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Compliance Review

Ongoing compliance updates for independent investment advisors

July 2014

Advisor Services

IN THIS ISSUE

Custody compliance: Creating more clarity

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I. Introduction

Compliance with the "Custody Rule"[1] continues to confuse and confound investment advisors. This is not surprising given the complexities of both the definition of "custody" and the requirements for avoiding it or complying if an advisor has it. Custody and clarity can seem mutually exclusive. What is surprising, however, especially after years of the Custody Rule being a compliance hot topic, is that some advisors remain unaware of basic custody dos and don'ts. While the Custody Rule can be murky, the actual uncertainties for most advisors should be few.[2] And what is clear is that the SEC takes Custody Rule compliance seriously and is closely examining advisors. The purpose of this *Compliance Review* and the accompanying materials[3] is to present the Custody Rule in a simple, easy-to-understand format so that investment advisors can strengthen their controls and better apply the Custody Rule's principles to their everyday business practices. For example, perhaps the most asked custody question at industry compliance conferences is, "Do standing letters of authorization, or 'SLOAs,' result in custody?" We answer this question (see "III. What is custody? A. Authorization to withdraw or transfer securities and funds—Standing letters of authorization," below), as well as others that many advisors are still asking. But first, it is important to set some context.

Investment advisors approach custody of client assets in different ways based on their firms' business models. Some advisors embrace custody, and they have designed their operations around their authority to transfer assets to and from their clients' accounts. Conversely, other investment advisors have implemented detailed policies to avoid confronting the complexities associated with custody. Still, there is another group of investment advisors who have custody but don't realize it. Given the many forms and shapes that custody can take, this lack of awareness is somewhat understandable, but it's not defensible in the eyes of regulators. Regardless of whether an investment advisor embraces custody or avoids it, Custody Rule compliance must be an integral part of advisors' business operations.[4]

II. Regulatory scrutiny

Desiring to avoid the splashy headlines tied to Ponzi schemes and other misappropriation of client assets, the SEC has intensified its scrutiny of custody arrangements since the Madoff scandal in 2008. Following a national examination campaign related to safekeeping of client assets, the SEC published a Risk Alert[5] on March 4, 2013. That Alert reported significant custody deficiencies in one-third of the investment advisors examined by the SEC. The Alert grouped the reported deficiencies as follows:

- Advisors didn't realize they had custody of client assets.
- Advisors were not aware that they needed a "surprise exam."
- Advisors did not place client assets with a "qualified custodian."
- Advisors did not require their private pooled funds to undergo an annual audit.

Requirements of the Custody Rule

"…it is a fraudulent, deceptive or manipulative act, practice, or course of business within the meaning of Section 206(4) of the [Advisers] Act for you [any investment advisor registered (or required to be registered) under Section 203 of the Act] to have custody of client funds or securities unless:

(1) Qualified custodian. A qualified custodian maintains those funds and securities (i) in a separate account for each client under that client's name; or (ii) in accounts that contain only clients' funds and securities, under your name as agent or trustee for the clients.

(2) Notice to clients. If you open an account with a qualified custodian on your client's behalf, … you notify the client in writing of the qualified custodian's name, address, and the manner in which the funds or securities are maintained, promptly when an account is opened and following any changes to this information…

(3) Account statements to clients. You have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement, at least quarterly, to each of your clients for which it maintains funds or securities, identifying the amount of funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period.

(4) Independent verification. The client funds and securities of which you have custody are verified by actual examination at least once during each calendar year… by an independent public accountant, pursuant to a written agreement between you and the accountant, at a time that is chosen by the accountant without prior notice or announcement to you and that is irregular from year to year…"

A series of enforcement cases followed. Last October, the SEC censured and imposed a civil penalty against an investment advisor who lacked proper safeguards for client arrangements that gave the investment advisor custody—that is, arrangements through which the advisor had access to, and the ability to transfer, client funds using blank letters of authorization.[6] In December, the SEC revoked the privileges of three accountants to appear or practice before the Commission for failure to complete a surprise exam and prepare a Form ADV-E for an investment advisor that maintained custody of client assets. In a companion case, the president and CCO of an investment advisor who failed to determine whether the accountants had verified assets had to pay a civil penalty of $40,000.[7]

III. What is custody?

The Custody Rule defines "custody" to mean holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. It is clear from SEC guidance that custody will result in nearly any circumstance in which there is a risk of misuse or misappropriation of client assets by an investment advisor. Let's examine some common examples of "custody" that are also areas of confusion for advisors. Our focus is on an advisor's authority to transfer funds from a client's account, but we will also briefly cover a few other common custody scenarios.

