advisers have no control over the Third Party and they have not directly or indirectly caused the Third Party to deliver client assets to them. In addition, you state that your member advisers have, in good faith, used their reasonable best efforts to cause the Third Parties to deliver client assets to their advisory clients or a qualified custodian, as defined under the Custody Rule, at which the advisers maintain their clients' assets ("qualified custodian").[3] You state that, despite such efforts, some Third Parties continue to deliver client assets to the advisers without regard to the advisers' instructions to address and send such client assets to the relevant client or a qualified custodian. For example, you state that advisers have requested Third Parties such as Fair Fund administrators to send distribution checks directly to clients or their custodians. You state that the administrators nevertheless continue to send the distributions to advisers without regard to these requests. In these situations and circumstances you assert that these advisers inadvertently receive client assets from Third Parties.

You state that your member advisers believe that it would be in the best interests of their clients to forward, to their clients or a qualified custodian, the client assets that the advisers inadvertently receive from Third Parties. You are concerned, however, that any adviser that does so without complying with the provisions of the Custody Rule may violate Section 206(4).

II. Discussion

Section 206(4) of the Advisers Act generally provides that it is unlawful for any investment adviser, directly or indirectly, to engage in any act, practice, or course of business which is fraudulent, deceptive or manipulative. Under the Custody Rule, any adviser registered or required to be registered with the Commission that has "custody" of client assets violates Section 206(4) unless, among other things: (1) a qualified custodian maintains those assets as required by the Custody Rule; and (2) the adviser (i) has a

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http://www.sec.gov/litigation/admin/2007/34-55466.pdf; Fred Alger Management, Inc. and Fred Alger & Company, Incorporated, Exchange Act Release No. 55118 (Jan. 18, 2007), http://www.sec.gov/litigation/admin/2007/34-55118.pdf.

[3] Rule 206(4)-2(c)(3) under the Advisers Act generally defines a qualified custodian to include certain banks, savings associations, broker-dealers and other financial entities. A qualified custodian must either hold client assets in a separate account for each client under the client's name or in an account under the adviser's name as agent or trustee for the client. *See* Rule 206(4)-2(a)(1).

reasonable belief that the qualified custodian sends quarterly account statements to the clients or (ii) sends quarterly account statements to the clients.[4]

The Custody Rule was adopted in 1962[5] and most recently amended in 2003.[6] The Custody Rule was designed to protect client assets against loss, misuse and misappropriation and to ensure that client assets "will be insulated from and not be jeopardized by financial reverses" of the investment adviser.[7] The Commission amended the Custody Rule in 2003 to "harmonize" the rule with current custodial practices and to require advisers with custody of client assets to maintain those assets with qualified custodians.[8]

In the 2003 amendments, the Commission revised the Custody Rule to provide a definition of "custody" and to clarify the circumstances under which advisers have custody of client assets. As amended, the Custody Rule defines custody, in pertinent part, to include "possession of client funds or securities (but not of checks drawn by clients and made payable to third parties) unless [the adviser receives] them inadvertently and [returns] them to the sender promptly but in any case within three business days of receiving them."[9] In adopting this particular provision, the Commission considered a similar procedure described by a registered investment adviser in a 1991 no-action request relating to the Custody Rule.[10] The procedure was intended to discourage

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[4] In the latter case, an independent auditor is required to perform an annual surprise examination to verify all of the assets by actual examination and the auditor must notify the Commission of any material discrepancies found during the course of the audit. *See* Rule 206(4)-2(a)(3)(ii).

[5] *See* Adoption of Rule 206(4)-2 under the Investment Advisers Act of 1940, Advisers Act Release No. 123 (Feb. 27, 1962) ("Adopting Release").

[6] *See* Custody of Funds or Securities of Clients by Investment Advisers, Advisers Act Release No. 2176 (Sept. 25, 2003) ("2003 Release").

[7] *See* Adopting Release; 2003 Release.

