

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Parts 275 and 279

[Release No. IA-2176; File No. S7-28-02]

RIN 3235-AH 26

### Custody of Funds or Securities of Clients by Investment Advisers

**AGENCY:** Securities and Exchange Commission (the "Commission").

**ACTION:** Final rule.

**SUMMARY:** The Commission is adopting amendments to the custody rule under the Investment Advisers Act of 1940. The amendments modernize the rule by conforming the rule to modern custodial practices and requiring advisers that have custody of client funds or securities to maintain those assets with broker-dealers, banks, or other qualified custodians. The amended rule also provides a definition of "custody" and illustrates circumstances under which an adviser has custody of client funds or securities. The amendments are designed to enhance protections for client assets while reducing burdens on advisers that have custody of client assets.

**DATES:** *Effective Date:* November 5, 2003. *Compliance Date:* April 1, 2004.

**FOR FURTHER INFORMATION CONTACT:** Vivien Liu, Senior Counsel, or Jennifer L. Sawin, Assistant Director, at 202-942-0719 or [IArules@sec.gov](mailto:IArules@sec.gov), Office of Investment Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0506.

**SUPPLEMENTARY INFORMATION:** The Commission is adopting amendments to rule 206(4)-2 (17 CFR 275.206(4)-2)<sup>1</sup> under the Investment Advisers Act of 1940 (15 U.S.C. 80b) (the "Advisers Act" or "Act") and to Part 1A, Item 9 and Part II, Item 14 of Form ADV (17 CFR 279.1).

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<sup>1</sup> Unless otherwise noted, when we refer to rule 206(4)-2 or any paragraph of the rule, we are referring to 17 CFR 275.206(4)-2 of the Code of Federal Regulations in which the rule is published.

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### Executive Summary

The Commission is amending rule 206(4)-2, the custody rule under the Advisers Act, to reflect modern custodial practices and clarify circumstances under which an adviser has custody of client assets. The amendments require advisers that have custody to maintain client funds and securities with a broker-dealer, bank, or other "qualified custodian." If the qualified custodian sends account statements directly to an adviser's clients, the adviser is relieved from sending its own account statements and from undergoing an annual surprise examination. The amendments also add a definition of "custody" to the rule and illustrate circumstances under which an adviser has custody of client funds or securities. Finally, the amendments remove the Form ADV requirement that advisers with custody include an audited balance sheet in their disclosure brochure to clients.

### I. Background

Rule 206(4)-2 regulates the custody practices of advisers registered under the Advisers Act. The rule requires advisers that have custody of client securities or funds to implement a set of controls designed to protect those client assets from being lost, misused, misappropriated or subject to the advisers' financial reverses.

Last year we proposed comprehensive amendments to rule 206(4)-2. Our proposal was designed to enhance the protections afforded to advisory clients' assets, harmonize the rule with current custodial practices, and clarify circumstances under which advisers have custody.<sup>2</sup> We received 49 comment letters in response to our proposed rule. Commenters strongly supported the approach of the proposal. One noted that our proposal would replace "highly detailed compliance requirements with an overall regulatory framework in order to achieve greater accountability and transparency of transactions in client accounts."<sup>3</sup> We are adopting the

<sup>2</sup> *Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Release No. 2044 (July 18, 2002) [67 FR 48579 (July 25, 2002)] ("Proposing Release").

<sup>3</sup> See *Summary of Comments* prepared by our staff, available in our Public Reference Room in File

amendments to rule 206(4)-2 with certain changes that respond to commenters' recommendations.

### II. Discussion

#### A. Definition of Custody

We have added to the rule a definition of the term "custody." An adviser has custody of client assets, and therefore must comply with the rule, when it holds, "directly or indirectly, client funds or securities or [has] any authority to obtain possession of them."<sup>4</sup> We provide three examples designed to illustrate circumstances under which an adviser has custody of client funds or securities. Commenters agreed that the examples will be helpful to advisers.

The first example clarifies that an adviser has custody when it has possession of client funds or securities, even briefly.<sup>5</sup> An adviser that holds clients' stock certificates or cash, even temporarily, puts those assets at risk of misuse or loss. The amendments, however, expressly exclude inadvertent receipt by the adviser of client funds or securities, so long as the adviser returns them to the sender within three business days of receiving them.<sup>6</sup> The rule does not permit advisers to forward

No. S7-28-02, and on our Web site at <http://www.sec.gov/rules/extra/s72802csumm.htm>.

<sup>4</sup> Amended rule 206(4)-2(c)(1). One commenter asked whether an adviser with multiple lines of business within the same corporation or other business entity has "custody" if its non-advisory business gives the adviser or its personnel authority to obtain customers' funds or securities. For example, an adviser might provide investment advice and also offer, separately, a bill-paying service through which the adviser's employees gain signatory power over a customer's checking account. If the customer is not an advisory client of the adviser, the adviser does not have custody of "client funds and securities." If, however, the customer is also an advisory client, the adviser has access to a client's assets, and therefore has custody, even though that access arises through a separate line of business.

The same access could also arise through an affiliate of the adviser. An adviser may, for example, have custody if its affiliate holds funds or securities of the adviser's clients under circumstances in which the adviser or its personnel have access to those client assets through the affiliate. Our staff previously has expressed similar views in *Crocker Investment Management Corp.*, SEC Staff Letter (Apr. 14, 1978).

<sup>5</sup> Amended rule 206(4)-2(c)(1)(i). In our proposed rule, our first example of custody referred to "possession or control" of client funds or securities, but commenters suggested that the term "control" improperly suggested that an adviser that merely has trading authority over a client's securities account has custody for purposes of the rule. See *infra* note. We believe that the definition and other examples make it clear that an adviser has custody when it can control client funds or securities for purposes other than authorized trading, and that the word "control" is therefore not needed in the first example.

<sup>6</sup> We had proposed requiring the adviser to return the funds and securities in one day, but commenters suggested that a longer period was needed to reduce inadvertent violations of the rule.