A. Authorization to withdraw or transfer securities and funds

Frequently, clients will provide investment advisors with disbursement authority—the authority to transfer assets from the client's account at the qualified custodian. The definition of "custody" includes: "Any arrangement (including a general power of attorney) under which you [the advisor] are authorized or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian."[8] The rationale is that under these circumstances the investment advisor could direct payments from the client account to itself or to third parties it controls. Obviously, this arrangement creates opportunity for misuse or misappropriation. The definition of custody includes an advisor's authority to instruct the custodian to debit the client's account for the amount of the advisor's fees. This is the most common way for an advisor to have custody. And if this is the only reason the advisor has custody, then it need not disclose that it has custody in its Form ADV and it need not obtain the independent verification of those clients' assets (see "IV. So I have custody. Now what?" on page 5).

Limited disbursement authority. Disbursement authority is generally custody. Significantly, however, when the advisor's disbursement authority is limited to transferring assets to the client at an identically registered account (whether at the same or a different qualified custodian) or the client's address of record, the SEC has made clear that the arrangement is not custody.[9] The account agreements of many qualified custodians give advisors' clients the option of granting their advisor this narrow form of disbursement authority. For this not to be deemed custody, certain conditions must be met:

1. The authority must be in writing, with a copy provided to the custodian.
2. The authorization must specify the client account to which the transfer is to be made.

3. The advisor must have no authority to open an account on behalf of the client.
4. The advisor must have no authority to designate or change the client's address of record with the custodian unless the advisor reasonably believes that the custodian sends a notice of address change to the client at the client's old address.[10]

Third-party disbursement authority. Advisors sometimes have broader disbursement authority over a client's account. This can arise in a family office setting or for advisors providing so-called wealth management services where, in addition to managing the client's investments, the advisor is engaged to manage other financial affairs, most typically paying the client's bills. Other purposes for broader disbursement authority include making payments for taxes, children's tuition, charitable contributions, and capital calls by private funds in which the client is invested.

The client's grant of third-party disbursement authority to the advisor can take many forms, the most common of which are full power of attorney (whether generally for all matters or specific to the client's account at a custodian) and check-writing authority. Other forms can include standing letters of authorization and the client furnishing the investment advisor with the client's login credentials (user name and password) to access the client's account online.

Client login credentials. Regarding an advisor's possession of a client's account web access login credentials, the SEC has made clear that if the website allows the user to transfer funds or securities from the account, then possession of the credentials is custody.[11] This is true regardless of whether the advisor uses the credentials to actually make any withdrawals or transfers and regardless of whether the client's agreement with the advisor limits the advisor's use of the credentials to only viewing the account. In either case, the custodian would not be aware that the advisor's authority is limited, and the advisor's access to the transfer or withdrawal capabilities makes the arrangement custody.[12]

Standing letters of authorization. A standing letter of authorization ("SLOA") is a letter signed by the client and addressed to the custodian authorizing the client's investment advisor to instruct the custodian to disburse funds or securities from the client's account. To be clear, we are not talking about a letter of authorization in which the client provides all details of the authorized disbursement (payee, amount, timing, etc.) with nothing left to the advisor's discretion in instructing the custodian. The advisor's role, if any, with this simple and common form letter of authorization may be merely to forward it to the custodian. In contrast, an SLOA gives the advisor some discretion, the scope of which can vary, to determine, and instruct the custodian on, one or more elements of the disbursement, such as:

- The payee
- The dollar amount (or quantity of securities)
- The number and frequency of disbursements (either individual disbursements or recurring periodic disbursements)

Who is the payee—the client or a third party? As discussed on page 2 (see "Limited disbursement authority"), if the client-designated payee in the SLOA is the client itself (either to another of the client's accounts or to the client at its address of record), then the SLOA does *not* give the advisor custody. But if an SLOA leaves it to the advisor to designate the transferee, then the SLOA would generally result in the advisor having custody. While the SEC has not said this directly, it is reflected in two SEC administrative proceedings.