[8] *See* 2003 Release.

[9] *See* Rule 206(4)-2(c)(1)(i). In discussing the definition of custody, the Commission stated that "an adviser has custody when it has possession of client funds or securities, even briefly . . . . The rule does not permit advisers to forward clients' funds and securities without having 'custody,' although advisers may certainly assist clients in such matters." *See* 2003 Release. The Commission further clarified that some advisers may "meet with clients to prepare or compile documents, including stock certificates, for forwarding to a custodian or third party. Nothing in the amended rule suggests that preparing these documents with a client gives the adviser 'custody.'" *See* 2003 Release at n.7.

[10] *See* Proposed Rule: Custody of Funds or Securities of Clients by Investment Advisers, Advisers Act Release No. 2044 (July 18, 2002) at n.18, citing to Hayes Financial Services, Inc., SEC No-Action Letter (Apr. 2, 1991) (the adviser represented that certain clients on an unsolicited basis sometimes sent securities to the adviser for delivery to the adviser's custodian, which caused the adviser to be in violation of the Custody Rule; we agreed that we would not recommend enforcement action to the Commission under the Custody Rule if the adviser, among other things, returned the securities received by it to the client with instructions to deliver the returned assets to the custodian).

advisory clients from sending their assets to their advisers and to result in clients sending those assets directly to custodians without involving the adviser.[11]

You acknowledge that when advisers inadvertently receive client assets sent to them by their *clients*, requiring advisers to promptly return such assets to their *clients* effectively discourages clients from sending their assets to their advisers with little risk of loss involved. You contend, however, that the safety of client assets could be impaired if advisers that inadvertently receive client assets from Third Parties were required to return such assets to the Third Parties. You explain, for example, that if advisers were to return client assets to Third Parties instead of promptly forwarding them to the advisers' clients or a qualified custodian, clients likely would experience unnecessary delays in receiving their assets, and the risk of loss to such assets would increase.

In addition, you have concerns regarding the safekeeping of returned client assets because Third Parties, unlike advisers, are unlikely to be fiduciaries of the clients and may not have established procedures to properly safeguard client assets. Moreover, you believe that requiring advisers to promptly return inadvertently received client assets to Third Parties would not necessarily deter Third Parties from sending client assets to advisers in the future. In short, you believe that requiring advisers to promptly return client assets to Third Parties in the situations and under the circumstances described above may work to the detriment of their clients' interests and "create more problems than it solves."

Accordingly, you seek our assurances that we would not recommend enforcement action to the Commission under Section 206(4) and the Custody Rule if an adviser that inadvertently receives client assets from a Third Party promptly forwards such assets to its client or a qualified custodian within five business days of the adviser's receipt of those assets, provided that the adviser adopts and implements written policies and procedures reasonably designed to ensure the safekeeping of client assets that the adviser inadvertently receives from Third Parties.[12] You suggest a number of policies and procedures that you believe would be appropriate for an adviser to adopt and implement in this regard, such as those requiring the adviser to:

(1) promptly identify client assets that it inadvertently receives;

(2) promptly identify the client (or former client) to whom such client assets are attributable;

(3) promptly forward client assets to its client (or former client) or a qualified custodian, but in no event later than five business days following the adviser's receipt of such assets;

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[11] *See* 2003 Release.

[12] *See, e.g.,* Rule 206(4)-7 under the Advisers Act.

(4) promptly return to the appropriate Third Party any inadvertently received client assets that the adviser does not forward to its client (or former client) or a qualified custodian, but in no event later than five business days following the adviser's receipt of such assets; and

(5) maintain and preserve appropriate records of all client assets inadvertently received by it, including a written explanation of whether (and, if so, when) the client assets were forwarded to its client (or former client) or a qualified custodian, or returned to Third Parties.

You contend that advisers that adopt and implement such policies and procedures would provide safeguards for the safekeeping of client assets that advisers inadvertently receive from Third Parties that are consistent with the objectives of the Custody Rule.

