SPOTLIGHT ON

The Custody Rule for Registered Investment Advisors

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The SEC and many U.S. States have adopted "Custody Rules" under which investment advisors may have "custody" of client assets even if those assets are with a broker-dealer, bank, or other custodian. Advisors with "custody" over client assets must meet additional obligations, including providing additional disclosures, obtaining independent audits and retaining certain records.

This is a significant and oft-misunderstood rule. The SEC and state regulators regularly scrutinize whether an advisor has "custody" over its clients' assets and make sure those that have custody meet the additional obligations this status triggers. The SEC recently noted widespread non-compliance with important aspects of the Custody Rule, including the failure by many advisors to realize that the advisors had "custody" within the meaning of the Custody Rule.

This document is designed to provide a general overview of the Custody Rule, highlight some of the common pitfalls facing advisors under the rule, and summarize the main obligations imposed on advisors with "custody" of client assets.

When does an advisor have "custody" of client assets?

The scope of the Custody Rule is often misunderstood.

Under federal law, an advisor has "custody" over client assets if it is "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them." This includes situations where "a related person holds, directly or indirectly, client funds or securities, or has authority to obtain possession of them, in connection with the advisory services you [adviser] provide to clients." Therefore, advisors may be subject to the Custody Rule, Rule 206(4)-2 of
the Investment Advisers Act, because they have custody directly or indirectly (through a related person).

When does an advisor have "custody" of client assets? (cont.)

For example, under SEC and most state rules, an advisor is deemed to have custody over client assets if it:

- Has (however brief) possession of client funds or securities.
    - This includes handling checks or putting client money in the advisor's own account to transfer it to the broker unless:
        - the advisor receives the funds inadvertently and returns them to the sender (rather than forwarding them to the client's custodian) promptly, i.e., within three business days of receipt; or
        - the check is made payable to a third party (like the broker) and the advisor merely forwards on that check.
    - Advisor clients with Interactive Brokers accounts can deposit funds directly into their own separate accounts.

- Enters into arrangements (including a general power of attorney) authorizing the advisor to withdraw funds or securities from client accounts maintained with a custodian.
    - This includes:
        - the ability to sign checks on a client's behalf, to withdraw funds or securities from a client's account, or to disburse client funds or securities for any purpose (other than through trading);
        - providing bill-paying services to clients; and
        - fee arrangements with clients whereby the advisor can deduct fees from client accounts (or have the custodian deduct fees as an agent for the advisor rather than the client) unless the client has authorized the custodian to deduct the amount of advisory fees (either by specifying an exact amount or the method for calculating the fees) and the fees are reflected on the client's account statement;
        - Interactive provides automatic billing arrangements that do not result in advisors having custody under the SEC Custody Rule and allow clients to see the type of fee charged, the calculation methodology and the amount of the fee charged.

- Serves in a capacity (e.g., general partner to a limited partnership, trustee of a trust, or managing member of a limited liability company) giving the advisor or a supervised person legal ownership or access to client funds or securities.

Please keep in mind that these are simply examples provided by the SEC, and not an exhaustive list of the ways in which an advisor may have "custody" of client assets.

What an advisor with "custody" over client assets must do

An investment advisor with "custody" of client assets must comply with a number of additional obligations. This includes additional controls put in place by the SEC in 2010 as a result of the Madoff Scandal.

Specifically, under the federal and most state versions of the Custody Rule, registered advisors deemed to have "custody" must:

- Maintain client funds and securities with a "qualified custodian," e.g., registered broker-dealers and/or futures commission merchants (like Interactive Brokers), U.S. banks and savings associations, or similar foreign financial institutions.
    - These assets must be maintained either in a separate account for each client under the client's name or in accounts containing only client assets in which the advisor is the agent or trustee for its clients.
    - Interactive Brokers maintains separate accounts for each advisor client, over which the advisor can exercise discretionary trading authority from a distinct master advisor account.

- Notify clients in writing of the qualified custodian's name, address, and manner in which the funds or securities are held, promptly upon account opening and following any changes.

- Have a reasonable basis (following an appropriate inquiry) to believe that the qualified custodian sends account statements directly to the advisor's clients at least quarterly.
    - The account statements must, at least, identify the amount of funds and securities at the end of the period and all transactions in the account during that period.
    - Statements can be sent by mail or sent electronically, so long as the advisor has reason to believe that the client received the statements.
        - Simply making statements available online but not confirming the client reviewed them is not enough.
    - The account statements may be sent to the client's designated independent representative so long as this representative is independent from the advisor.
    - IB mails compliant quarterly account statements directly to advisors' clients.

What an advisor with “custody” over client assets must do (cont.)

- Have an independent public accountant perform an annual “surprise” examination verifying the funds and securities under the advisor’s “custody” pursuant to a written agreement.
  - Following the exam, the accountant must promptly file a certificate of accounting on Form ADV-E electronically though IARD.
  - This requirement does not apply to advisors who have “custody” solely because the advisor has authority to withdraw fees from the qualified custodian.
  - If an advisor has custody solely because it or a related person maintains client funds or securities as a qualified custodian, the independent public accountant retained to perform the surprise examination must be registered with, and subject to regular inspection by PCAOB, and the advisor must also obtain an annual internal control report from an independent public accountant (registered with, and subject to regular inspection by the PCAOB) regarding the effectiveness of the advisor’s related person’s (or the advisor’s itself) procedures for safeguarding client assets and funds and securities and verifying that funds and securities are reconciled against the records of a custodian other than the advisor or its related person.

- Disclose whether they have “custody” of client assets on their Form ADV Part 1A, including the number of clients whose assets the advisor has custody over, and the approximate amount of client assets under custody.

- Have policies and procedures for the safekeeping of client assets.

- Maintain certain records related to their custody accounts, including the internal control report required by the Custody Rule.

For additional information on advisors’ record-keeping obligations, please review our brochure, Spotlight on Advisors’ Record Keeping Obligations.

Additional state obligations may apply

Many states track the SEC Rule but some states impose additional or different obligations. You should research the particular rules of the state(s) in which you do business:

- Some states go as far as to prohibit advisors from having custody over client funds;
- Others impose bonding requirements on advisors (or their associated persons) with custody or discretionary authority over client funds to protect against larceny or embezzlement; and
- Advisors that may not qualify as custodians under the federal Custody Rule may nonetheless be deemed custodians under certain states' definitions.

It appears that regulatory interest in and focus on advisor "custody" of client assets will continue.

Advisors should therefore carefully analyze the Custody Rule and how it applies to the way they manage their clients' business. If advisors do not wish to have custody over client assets, they should structure their business and their agreements with clients to avoid the types of pitfalls discussed above. Advisors should also ensure they keep abreast of any new SEC pronouncements on or interpretations of the Custody Rule's very specific and technical requirements.