Who determines the payee—the client or the advisor? *In the Matter of GW & Wade, LLC*,[13] the investment advisor kept SLOAs pre-signed by its clients, which the advisor would then complete (including the designation of the third-party payee) and submit to the custodian when the client asked the advisor to arrange for a disbursement. The SEC deemed this custody and found that the advisor violated the Custody Rule by, among other things:

- Not disclosing the custody arrangement in its Form ADV
- Not having written policies and procedures designed to prevent violation of the Custody Rule
- Not obtaining the annual surprise accountant's examination of the client assets

This was consistent with the SEC's position on the issue in another case, *In the Matter of Comprehensive Capital Management*,[14] in which the SEC found custody existed where clients signed blank LOAs and wire transfer requests, which the investment advisor used to transfer client assets to an entity the investment advisor controlled.

The case for client-determined third-party payees—this may not be custody. What about an SLOA in which the client designates a third-party payee but authorizes the advisor to determine the amount and frequency of disbursements? For example, a client signs an SLOA instructing the custodian to send a tax payment or periodic tax payments to an identified taxing authority, with the address or account number to which payments are to be sent, when the investment advisor instructs the custodian of the time and amount of the payment(s). Is this custody? The SEC has not officially addressed it.

The argument that it is not custody is that the client has designated the payee, so there is no risk of the investment advisor misappropriating client assets. This argument has been made to the SEC staff in an effort to gain clarity (see the sidebar "Schwab and Investment Adviser Association efforts to gain clarity on SLOAs").

Two SEC staff FAQs are relevant but do not address the question head-on. The first is SEC FAQ III.1. There,[15] the staff said that when a client gives the custodian a standing instruction to debit the client's account for the advisor's fees each quarter, with the custodian calculating the amount based on the client's agreement with the advisor, the advisor does not have custody so long as the custodian is not a related person of the advisor. This is because, although the advisor is the payee, the custodian, not the advisor, determines the amount. And the timing of the disbursement (along with the method for determining the amount) is not determined by the advisor; it is determined by the custodian as agent for the client. The advisor is really not granted any authority.

The second is SEC FAQ II.4, which addresses limited disbursement authority to transfer assets to the client at an identically registered account. As noted above, the SEC staff has said that is not custody. But many have interpreted this FAQ as a negative implication that if the disbursement authority is to transfer assets to an account that is not identically registered (that is, to a third party), then custody applies even when the third-party payee is designated by the client and not the advisor.

Proceed cautiously with SLOAs. Given the lack of an SEC staff FAQ or other official SEC statement directly on point about SLOAs with client-designated payees, advisors should be cautious in this area until the SEC provides additional clarity. Make sure you know whether you have SLOAs with client-designated third-party payees and consult with your legal counsel and compliance professionals as needed.

Schwab and Investment Adviser Association efforts to gain clarity on SLOAs

The SEC has not specifically addressed whether SLOAs with client-designated third-party payees result in custody in all circumstances. In an effort to obtain more clarity for advisors, Schwab and the Investment Adviser Association have approached the SEC staff and asked for additional guidance. Given the Custody Rule's purpose of preventing advisor misappropriation, an SLOA arrangement with clear instructions and communications controlled by the client and custodian arguably could fall outside the scope of that regulatory concern. Some potential factors that may be relevant in considering whether an SLOA results in custody are:

- Whether the client provides written and signed instructions to the custodian designating the third-party payee's name, account number, and address
- Whether the advisor's authority is limited to instructing the custodian as to the time and dollar amount of a transfer
- Whether the custodian provides a notice of funds transfer directly to the account holder who alone may terminate or change the arrangement

B. Other common 'custody' scenarios

Inadvertent custody. Circumstances could arise in which the investment advisor, through no effort on its part, receives client funds or securities. Perhaps the client sends funds or securities to the advisor by mistake, or a check is made payable to the advisor and not the custodian for deposit into the client's account. An investment advisor that receives client securities or funds inadvertently will not be deemed to have custody if the advisor returns the securities or funds to the client within three business days of receipt. Note that, subject to very narrow exceptions, the Custody Rule does not permit the advisor who has inadvertent custody to forward the securities or funds (subject to the exception noted in "Forwarding clients' checks" on page 5) to a qualified custodian,[16] although investment advisors may certainly assist clients in such matters.