Based on the facts and representations in your letter, and without necessarily agreeing with your analysis, we would not recommend enforcement action to the Commission under Section 206(4) of the Advisers Act and the Custody Rule against any adviser registered or required to be registered under the Advisers Act if it promptly forwards client assets that it inadvertently receives from Third Parties in the situations and under the circumstances described above within five business days of the adviser's receipt of such assets, to its client (or former client) or a qualified custodian.[13] In taking this position, we expect that an adviser that inadvertently receives client assets from Third Parties in more than rare or isolated instances would adopt and implement written policies and procedures reasonably designed to ensure that the adviser: (1) promptly identifies client assets that it inadvertently receives; (2) promptly identifies the client (or former client) to whom such client assets are attributable; (3) promptly forwards client assets to its client (or former client) or a qualified custodian, but in no event later than five business days following the adviser's receipt of such assets; (4) promptly returns to the appropriate Third Party any inadvertently received client assets that the adviser does not forward to its client (or former client) or a qualified custodian, but in no event later than five business days following the adviser's receipt of such assets; and (5) maintains and preserves appropriate records of all client assets inadvertently received by it, including a written explanation of whether (and, if so, when) the client assets were forwarded to its client (or former client) or a qualified custodian, or returned to Third

[13] Our letter is limited to the three situations described above in which an adviser has, in good faith, used its reasonable best efforts to direct Third Parties to deliver client assets to its client or a qualified custodian, has no control over the Third Parties and has not directly or indirectly caused Third Parties to deliver client assets to it.

Parties.[14] You should note that any different facts or circumstances could result in a different conclusion.[15]

/s/ Lily C. Reid
Senior Counsel

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[14] We also expect that an adviser that inadvertently receives client assets from Third Parties in only rare and isolated instances would act in a manner that is consistent with (1) – (5) above.

[15] In the future, additional situations may arise in which we may consider extending the relief provided in this letter upon our review of the relevant facts and circumstances. Until such time, our position is limited to the factual situations described above.

You have not requested our views and we do not express any on circumstances in which advisers have custody of client assets with the consent of their clients. We take this opportunity, however, to reiterate the Commission's position that advisers that offer clients bill-paying services relying on a power of attorney from their clients have access to client assets and must comply with the requirements of the Custody Rule. *See* 2003 Release at text preceding n.10.

September 20, 2007

Via U.S. and Electronic Mail

Douglas J. Scheidt
Associate Director and Chief Counsel
Division of Investment Management
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Request for no-action relief relating to Rule 206(4)-2 under the Investment Advisers Act of 1940

Dear Mr. Scheidt:

The Investment Adviser Association[1] is writing to request no-action relief under Section 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-2 thereunder.[2] In particular, we request your assurance that the Division of Investment Management will not recommend that the Commission take enforcement action under Rule 206(4)-2 of the Advisers Act if a registered investment adviser forwards certain funds or securities it receives for its client to the client or the client's custodian in accordance with the procedures and conditions described below. In our view, the operation of these procedures will ensure that the provisions and policy goals of Rule 206(4)-2 will be met and that the interests of clients relating to the appropriate deposit of such funds and securities will be better protected.[3]

[1] The Investment Adviser Association (formerly the Investment Counsel Association of America) is a non-profit organization that represents the interests of the investment advisory profession. Founded in 1937, the IAA's current membership consists of nearly 500 SEC-registered investment advisory firms that collectively manage in excess of $8 trillion for a wide variety of individual and institutional clients. More information regarding the IAA, including a list of member firms, is available on our web site: www.investmentadviser.org.

[2] *Custody of Funds or Securities of Clients by Investment Advisers,* Advisers Act Release No. 2176 (Sept. 25, 2003) (Adopting Release); *Custody of Funds or Securities of Clients by Investment Advisers,* Advisers Act Release No. 2044 (July 18, 2002) (Proposing Release).

