

February 15, 2017

Via Electronic Mail ([scheidtd@sec.gov](mailto:scheidtd@sec.gov))

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

**Re: Request for interpretive guidance or no-action relief relating to Rule 206(4)-2 under the Investment Advisers Act of 1940 regarding certain standing letter of authorization arrangements**

Dear Mr. Scheidt:

The Investment Adviser Association (“**IAA**”)<sup>1</sup> is writing to request interpretive guidance or no-action relief under Section 206(4) of the Investment Advisers Act of 1940 (the “**Advisers Act**”) and Rule 206(4)-2 thereunder (the “**Custody Rule**”). In particular, we request clarification that an investment adviser that exercises limited authority pursuant to a standing letter of instruction or other similar asset transfer authorization arrangement established by a client with a qualified custodian (an “**SLOA**”) does not have custody under the Custody Rule. In the alternative, we request your assurance that the Division of Investment Management will not recommend that the Commission take enforcement action if an investment adviser exercises limited authority pursuant to an SLOA without undergoing an annual surprise exam by an independent public accountant to verify client assets as required by Rule 206(4)-2(a)(4) under the Custody Rule.

In an SLOA, the client instructs the qualified custodian that maintains the client’s account to transfer funds from time to time to a designated third party upon the future request of the adviser in accordance with the limited authority the client grants to the adviser, as described more fully below.

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<sup>1</sup> The IAA is a not-for-profit association that represents the interests of investment adviser firms registered with the U.S. Securities and Exchange Commission. The IAA has approximately 600 member firms that collectively manage nearly \$20 trillion for a wide variety of individual and institutional investors, including pension plans, trusts, investment companies, private funds, endowments, foundations, and corporations. For more information, please visit [www.investmentadviser.org](http://www.investmentadviser.org).

The staff's current responses to questions about the Custody Rule do not specifically address whether SLOAs with client-designated third party transferees result in custody in all circumstances.<sup>2</sup> As a result, there is widespread confusion and uncertainty among investment advisers, custodians, broker-dealers, compliance professionals and legal counsel as to whether SLOAs constitute custody. Staff clarification on these issues would help advisers understand their obligations under the Custody Rule.

## **Background**

Many clients maintain multiple accounts for different purposes at one or more qualified custodians. These clients want and need their advisers' help with both investment and cash management across their accounts. For example, an investment adviser's mandate might include liquidating certain investments in one account to pay tax bills or make disbursements to family members through another account in a timely manner that minimizes negative investment impact on the client's overall investment portfolio and strategy. Accordingly, it is common for clients to grant their registered investment advisers the limited power in a standing authorization to disburse funds to one or more third parties as specifically designated by the client. After granting the investment adviser this limited authorization, the client then instructs the qualified custodian for the client's account to accept the investment adviser's direction on the client's behalf to move money to the third party designated by the client on the SLOA. The qualified custodian takes that instruction in writing directly from the account holder (the adviser's client), and the adviser's authority is limited by the terms of that instruction. The adviser is authorized to act merely as an agent for the client. The client retains full power to change or revoke the arrangement.

The limited authority of an adviser under an SLOA arrangement is different, for example, from an investment adviser serving as a trustee with power to disburse funds out of the account to any third party if, in the view of the trustee, it was consistent with the purpose of the trust. It is also in contrast to an arrangement, such as general bill-paying or check-writing authority, in which an adviser has a full power of attorney on an account or broad discretionary authority to withdraw client funds upon the adviser's direction to the qualified custodian and make disbursements to any third party on behalf of the client.

## **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) for a registered investment adviser to have custody of client funds or securities unless (i) a "qualified custodian"

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<sup>2</sup> See Staff Responses to Questions About the Custody Rule, available at [http://www.sec.gov/divisions/investment/custody\\_faq\\_030510.htm](http://www.sec.gov/divisions/investment/custody_faq_030510.htm).

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; (ii) if the adviser opens the custodial account on behalf of the client, the adviser provides certain information to the client; (iii) the adviser has a reasonable belief, after due inquiry, that the qualified custodian sends account statements directly to clients; and (iv) the adviser undergoes an annual surprise exam by an independent public accountant to verify client assets.