Dual registrants. To provide a full range of financial services, some firms operate as dually registered investment advisors and broker-dealers. Their employees are dually registered as association persons of the investment advisor and registered representatives of the broker-dealer. In some instances these dual registrants may have a relationship with a client wherein the investment advisor has investment discretion over a portion of the client's assets while the client retains investment discretion over the other portion and engages the broker-dealer to execute trades. A situation could arise in which the client delivers stock certificates he or she wishes to sell to an employee dually registered with both the investment advisor and the broker-dealer. As long as the employee who accepts the certificates is acting within his or her capacity as a registered representative of the broker-dealer and not as an associated person of the investment advisor, then the employee could accept the securities or funds without causing the investment advisor to have custody.[17]

Investment advisor acting in a legal capacity to a trust or pooled investment vehicle. An investment advisor that acts as a trustee to a client account, a general partner to a partnership, or a managing member of a limited liability company will generally be deemed to have custody because in its legal capacity as trustee, general partner, or managing member it has access to client funds and securities. Investment advisors who are deemed to have custody because they serve as general partners and managing members of private funds are subject to a set of detailed requirements under the Custody Rule that are beyond the scope of this article.[18]

When an employee is a trustee of a trust that is a client of the investment advisor, the investment advisor generally

Forwarding clients' checks

If an advisor receives a check made payable to the custodian for deposit into the client's account, this is not deemed to be custody so long as the advisor forwards it on a timely basis. Be sure to record your receipt and forwarding of the client's check in your firm books and records, such as a check log. Here's an example of what a check log looks like.

Date funds/ security received	From whom	Client name	Action taken	Date action taken	Notes

has the trusteeship imputed to it (thus resulting in it having custody). However, as footnote 139 in the SEC's December 30, 2009, release adopting the amended Custody Rule (the "SEC Adopting Release") states,[19] "the role of the supervised person as trustee will not be imputed to the advisory firm if the supervised person has been appointed as trustee (or executor) as a result of a family or personal relationship with the grantor or beneficiary and not as a result of employment with the advisor."[20]

Related person to the investment advisor having custody of client assets. The Custody Rule defines a "related person" as an entity that (a) controls the investment advisor, (b) is controlled by the investment advisor, or (c) is under common control with the investment advisor. Client assets held by a related person of the investment advisor will be attributed to the investment advisor. However, different rules, as described later, apply if the related person is "operationally independent" of the investment advisor.[21]

IV. So I have custody. Now what?

The Custody Rule requires advisors with custody of client assets to satisfy certain requirements. All advisors with custody must satisfy at least two requirements, and some advisors may have up to five requirements to meet. These requirements are:

1. Using a qualified custodian (generally a registered broker-dealer or a bank) to hold assets
2. Having a reasonable basis, after due inquiry, for believing the custodian is sending client account statements
3. Subjecting custodied assets to verification by an independent public accountant's surprise examination on an annual basis
4. If the advisor opens the account at the qualified custodian on behalf of the client (this is rare), notifying the client of the name and address of the qualified custodian and the manner in which the assets are held
5. If the advisor or a related person is the qualified custodian, obtaining an internal control report prepared by an independent public accountant

The first three of these requirements, which are the most commonly applicable, are further described below.

A. Qualified custodian

Assets of investment advisory clients must be held by a "qualified custodian." Pursuant to the Custody Rule, a "qualified custodian" includes the type of financial institutions that clients and investment advisors customarily turn to for custodial services, including registered broker-dealers,[22] banks, and savings associations. Investment advisors who offer futures advice must comply with Commodity Futures Trading Commission rules, which require the "qualified custodian" to register as a futures commission merchant. Finally, for foreign financial institutions, a "qualified custodian" is one that customarily holds financial assets for its customers, provided that the foreign financial institution keeps advisory clients' assets in customer accounts segregated from its proprietary assets.

