## Financial Services Newsletter

# SEC Responds to No-Action Relief from the Custody Rule for Advisers with SLOAs

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By now, advisers and others within the investment community are familiar to some degree with the amendments to Rule 206(4)-2 under the Investment Advisers Act of 1940 (the "Custody Rule" or the "Rule"). Although most agree that the Custody Rule has provided additional protection to investors, it has also placed an additional regulatory and economic burden on investment advisers.

The SEC recently provided some guidance to investment advisers which we have summed up in this newsletter.

### Backdrop

As many clients seek advisers' assistance with their investment and cash management needs, they often do so through their qualified custodian by setting up an arrangement known as a Standing Letter of Authorization ("SLOA"). Through an SLOA, a client instructs its qualified custodian to allow the adviser to request the transfer of funds to specifically-designated third parties.

The SLOA provides advisers with limited authority over client funds. Clients retain the power to modify or revoke the SLOA. As a result, there has been debate in the investment adviser community as to whether such an arrangement actually constitutes custody and, therefore, would require that adviser to undergo a Surprise Custody Examination performed by an independent public accountant pursuant to the Rule.

### Request

In a letter dated February 15, 2017, the Investment Adviser Association (IAA) requested interpretive guidance or no-action relief relating to the Custody Rule for certain SLOA arrangements. Specifically, the IAA asked the SEC to confirm the IAA's position that an SLOA arrangement — which provides such limited authority to the adviser over client funds — does not constitute custody as contemplated by the Rule. Alternatively, the IAA requested assurance that the SEC would not recommend enforcement action for those instances where an adviser acts pursuant to an SLOA when a specific set of circumstances are present and the adviser does not undergo an annual Surprise Custody Examination pursuant to the Rule.

### Response

In a letter dated February 21, 2017, the SEC responded to the IAA and expressed their disagreement with the IAA's interpretation of SLOA arrangements. The SEC made it clear that an investment adviser with such arrangements would be required to comply with the Custody Rule. However, the SEC also stated that the Division of Investment Management would not recommend enforcement action to the Commission under the Rule against an adviser that does not obtain a Surprise Examination when it acts pursuant to an SLOA arrangement under the specific circumstances outlined in their letter.

## Circumstances Required for No-Enforcement Action

The SEC agreed that it would not recommend enforcement action against an investment adviser if that adviser does not obtain a Surprise Examination under the Custody Rule if the following circumstances exist:

- 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 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 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 client has the ability to terminate or change the instruction to the client's qualified custodian.
- 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 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.
- The client's qualified custodian sends the client, in writing, an initial notice confirming the instruction and an annual notice reconfirming the instruction.

## Implementation Period

The SEC also recognized in their letter that a reasonable period of time would be required to implement the processes and procedures necessary to comply with this relief. Further, it stated that beginning with the next annual updating amendment after October 1, 2017, an adviser should include client assets that are subject to an SLOA that result in custody in its response to Item 9 of Form ADV.

## Recommendation

Advisers that service clients through SLOAs should carefully review with their professional advisers the SEC's no-action letter to determine if they meet or can arrange to meet the requirements outlined in the letter to ascertain if they could benefit from the relief and avoid the regulatory and economic burden of undergoing an annual Surprise Custody Examination.

## Contact Us

For more information about the SEC Custody Rule, Surprise Custody Examinations, and safeguarding client assets, contact Michael Provini, CPA (mprovini@pkfod.com); Victor Peña, CPA (vpena@pkfod.com); or Eric Gelb, CPA (egelb@pkfod.com) at 212.286.2600.

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