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."<sup>3</sup> Rule 206(4)-2, in its current form, is a result of amendments adopted in 2003 to "harmonize the custody rule with current custodial practices, enhance the protections afforded to advisory clients' assets, and reduce advisers' compliance burden"<sup>4</sup> and in 2009 to "provide additional safeguards under the Advisers Act when a registered adviser has custody of client funds or securities."<sup>5</sup>

Although the Custody Rule was amended in 2009 to address related person custodian situations,<sup>6</sup> the core definition of custody has not changed. The rule defines custody as "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them,"<sup>7</sup> 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:

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.<sup>8</sup>

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<sup>3</sup> *Adoption of Rule 206(4)-2 Under the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 123 (Feb. 27, 1962).

<sup>4</sup> *Custody of Funds or Securities of Clients by Investment Advisers*, Advisers Act Release No. IA-2176 (Sept. 25, 2003).

<sup>5</sup> *Custody of Funds or Securities of Clients by Investment Advisers*, Advisers Act Release No. IA-2968 (Dec. 30, 2009).

<sup>6</sup> The definition of custody now includes the following sentence: "You have custody if 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." Rule 206(4)-2(d)(2).

<sup>7</sup> Rule 206(4)-2(d)(2).

<sup>8</sup> Rule 206(4)-2(d)(2)(ii).

### **Scope of Relief Requested**

An adviser simply following a client's instructions to transfer assets pursuant to the limited authority granted to the adviser under an SLOA and the adviser's corresponding direction to the custodian do not result in an adviser "holding" client funds, give an adviser "authority to obtain possession" of client funds, or authorize or permit an adviser to "withdraw client funds" for any purpose, as contemplated by the rule. Accordingly, SLOAs should not trigger the Custody Rule's concerns and measures intended to safeguard client assets. Nevertheless, recognizing that there may be some confusion in the asset management industry, we request confirmation that you do not interpret the authority to withdraw assets (which could result in an adviser having custody) to extend to the adviser's limited authority to request that a qualified custodian transfer client funds to a designated third party pursuant to an SLOA.

In the alternative, we request your assurance that the Division of Investment Management will not recommend that the Commission take enforcement action if an investment adviser exercises limited authority pursuant to an SLOA without undergoing an annual surprise exam by an independent public accountant to verify client assets as required by Rule 206(4)-2(a)(4) under the Custody Rule provided that advisers relying on this relief act pursuant to such an arrangement under the following circumstances:

1. The client provides an instruction to the qualified custodian, in writing, that includes the client's signature, the third party's name, and either the third party's address or the third party's account number at a custodian to which the transfer should be directed.
2. The client authorizes the investment adviser, in writing, either on the qualified custodian's form or separately, to direct transfers to the third party either on a specified schedule or from time to time.
3. The client's qualified custodian performs appropriate verification of the instruction, such as a signature review or other method to verify the client's authorization, and provides a transfer of funds notice to the client promptly after each transfer.
4. The client has the ability to terminate or change the instruction to the client's qualified custodian.
5. The investment adviser has no authority or ability to designate or change the identity of the third party, the address, or any other information about the third party contained in the client's instruction.
6. The investment adviser maintains records showing that the third party is not a related party of the investment adviser or located at the same address as the investment adviser.

7. The client's qualified custodian sends the client, in writing, an initial notice confirming the instruction and an annual notice reconfirming the instruction.

### **Analysis of Proposed Safeguards**

We believe that the safeguards and procedures listed above significantly mitigate any risks and concerns that the Custody Rule is intended to address with respect to transfers pursuant to an SLOA. These protocols are designed to safeguard client assets, and to prevent client assets from being misappropriated or otherwise lost or misused.

**1. The client provides an instruction to the qualified custodian, in writing, that includes the client's signature, the third party's name, and either the third party's address or the third party's account number at a custodian to which the transfer should be directed.** The client's provision of the instruction in writing ensures that the client understands the terms of the SLOA and wants the custodian to accept the adviser's direction within the scope of the authority set forth in the SLOA. The client's provision of the third party's name and address or account number assure that the client maintains control over the disbursement instruction and reflects that the adviser does not have authority to obtain possession of the funds or otherwise withdraw the funds for any other purpose.