B. Account statements to clients—reasonable basis after due inquiry

Investment advisors are required to form a reasonable belief after "due inquiry" that the qualified custodian is sending quarterly (or more frequent) account statements directly to clients. The SEC has said that there is no single method for forming this belief and has left investment advisors with flexibility to determine how best to meet this requirement. For example, an investment advisor could form a reasonable belief after "due inquiry" if the qualified custodian provides the investment advisor with a copy of the client's quarterly account statement. An advisor could also satisfy the due inquiry requirement if the qualified custodian confirms in writing that it has sent account statements to the advisor's clients each quarter.[23] A practice that would not satisfy the "due inquiry" requirement is if the investment advisor accesses account statements only through the qualified custodian's website. According to the SEC, viewing the statement on the website merely confirms that the statements are available—not that they were sent.[24]

C. Independent verification ('surprise exam')

Advisors with custody must, with certain limited exceptions, undergo annual surprise examinations by an independent public accountant to verify client assets unless the sole reason the advisor has custody is because it is authorized to withdraw its fees from the client accounts. The purpose of the surprise exam is to verify that a qualified custodian is holding client funds and securities in a separate account and that no misappropriation has occurred. Investment advisors should expect to furnish accountants performing the verification with records that detail client funds and securities of which the investment advisor has custody and the identification of the qualified custodian. Note that the surprise exam need cover only those accounts over which the advisor has custody. If there are a large number of accounts, a sampling method may be acceptable to the accountant. In every case, the accountant must file Form ADV-E with the SEC. If the accountant finds any material discrepancy during the course of the examination, it must notify the SEC within one business day.

Investment advisors should take these surprise exams seriously. A discrepancy report is tantamount to material noncompliance with the Custody Rule and will likely trigger a swift SEC inspection and possibly an enforcement action. Similarly, the SEC will view unfavorably any attempt by an investment advisor to game the timing of the surprise exam. Recently, an SEC director said the staff would likely question whether an exam that is scheduled around the same time each year would qualify as a "surprise exam."[26] There are consequences for investment advisors and their accountants that fail to conduct surprise exams. In December 2013, the SEC brought two companion administrative proceedings against three accountants and a president and chief compliance officer ("CCO") of an advisor for failing to perform a surprise exam and failing to determine whether the accountants had performed the exam, respectively. The SEC suspended the privileges of the three accountants and ordered the president and CCO to pay a civil penalty of $40,000 and barred him from serving as the CCO of any investment advisor.[27]

Schwab assistance with due inquiry requirement

To assist advisors in satisfying their obligation to make due inquiry and have a reasonable basis for believing the custodian is sending account statements, each month Schwab posts a statement delivery confirmation alert on its website for advisors[25] notifying the advisor that Schwab has mailed or electronically delivered account statements to the advisor's clients and made copies available to the advisor on the website. Advisors could document a process in which they verify their due inquiry each month by accessing this notification on Schwab's website. Investment advisors should also periodically confirm with selected clients that they are receiving statements from the custodian.

D. Client notification

In instances when the investment advisor opens a custodial account on behalf of its client, the Custody Rule requires the advisor to give prompt notice to the client, identifying the qualified custodian's name, its address, and the manner in which the funds or securities are maintained. This situation is rare because generally the advisor's client signs an account application and agreement with the custodian to open the account (even if the advisor prepares the account application for the client's signature). But if the investment advisor actually opens the account for its client, then this notice requirement applies, and if the advisor elects to send its own account statements to the client, the initial notice to the client and any subsequent statements the investment advisor sends must include a legend urging the client to compare the account statements they receive from the custodian with those they receive from the investment advisor.

E. Internal control report for related persons

Some investment advisors have related persons who meet the definition of a qualified custodian and use them to custody client assets. Special rules apply when a related person of the investment advisor is the qualified custodian. In addition to the surprise exam, which must be performed by an independent public accountant registered with the Public Company Accounting Oversight Board ("PCAOB"),[28] the Custody Rule requires the investment advisor to obtain annually a written report, which includes an opinion from an independent public accountant with respect to the related person's controls for custody of client assets ("internal control report"). The internal control report must reconcile the custodial records of the related person with the custodial records of unaffiliated entities up the custodial chain, such as the Depository Trust Company. The internal control report must also be prepared by an accountant registered with the PCAOB.