[3] This request for no-action relief is without prejudice to potential additional requests for relief regarding other aspects of the custody rule, certain of which we have previously discussed with Division staff.

Applicable Law

Section 206(4) of the Advisers Act generally makes it unlawful for an investment adviser to engage in any act, practice or course of business that is fraudulent, deceptive or manipulative. Rule 206(4)-2 under the Advisers Act generally makes it a fraudulent, deceptive or manipulative act, practice or course of business within the meaning of Section 206(4) of the Advisers Act for a registered investment adviser to have custody of client funds or securities unless a "qualified custodian" maintains the funds or securities in a separate account for each client under that client's name or in accounts that contain only the client's funds and securities under the investment adviser's name as agent for the client.

The Commission initially adopted Rule 206(4)-2 in 1962 to require "an investment adviser who has custody of funds or securities of any client to maintain them in such a way that they will be insulated from and not be jeopardized by financial reverses, including insolvency, of the investment adviser."[4] Rule 206(4)-2, in its current form, is a result of amendments proposed in 2002 and adopted in 2003 to "reflect modern custodial practices and clarify circumstances under which an investment adviser has custody of client assets."[5] The amended rule defines "custody" as "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them,"[6] and includes three examples designed to illustrate circumstances under which an investment adviser has custody of client funds or securities, of which only the following is relevant for purposes of this no-action request:

> 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.[7]

The release adopting the amendments noted that this example clarifies that an adviser has custody when it has possession of client funds or securities, even briefly, as those assets may be at risk of misuse or loss. The Commission, however, explicitly excluded from the definition of "custody" instances when an adviser inadvertently received a client's funds or securities and returns them to the sender promptly.[8]

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[4] *Adoption of Rule 206(4)-2 Under the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 123 (Feb. 27, 1962).

[5] Adopting Release, *supra* note 2.

[6] Rule 206(4)-2(c)(1).

[7] Rule 206(4)-2(c)(1)(i).

[8] This exclusion appears to have been based generally on a staff position under which a registered investment adviser is deemed not to have custody or possession of client funds or securities as a result of procedures developed by the adviser intended to ensure that the adviser's clients did not deliver funds or securities to the adviser and, if a client did deliver funds or securities to the adviser, to require the adviser to

Shortly after the Commission amended Rule 206(4)-2, the Commission staff provided informal commentary about the Rule in its Staff Responses to Questions about Amended Custody Rule ("Staff Q&A").[9] Of particular relevance, Question II.l of the Staff Q&A states:

Q: If an adviser inadvertently receives securities from a client, under the amended rule may the adviser forward the securities to the qualified custodian instead of returning the securities to the client?

A: No. If the adviser does not return the securities to the sender within three business days, the adviser not only has custody but has also violated the amended rule's requirement that client securities be maintained in an account with a qualified custodian.[10]

Although this Staff Q&A refers only to securities, the language of Rule 206(4)-2 and other staff interpretations may suggest that an investment adviser could, when it receives client settlement checks, tax refund checks or other assets, be deemed to have custody of these assets.[11] As a result, an adviser could be out of compliance with the Rule if the adviser receives client assets and forwards those assets to a client or its custodian. An adviser's only available remedy under the Rule would be to return the funds or securities to the sender within three business days.

Facts

Our member firms have identified the following situations where they may receive clients' securities or funds inadvertently and it would be in clients' best interests to forward the securities or funds to the client or custodian rather than return them to sender:

1. *Settlement checks from class action lawsuits*. Advisers may receive checks from commercial class action administrators distributing funds in settlement of class

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return immediately the funds or securities to the client. Proposing Release, *supra* note 2, at n. 18 (citing *Hayes Financial Services*, SEC No-Action Letter, (Apr. 2, 1991)).

[9] Staff Responses to Questions about Amended Custody Rule, available at http://www.sec.gov/divisions/investment/custody_faq.htm (updated as of Jan. 10, 2005).