**2. The client authorizes the investment adviser, in writing, either on the qualified custodian's form or separately, to direct transfers to the third party either on a specified schedule or from time to time.** The client's provision of the instruction in writing and specification of a third party ensures that the qualified custodian is taking instruction directly from the client and also serves to prevent the client's funds from being lost or moved to an unauthorized recipient, while at the same time providing flexibility with respect to timing and amount to accommodate the client's future needs.

**3. The client's qualified custodian performs appropriate verification of the instruction, such as a signature review or other method to verify the client's authorization, and provides a transfer of funds notice to the client promptly after each transfer.** The custodian's verification that the client has authorized the investment adviser to transmit or withdraw funds from the client's account on its behalf reflects the custodian's role to detect and prevent irregularities and abuses in client accounts and respond to any red flags indicating fraudulent conduct. In addition, the custodian's notification directly to the client promptly after each transfer would alert the client to any unauthorized activity.

**4. The client has the ability to terminate or change the instruction to the client's qualified custodian.** The client's retention of power to change or revoke the instruction at any time ensures that the client has full autonomy over the arrangement and can immediately terminate it at any time.

**5. The investment adviser has no authority or ability to designate or change the identity of the third party, the address, or any other information about the third party contained in the**

**client's instruction.** The adviser's lack of authority and inability to designate or change the third party, its address, or any other information about the third party reinforces that the adviser is not permitted to withdraw client funds or securities and instead is acting as a limited agent on behalf of the client who has provided a corresponding instruction to the custodian.

**6. The investment adviser maintains records showing that the third party is not a related party of the investment adviser or located at the same address as the investment adviser.** This documents that the authority the adviser has does not allow it to obtain possession of client funds or securities. The absence of such documentation would indicate that the adviser may have custody.

**7. The client's qualified custodian sends the client, in writing, an initial notice confirming the instruction and an annual notice reconfirming the instruction.** The custodian's written notification to the client when an SLOA is established, and annual confirmation that the SLOA continues, reinforce that the original instruction is from the client to the custodian and that the client retains control over that instruction, thereby providing an additional layer of protection over the verification discussed above.

We submit that these significant protective protocols address any concerns under the Custody Rule regarding safeguarding client assets and preventing adviser misappropriation of client assets, and therefore an investment adviser exercising limited authority pursuant to an SLOA should not be required to undergo an annual surprise exam.

### **Implementation of Safeguards**

If the staff determines to issue no-action relief, we note that implementation of these safeguards will involve a number of steps, including some that require investment advisers and custodians to work collaboratively in good faith to ensure that these protocols are met. Investment advisers that choose to adhere to the no-action letter will have to develop policies and procedures in order to have a reasonable basis, after due inquiry, for reasonably believing that the qualified custodian is taking the actions described above. They may need to revise documentation and obtain additional information from clients, train personnel, explain the new procedures to clients, and obtain records concerning third parties. Custodians may need to revise account forms or other disclosure documents and provide notice to customers. For example, custodians will need to provide an initial notice for new SLOAs, and annual notices for all SLOAs. Their systems may need to be reprogrammed to capture the information and maintain records of verification and notification.

It is our understanding that it will likely take at least six months for investment advisers to fully implement the safeguards and to allow custodians to make the necessary systems changes.

Douglas J. Scheidt, Associate Director and Chief Counsel  
U.S. Securities and Exchange Commission  
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## **Conclusion**

Accordingly, we request interpretive guidance that an investment adviser that exercises limited authority pursuant to an SLOA does not have custody under the Custody Rule.

In the alternative, we request your assurance that the Division of Investment Management will not recommend that the Commission take enforcement action if an investment adviser exercises limited authority pursuant to an SLOA, in accordance with the safeguards described above, without undergoing an annual surprise exam under Rule 206(4)-2(a)(4) of the Advisers Act.

We appreciate your consideration of this request and look forward to further discussion with you. Please contact the undersigned or Karen Barr, President & Chief Executive Officer, at (202) 293-4222 if we may provide any additional information or assistance in this regard.

Sincerely,



Laura L. Grossman  
Assistant General Counsel

cc: David Grim, Director, Division of Investment Management