F. Special requirements for pooled investment vehicles

As mentioned previously, investment advisors who act as general partners or managing members of private funds are deemed to have custody because of their legal capacity to access fund assets. These advisors generally have two options to satisfy the independent verification requirement under the Custody Rule: (i) the annual surprise accountant's exam or (ii) an audit of the fund by an independent public accountant registered with the PCAOB and distribution of the audited financial statements to fund shareholders within 120 days of the fund's fiscal year-end.[29]

V. Other custody compliance requirements

A. Form ADV disclosure of custody practices

Form ADV requires investment advisors to make certain disclosures regarding custody. Item 9 of Part 1 asks the advisor to disclose whether it or a related person has custody of clients' cash, bank accounts, or securities. An advisor should answer "no" to Item 9A.(1)(a) and (b) if the sole reason it has custody is its authority to deduct its fees from a client's account or because a related person who is operationally independent has custody of the advisor's clients' assets. When the advisor is required to answer "yes," then further disclosures are required. But even if the advisor can answer "no," it still must make further disclosures in response to Item 9, including 9.F, which essentially asks how many qualified custodians the advisor uses. Advisors who can answer "no" commonly overlook this and do not make the additional disclosures required by Item 9, and they are cited for it in exams. In addition, Item 15 of Part 2A of Form ADV requires investment advisors that have custody to remind clients to carefully review account statements they receive from their qualified custodians and urge them to compare those statements with the statements they receive from the investment advisor.

If an investment advisor has custody of client assets but is not cognizant of that fact, it will likely provide incorrect or incomplete responses to the Form ADV custody questions. This can occur both when the advisor believes it has no arrangements giving it custody and when it understands it has custody (for example, because an employee serves as trustee of a client's trust) but is unaware of all the arrangements that give it custody (for example, the same advisor also has check-writing authority on another client's account). The advisor's ADV disclosures will be defective. This, in turn, could give rise to an SEC claim that the advisor has violated Section 207 of the Advisers Act, which makes it "unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the Commission ... or willfully to omit to state in any such application or report any material fact which is required to be stated therein."[30]

B. Custody policies and procedures

SEC Rule 206(4)-7 under the Advisers Act,[31] commonly referred to as the "compliance program rule," requires registered investment advisors to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder.[32] This includes the Custody Rule and the need for policies and procedures that address the safeguarding of client assets from conversion or inappropriate use by advisory personnel. Custody Rule violations can result in violations of the compliance program rule.[33] Given the much broader application of the compliance program rule, advisors should have an existing framework within which to house their custody policies and procedures. In that regard, here are some steps we recommend:

1. Through firmwide training, develop *awareness of circumstances that will result in custody* of client assets.
2. Verify at the outset of the relationship that each new client has or will transfer his or her account to a *qualified custodian*.
3. Adopt policies to *avoid inadvertent custody*—train employees to return client funds or securities inadvertently received within three business days of receipt.
4. Adopt protocols to make *due inquiry and form a reasonable belief that the qualified custodian is sending account statements* to clients.
5. Assess all arrangements through which your firm has *authority to withdraw or transfer client assets* (or capability to do so, such as through possession of client login credentials), which could trigger the need for the annual surprise exam by an independent public accountant.
6. Determine whether your firm must obtain the *annual surprise exam by an independent public accountant* and, if so, retain the accountant and adopt policies that verify that the accountant has timely completed the exam and filed Form ADV-E.
7. Review Item 9 of Form ADV Part 1 and Item 15 of Form ADV Part 2A to ensure that you *accurately disclose your firm's custody policies and practices*.
8. If custody results from being a *general partner or managing member of a private fund*, address the special Custody Rule compliance requirements and tailor your firm's custody policies accordingly.

VI. Conclusion

The SEC adopted the Custody Rule to strengthen the protection of client assets. Through public communications and administrative actions, the SEC has put investment advisors on notice to take Custody Rule compliance very seriously. The Custody Rule remains a key component of the SEC's examination program, and violators may find themselves in embarrassing and costly administrative proceedings.

Violating the Custody Rule can have dire consequences. The Custody Rule exists under the antifraud provisions of Section 206 of the Advisers Act. Accordingly, any failure on the part of an investment advisor to comply with the Custody Rule, no matter how technical or inadvertent, could give rise to a claim by the SEC that the investment advisor has willfully violated Section 206 of the Advisers Act and engaged in "acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."[34]

Although the Custody Rule can be complex and confusing, and while there remains some uncertainty as to its application, most custody scenarios are settled, and the Custody Rule requirements are clear. Advisors must take the time to dial in their compliance. There is no doubt that the SEC is watching closely and will find gaps and take action.