[10] *Id.*

[11] Indeed, temporary possession of a check made out to the client or a former client arguably is not "possession" of "funds" in that the check is not negotiated to the adviser and is not available for the adviser to cash or deposit. The adviser can only pass it along to a person or entity with authority to negotiate the instrument – the client or its custodian. Similarly, the money represented by the check would not be "funds available" to the adviser in case of insolvency, a stated concern of the custody rule.

action lawsuits.[12] These lawsuits are brought by others in situations where neither the client nor adviser initiates the class action legal proceedings. In fact, clients are required to waive their own rights to bring suit in order to receive payments under most of these settlements. Typically, the amounts of such checks are relatively small.

2. *Fair Funds.* By way of example, late last year, a number of investment adviser firms began receiving checks referencing the SEC Specialist Settlement Fund without having submitted proofs of claim or other documentation related to the Fund. The checks were delivered in connection with the Commission's 2004 action charging seven NYSE specialist firms with certain trading violations. As part of the settlement, the firms made payments to a fund that, in turn, was to be distributed to "injured customers" harmed by the trading violations. A fund administrator was appointed to identify injured clients and issue reimbursement checks. It is unclear how the fund administrator identified investment adviser firms to whom it issued checks, but many of the checks were made payable to the adviser with a custodial master account indicated on the check. Since then, this situation has occurred in a number of additional Fair Fund actions.

3. *Tax refund checks from the IRS, state or other governmental taxing authorities*. Advisers sometimes receive tax refund checks because they may have sent or forwarded required tax payments at the direction of their clients or the clients' agents such as tax lawyers, accountants, or others. They may have also completed tax forms and filed them with a taxing authority. Under the Rule, an adviser must return the check to the taxing authority rather than forwarding the check to the client or the client's custodian.

4. *Dividend payments and stock certificates*. Sometimes advisers receive stock certificates or dividend checks in the name of their clients. On occasion, an adviser may receive stock certificates (or evidence of new debt) in a class action involving bankruptcy where shares are issued in a newly organized entity, or as a result of a business reorganization.

Most of the checks received by advisers in these contexts are made out to the client or the client's account. Checks payable to the client's account may also include the adviser's name as agent for the client.[13] Less frequently, checks are made payable to the

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[12] This situation of inadvertent receipt often arises because class action administrators have the adviser's name and address where the adviser has assisted in filing proofs of claim on behalf of clients. Further, proofs of claim and related forms often have room for only one address and telephone number or request the name of a person to be contacted for further information. This role is frequently filled by the adviser.

[13] Checks may be construed as payable to the client if the client is identified in "any way, including by name, identifying number, office, or account number." Uniform Commercial Code Article 3 – Negotiable Instruments, Section 3-110. Similarly, checks payable to a person identified as agent for another would be payable to the represented person. *Id.*

adviser without reference to a client or client account on the check itself but are for the benefit of an identifiable client.[14]

In each of these situations, the investment adviser has not directly or indirectly caused the third party to deliver client assets to it and has no control over whether it receives client assets because the third party payor or sender is not connected to the adviser-client relationship. The involvement of the adviser as the client's fiduciary may create uncertainty on the part of the third party as to the correct destination of funds or securities. However, because the third party is not a part of the advisory relationship, the adviser cannot compel the third party to send assets directly to the correct destination. In addition, advisers have, in good faith, used their reasonable best efforts to cause third parties to deliver client assets to their clients or clients' custodians. Despite such efforts, some third parties continue to deliver client assets to the advisers without regard to the advisers' instructions to address and send such client assets to the relevant client or a qualified custodian. For example, advisers have requested third parties such as Fair Fund administrators to send distribution checks directly to clients or their custodians. The administrators nevertheless continue to send the distributions to advisers without regard to these requests. Thus, an adviser controls only its own procedures to safeguard client assets, as discussed below. We believe that in the situations and under the circumstances described above, an investment adviser inadvertently receives client assets.

