IM Guidance Update

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INADVERTENT CUSTODY: ADVISORY CONTRACT VERSUS CUSTODIAL CONTRACT AUTHORITY

The staff of the Division of Investment Management has determined that under the Investment Advisers Act of 1940 custody rule, Rule 206(4)-2, an investment adviser may inadvertently have custody of client funds or securities because of provisions in a separate custodial agreement entered into between its advisory client and a qualified custodian. This guidance update discusses, among other things, some circumstances the staff has encountered where such inadvertent custody could arise.

The staff cautions advisers to be aware that they may have custody due to the authority resulting from various agreements that may be in place in connection with relevant custodial and advisory agreements. The custodial agreement between a client and custodian may grant an adviser broader access to client funds or securities than the adviser's own agreement with the client contemplates. Depending on the wording of or rights conferred by these custodial agreements, an adviser may have custody, and may also be subject to the surprise examination requirement, even though it did not otherwise intend to have such access.

The staff has observed that, in some cases, the terms of an agreement between a client and qualified custodian might permit the client's adviser to instruct the custodian to disburse, or transfer, funds or securities.[1] Examples of such agreements between clients and qualified custodians include:

- A custodial agreement that grants the client's adviser the right to "receive money, securities, and property of every kind and dispose of same."
- A custodial agreement under which a custodian "may rely on [adviser's] instructions without any direction from you. You hereby ratify and confirm any and all transactions with [the custodian] made by [adviser] for your account."
- A custodial agreement that provides authorization for the client's adviser to "instruct us to disburse cash from your cash account for any purpose . . . ."

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The definition of custody turns on whether the adviser is permitted to "withdraw" client funds or securities "upon [the adviser's] instruction to the qualified custodian."[2] The staff believes that an adviser would have custody where the custodial agreement enables the adviser to withdraw, or transfer, client funds or securities upon instruction to the custodian. An adviser could also have custody when provisions in a custodial agreement and advisory agreement conflict as to an adviser's authority to withdraw, or transfer, client funds or securities upon instruction to the custodian. For example, the staff believes an adviser would have custody if the custodial agreement authorizes the adviser to withdraw client funds or securities, notwithstanding a provision in the advisory agreement to the contrary. Moreover, a separate bilateral restriction between the adviser and the client would be insufficient to prevent the adviser from having custody where the custodial agreement enables the adviser to withdraw or transfer client funds or securities upon instruction to the custodian.[3] An adviser would have custody, in either case, because from the qualified custodian's perspective the client has authorized the adviser to withdraw the client's funds or securities. While there may be constraints contained in the advisory agreement between the adviser and its client(s), the custodian may not be aware of them; accordingly, if, for example, the adviser attempted to withdraw funds from the account, the custodian would view the adviser as authorized to do so and would release those funds. In this regard, however, where a custodial agreement is structured narrowly to permit the deduction of advisory fees (without granting any other rights that would impute custody), an adviser may have custody but not need a surprise examination, provided it otherwise complies with the exception under Rule 206(4)-2(b)(3) available to advisers with limited custody due to fee deduction.[4]

Accordingly, depending on the facts and circumstances, custodial agreements could impute advisers with custody they otherwise did not intend to have. The staff cautions advisers to be aware of this possibility and, if applicable, take steps to ensure they comply with the custody rule. One way for an adviser to avoid such inadvertent custody would be to draft a letter (or other form of document) addressed to the custodian that limits the adviser's authority to "delivery versus payment," notwithstanding the wording of the custodial agreement, and to have the client and custodian provide written consent to acknowledge the new arrangement.[5]

Endnotes

1 An adviser's authority to issue instructions to a broker-dealer or a custodian to effect or to settle trades does not constitute "custody." Clients' custodians are generally under instructions to transfer funds (or securities) out of a client's account only upon corresponding transfer of securities (or funds) into the account. This "delivery versus payment" arrangement minimizes the risk that an adviser could withdraw or misappropriate the funds or securities in its client's custodial account. This guidance update contemplates custody arising from authority that goes beyond such arrangements.

2 Rule 206(4)-2 defines "custody," in part, to mean "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. . . ." Custody includes "[a]ny arrangement (including a general power of attorney) under which [an adviser is] authorized or permitted to withdraw client funds or securities maintained with a custodian upon [its] instruction to the custodian."

3 Such a restriction might appear in account agreements or powers of attorney with the adviser. For example, the staff has observed wording seeking to limit an adviser's authority in a power of attorney stating that it "implies no power to personally obtain custody or possession of any securities."

4 For example, such a custodial agreement might provide "(1) [Custodian name] is permitted to rely upon the authority of the [adviser] to provide instructions to disburse cash from your cash account if [custodian] in good faith believes such instructions to be given in connection with or in accordance with: (a) securities trading activity; or (b) the payment of fees that you owe [adviser]. (2) Any other instructions to disburse cash from your accounts must come from you or other persons whom you have authorized to do so in accordance with the agreement, but excluding your [adviser]. (3) Your [adviser] will not have the authority to provide us with any instruction to disburse cash from your accounts on your behalf except as contemplated above."

5 Without written consent, the adviser would retain the authority conferred under the original agreement, and the adviser would continue to have custody.

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