Finally, we have included the following chart, which is intended to help you navigate Custody Rule compliance for some of the most common scenarios encountered in advisors' practices.

A road map to the Custody Rule

Do I have custody?		Fee deduction	Third-party[2] disbursement authority	Trustee; private fund sponsor
Arrangements that are "custody"		Am I authorized to deduct my fees from a client's account?	Do I have authority and permission to withdraw funds or securities from a client's account?	Do I (or a supervised person) serve in a capacity that gives me legal ownership or access to client funds or securities?
Examples		▪ Client confers fee payment authority in custodian's account application or separate LPOA	▪ Full (general) power of attorney ▪ Check-writing authority ▪ Standing letter of authorization (SLOA) for disbursements to third parties[3]	▪ Trustee of client's trust[5] ▪ General partner of limited partnership, managing member of LLC, or comparable position for another type of pooled investment vehicle
What do I have to do to comply?		⇩	⇩	⇩
Core Custody Rule compliance requirements	**Qualified custodian** Use a qualified custodian to maintain client funds and securities	✓	✓	✓
	Account statements Reasonable belief after due inquiry that qualified custodian sends account statements to clients.	✓	✓	✓[6]
	Independent verification Annual surprise examination by independent public accountant[4] to verify client assets.	Not applicable[1]	✓	✓[6]
Possible additional Custody Rule compliance requirements	**Notice to clients** Of custodian's name, address, and manner in which assets are held (in client's name or your name as agent).	**Did you open the account with the custodian on the client's behalf (client did not sign account agreement)?** Yes → ✓[6] No → Not applicable		
	Internal control report Annual report by a PCAOB-registered independent public accountant on the custodian's safeguarding and related internal controls.	**Do you or a related person serve as the qualified custodian?** Yes → ✓ No → Not applicable		
Other compliance requirements	**ADV disclosure** Item 9 of Part 1 requires that you disclose whether you have custody and, if so, describe why. Item 15 of Part 2A requires disclosure to clients that they should carefully review account statements sent to them by the qualified custodian.	Answer "No" to 9.A.(1)(a) and (b), but other parts of Items 9 and 15 apply.	✓	✓
	Custody policies and procedures Rule 206(4)-7 requires advisors with custody to adopt written policies and procedures designed to prevent Custody Rule violations.	✓	✓	✓

[1] So long as qualified custodians are not related persons or, if they are, they are operationally independent of you.
[2] Advisor-directed disbursements to clients at their addresses of record or to another account of identical registration are not custody.
[3] Uncertainty remains about whether an SLOA is custody if the client designates the third-party payee in the SLOA and certain other conditions are met.
[4] If you are, or a related person is, the qualified custodian, the independent public accountant must be PCAOB registered.
[5] There is a very narrow exception for certain personal relationships.
[6] This requirement does not apply if the fund is annually audited by a PCAOB-registered independent public accountant and distributes its audited financial statements to beneficial owners.

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Michelle L. Jacko is the managing partner and CEO of Jacko Law Group, PC, a securities law firm that offers securities and corporate legal services to broker-dealers, investment advisors, hedge/private funds, and financial professionals. In addition, Ms. Jacko is the founder and CEO of Core Compliance & Legal Services, Inc., a compliance consultation firm. Ms. Jacko specializes in investment advisory and broker-dealer firm formation, hedge and private fund development, mergers and acquisitions, transition risks, and investment counsel on regulatory compliance and securities law.

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Charles H. Field, Esq., is of counsel for Jacko Law Group, PC and has more than 27 years of experience collaborating with business leaders and senior executives on complex matters affecting investment advisors, broker-dealers, and private funds. Mr. Field concentrates his practice on securities regulation and commercial transactions, including structuring and offering mutual funds, private funds, wrap accounts, and separately managed institutional accounts. Mr. Field also advises on lift outs, private placements, trading and derivative agreements, trade secrets, errors and omissions, and industry practices related to ethics and governance.