Scope of Relief Requested

In the circumstances described above, returning funds or securities to the sender may work to the detriment of clients' interests, for example, by creating additional and unnecessary delays or even risking loss of such funds or securities.[15] Nor does returning funds or securities to the sender make sense from a cost-benefit perspective. In general, the amounts involved are very small. Thus, the administrative costs of returning these inadvertent items to the sender would impose significantly more effort and related transactional and tracking costs than many or most of the transactions are worth in the first place. To address these issues, we seek no-action relief under the following circumstances:

1. The adviser inadvertently receives client securities or funds from a third party.
2. The adviser forwards the client securities or funds to the client or the client's custodian promptly, but in no event later than five business days following receipt by the adviser of the client assets.

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[14] The adviser would be able to ascertain that the check is for the benefit of a client rather than the adviser based on a cover letter, accompanying documents, or other surrounding circumstances.

[15] To illustrate the difficulty and potentially large magnitude of resolving misdirected items, see the SEC's enforcement matter *In Re Bank of New York*, SEC Rel. No. 53709, File No. 3-12269 (Apr. 24, 2006), available at http://www.sec.gov/litigation/admin/2006/34-53709.pdf. That case involved declaring "lost" client funds and securities sent to the client whose correspondence was returned as undeliverable, resulting, in part, in $11.5 million escheating to the State of New York from 1998 to 2004 affecting over 14,000 individuals.

3. The adviser performs the function of forwarding the securities or funds without imposing any additional service charges other than the fees charged for managing the clients' funds under the client advisory agreement.
4. The adviser provides written disclosure to its client of the practice of forwarding such securities or funds in the advisory agreement, or in notice given or mailed to the client, or in the adviser's Form ADV Part II disclosure.
5. The adviser establishes and implements policies and procedures reasonably designed to protect client funds and securities from loss and to track receipt and transmittal of these assets, including procedures reasonably designed to ensure that the adviser: (1) promptly identifies client assets that it inadvertently receives; (2) promptly identifies the client (or former client) to whom such client assets are attributable; (3) promptly forwards client assets to its client (or former client) or a qualified custodian, but in no event later than five business days following the adviser's receipt of such assets; (4) promptly returns to the appropriate third party sender any inadvertently received client assets that the adviser does not forward to its client (or former client) or qualified custodian, but in no event later than five business days following the adviser's receipt of such assets; and (5) maintains and preserves appropriate records of all client assets inadvertently received by it, including a written explanation of whether (and, if so, when) the client assets were forwarded to its client (or former client) or a qualified custodian, or returned to the third party sender.

Analysis

Safeguards Provided by Proposed Conditions

The conditions and procedures discussed above would significantly mitigate the risks and concerns that the custody rule is intended to address. These procedures are designed to minimize receipt of such assets where feasible, require advisers to monitor and document the receipt of any checks or securities, to deliver any check to the custodian or client promptly,[16] and to provide full notice to clients regarding the firm's practice of forwarding funds and securities. Indeed, the procedures provide more protection against misappropriation than the return-to-sender policy adopted by the Commission.

These procedures would also ensure that an adviser upholds its fiduciary duty to safeguard its clients' assets. Question II.1 of the Staff Q&A addresses an adviser's receipt of securities sent by the client. This Q&A, however, does not appear to contemplate the situation of client assets that are sent to an adviser by someone other than the client. In this context, the staff's guidance would require an adviser to return client assets not to its client or the custodian, but to the sender – an unrelated party – who would not be in a position to safeguard the assets and could lose or misuse the assets. Unlike advisers, these third parties are unlikely to be fiduciaries of the clients. If an

[16] This direct delivery to clients is consistent with the result of the *Hayes* no-action letter, *supra* note 8.