1. The Securities and Exchange Commission's ("SEC") Rule 206(4)-2 (the "Custody Rule" or "Rule") under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Most state-registered investment advisors are subject to requirements that are the same or substantially similar to the SEC's Custody Rule and its interpretations. Of course, advisors should confer with their own compliance professionals and legal counsel about the matters discussed by this article.
2. Schwab and others in the industry, notably the Investment Adviser Association, continue efforts to resolve the uncertainties, particularly regarding standing letters of authorization.
3. Along with this *Compliance Review*, Schwab is also publishing an update to its *Frequently Asked Questions About the SEC's Amended Custody Rule*, previously published in April 2010.
4. There is a wealth of resources about the Custody Rule available to advisors. Schwab has published previous *Compliance Review* articles and various compliance updates, and has hosted webcasts. Visit the compliance page on schwabadvisorcenter.com for current and previous Custody Rule publications. In addition, the SEC staff has published, and periodically updates, a set of frequently asked questions—"SEC Staff Responses to Questions About the Custody Rule," updated as of September 1, 2013 (the "SEC FAQs"), available at www.sec.gov/divisions/investment/custody_faq_030510.htm.
5. Office of Compliance Inspections and Examinations, "Significant Deficiencies Involving Advisor Custody and Safety of Client Assets," *National Exam Program Risk Alert*, Vol. III, Issue 1, March 4, 2013.
6. *In the Matter of GW & Wade, LLC*, Investment Advisers Act Rel. No. 3706, ct. 28, 2013.
7. *In the Matter of Rodney A. Smith, Michael Santicchia, CPA, and Stephen D. Cheaney, CPA*, Investment Advisers Act Rel. No. 3738, Dec. 12, 2013.
8. Rule 206(4)-2(d)(2)(ii).
9. See SEC FAQs, Questions II.4, II.5.A and II.5.B.
10. SEC FAQs, II.5.B
11. SEC FAQs, II.6.
12. See "Continuing Custody Quandary: Client Account Numbers and Passwords," located on the compliance page on schwabadvisorcenter.com.
13. See Note 6, above (hereinafter "GW & Wade").
14. Investment Advisers Act Rel. No. 3636, July 9, 2013.
15. SEC FAQs, Question III.1.
16. SEC FAQs, Question II.1.
17. See Question II.2 in the January 2005 version of the SEC FAQs.
18. See SEC FAQs, Questions VI.1–11, and Michael Caccese and Rebecca O'Brien Radford, "The Amended Custody Rule: What It Means for You," *Charles Schwab Compliance Review*, Vol. 19, Issue 3, April 2010. (*Schwab Compliance Review* is on the compliance page on schwabadvisorcenter.com.)
19. See sec.gov/rules/final/2009/ia-2968.pdf.
20. SEC FAQs, Question II.2.
21. Rule 206(4)-2(d)(5) presumes operational independence if (i) client assets in the custody of the related person are not subject to claims of the investment advisor's creditors; (ii) advisory personnel do not have custody or possession of, or direct or indirect access to, client assets of which the related person has custody, or the power to control the disposition of such client assets to third parties for the benefit of the investment advisor or its related persons, or otherwise have the opportunity to misappropriate such client assets; (iii) advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision; and (iv) advisory personnel do not hold any position with the related person or share premises with the related person.
22. Such as Charles Schwab & Co., Inc.
23. Investment Advisers Act Rel. No. 2876, n.61, May 20, 2009.
24. SEC Adopting Release, n.21.
25. schwabadvisorcenter.com.
26. See 206(4)-2(a)(4), which provides that the exams must be "at a time that is chosen by the accountant without prior notice or announcement to you and that is irregular from year to year."
27. *In the Matter of Mark M. Wayne*, Investment Advisers Act Rel. No. 3737, ec. 12, 2013.
28. Rule 206(4)-2(b)(6) provides an exception to the surprise examination requirement to an advisor when a related person is acting as qualified custodian for the advisor's clients if the related person is operationally independent of the investment advisor.
29. One hundred and eighty days for a fund of funds.
30. *See GW & Wade*.
31. Like the Custody Rule, 206(4)-7 is an antifraud rule with severe consequences for violations.
32. See Investment Management Group of Paul Hastings, Janofsky & Walker LLP, "New Rule Requiring Compliance Programs for Investment Advisors," *Charles Schwab Compliance Review*, Vol. 13, Issue 1, Jan.–Feb. 2004, on the compliance page on schwabadvisorcenter.com.
33. See, again, *GW & Wade*.
34. See Advisers Act Section 206(4).

Online compliance resources

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HNW (0714-4440) NWS15120JUL14-00 (07/14)

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