adviser were to follow the staff's interpretation and return settlement and refund checks and other client assets to a claims administrator or taxing authority, the adviser may be deemed not to be acting in the best interest of its clients, as such entities do not necessarily have procedures in place to ensure that client assets are properly safeguarded. These entities are not necessarily responsive to requests from investment advisers, nor are they subject to Commission examination. As a result, the adviser would have no assurance that the claims administrator or taxing authority would properly forward client assets to those clients or their custodians, as neither the claims administration nor the taxing authority may have the clients' or custodians' addresses and contact information as part of its official records. Thus, returning such securities or funds to the sender may work to the detriment of clients and create more problems than it solves.[17] Under the proposed procedures for handling settlement and refund checks and other assets, however, an adviser would take the safer course of forwarding these assets directly to its client or its client's custodian.

Comparison to Checks Drawn by a Client

The Commission, in adopting the recent amendments to Rule 206(4)-2, stated that "an adviser's possession of a check drawn by the client and made payable to a third party is not in possession of client funds for purposes of the custody definition."[18] The Commission also stated that an investment adviser may receive checks payable to the adviser for advisory or similar fees, but an adviser that "holds a check drawn by the client and made payable to the adviser with instructions to pass the funds through to a custodian or third party" would be deemed to have custody of client funds.[19] It would appear that Rule 206(4)-2 permits an investment adviser to receive a check drawn by a client and made payable to third party without being deemed to have "possession" or "custody" of client funds for two reasons: (1) the client would have knowledge that the check is in the adviser's possession, presumably because the client had written the check and forwarded it to the adviser; and (2) the client is protected from potential misappropriation by the adviser because the check is made payable to a third party and is subject to additional banking regulation protection.[20]

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[17] This situation is distinguishable from that in which the *client* sends its own assets to the adviser. In that case, requiring the adviser to return the assets to the client would deter clients from sending their assets to their advisers, with little risk of loss or delay of funds. *See Hayes*, *supra* note 8. On the other hand, requiring advisers to return client assets to a third-party sender would not deter such third parties from sending client assets to advisers in the future and would expose clients to increased risk of loss.

[18] Adopting Release, *supra* note 2.

[19] *Id.*

[20] Under the Uniform Commercial Code (UCC or state law), section 3-403, a person such as an adviser holding a negotiable instrument (*e.g.* a check made out to someone else or that person's account) would not be a *holder in due course* because the instrument would not have been negotiated to the adviser and the adviser would have no means to endorse, cash, or otherwise transfer the check. Any endorsement or attempted endorsement by the adviser to itself would be an "unauthorized signature." *See supra* note 13.

We believe this reasoning should apply to permit the adviser to forward client securities or funds from third parties to the client or the client's custodial account under the conditions discussed above. Many of the same protective factors that are present when an investment adviser receives a check from its client made payable to a third party would apply to a check from a third party, such as a settlement or refund check. Like a check written by the client to a third party, a check written by a third party to the client provides an adviser no means to endorse, cash, or otherwise transfer the check to itself. The client is protected against misappropriation by the adviser because the check is made payable to the client/client's account or endorsed to the client's account and is subject to banking protocols designed to identify and detect forgery. Finally, the client will have knowledge of the adviser's practices in this regard because advisers would disclose in writing the circumstances under which it may forward funds or securities to the client or custodian.

Conclusion

Accordingly, we request your assurance that the Division of Investment Management will not recommend that the Commission take enforcement action under Rule 206(4)-2 of the Advisers Act if a registered investment adviser forwards certain funds or securities it receives for its client to the client or the client's custodian in accordance with the procedures and conditions described above.

We appreciate your consideration of this request and look forward to further discussion with you. Please do not hesitate to contact us if we may provide any additional information or assistance in this regard.

Sincerely,

Karen L. Barr
General Counsel

cc: Andrew Donohue, Director, Division of Investment Management
Robert E. Plaze, Associate Director, Division of Investment Management

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Similarly, the broker-dealer regulatory structure has extensive safeguards and procedures for assuring proper identity and handling of securities.