

clients' funds and securities without having "custody," although advisers may certainly assist clients in such matters.⁷ In addition, the amendments clarify that an adviser's possession of a check drawn by the client and made payable to a third party is not possession of client funds for purposes of the custody definition.⁸

The second example clarifies that an adviser has custody if it has the authority to withdraw funds or securities from a client's account.⁹ An adviser with power of attorney to sign checks on a client's behalf, to withdraw funds or securities from a client's account, or to dispose of client funds or securities for any purpose other than authorized trading has access to the client's assets.¹⁰ Similarly, an adviser authorized to deduct advisory fees or other expenses directly from a client's account has access to, and therefore has custody of, the client funds and securities in that account.¹¹ These advisers might not have possession of client assets, but they have the authority to obtain possession.

Several commenters suggested that we change the definition of "custody" to exclude advisers' access to client funds through fee deductions. We are not adopting this suggestion. Removing this form of custody from the definition would mean that clients would not receive the quarterly account statements

that are required under the rule, and which are needed so that clients may confirm that the adviser has not improperly withdrawn amounts in excess of its fees.¹² We are, however, amending Form ADV so advisers that have custody only because they deduct fees will not need to amend their registration statements.¹³

The last example clarifies that an adviser has custody if it acts in any capacity that gives the adviser legal ownership of, or access to, the client funds or securities.¹⁴ One common instance is a firm that acts as both general partner and investment adviser to a limited partnership.¹⁵ By virtue of its position as general partner, the adviser generally has authority to dispose of funds and securities in the limited partnership's account and thus has custody of client assets.¹⁶

¹² See Section II.C. of this Release. We note, however, that rule 206(4)-2 defines "custody" broadly in order to serve the remedial purposes of the rule, and to ensure that advisory clients receive timely reports on transactions in their assets and thus can take action to protect themselves in the event of an adviser's misuse of their funds. Consequently, an adviser that has "custody" for purposes of rule 206(4)-2 may not necessarily have custody for other purposes.

¹³ See Section II.E. of this Release.

¹⁴ Amended rule 206(4)-2(c)(1)(iii).

¹⁵ This example applies equally to an adviser that acts as both managing member and investment adviser of a limited liability company or another type of investment vehicle, or as both trustee and investment adviser of a trust. A firm may also have custody when a supervised person fills one of these roles, such as when a portfolio manager serves as trustee of a client trust. *E.g., In the Matter of Gofen and Glossberg, Inc.*, Investment Advisers Act Release No. 1400 (Jan. 11, 1994). We understand that supervised persons may, on occasion, engage the advisory firm to advise an estate, conservatorship or personal trust for which the supervised person serves as executor, conservator or trustee. We would not view the adviser to have custody of the funds or securities of the estate, conservatorship, or trust solely because the supervised person has been appointed in these capacities as a result of family or personal relationship with the decedent, beneficiary or grantor (and not a result of employment with the adviser).

The amended rule contains a limited exception from the rule for client accounts that are limited partnerships subject to an annual audit. *See infra* Section II.D.2 of this Release. Some commenters asked whether they could, instead of complying with the amended rule, continue following procedures established under certain no-action letters, *e.g., Bennett Management Co.*, SEC Staff Letter (Feb. 26, 1990); *PIMS, Inc.*, SEC Staff Letter (Oct. 21, 1991); *Canyon Management Co.*, SEC Staff Letter (Oct. 15, 1991); *Pacific Management, Ltd.*, SEC Staff Letter (Oct. 29, 1991); *Lee Capital Management*, SEC Staff Letter (Oct. 29, 1991); *Eichler Magnin, Inc.*, SEC Staff Letter (Nov. 4, 1991); *GBU, Inc.*, SEC Staff Letter (Apr. 22, 1993). The staff is withdrawing those letters. Advisers, including those firms that have relied on these letters in the past, must comply with the amended rule.

¹⁶ Investment advisers that also act as general partners for real estate partnerships in which their advisory clients are limited partners requested

B. Use of Qualified Custodians

We are adopting, as proposed, a requirement that advisers with custody of client funds and securities maintain them with qualified custodians.¹⁷ The qualified custodian must hold the funds or securities in an account either under the client's name or under the adviser's name as agent or trustee for its clients.¹⁸

"Qualified custodians" under the amended rule include the types of financial institutions that clients and advisers customarily turn to for custodial services. These include banks and savings associations¹⁹ and registered broker-dealers.²⁰ In order to allow advisers that also offer futures advice to comply with Commodity Futures Trading Commission rules, "qualified custodians" also include registered futures commission merchants.²¹ Finally, "qualified custodians" include foreign financial

clarification about the rule's application to such partnerships. In such circumstances, the rule does not apply to the assets of the real estate partnership unless the partnership is an advisory client of the investment adviser.

¹⁷ Amended rule 206(4)-2(a)(1). The amended rule does not prohibit an adviser from using more than one qualified custodian to hold funds and securities of a client.

¹⁸ Under the amendments, client funds and securities must be held on behalf of the client by the qualified custodian so that the qualified custodian can provide account information to the clients. Keeping stock certificates in the adviser's bank safe deposit box, for example, would not satisfy the requirements of the rule.

¹⁹ Amended rule 206(4)-2(c)(3)(i). A "bank" under section 202(a)(2) of the Advisers Act (15 U.S.C. 80b-202(a)(2)) includes national banks, members of the Federal Reserve System, and other banks and trust companies having similar authority to national banks and supervised by State or Federal banking agencies. A "savings association" is a financial institution as defined in section 3(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(b)(1)) and insured and supervised by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act (12 U.S.C. 1811).

²⁰ Amended rule 206(4)-2(c)(3)(ii). "Qualified custodian" includes any broker-dealer that is registered with and regulated by us under the Securities Exchange Act of 1934 (the "Exchange Act"), holding the client assets in customer accounts.

²¹ Amended rule 206(4)-2(c)(3)(iii). Futures commission merchants are registered with the Commodity Futures Trading Commission ("CFTC") under section 4f(a) of the Commodity Exchange Act (7 U.S.C. 6f(a)) and regulated by the CFTC.

"Qualified custodian" includes a registered futures commission merchant holding the client assets in customer accounts. Registered investment advisers that also provide clients with advice about futures, including "security futures," may also be subject to CFTC rules; CFTC rules require that "customer funds" be custodied with a futures commission merchant. *See* rule 4.30 (17 CFR 4.30) under the Commodity Exchange Act. *See also* Commodity Futures Modernization Act (Pub. L. 106-554, 114 Stat. 2763 (2000)) (security futures are both securities and futures). The rule also allows advisers to maintain client securities with a futures commission merchant to the extent the securities are incidental to client futures transactions.

⁷ We understand that some advisers meet with clients to prepare or compile documents, including stock certificates, for forwarding to a custodian or third party. Nothing in the amended rule suggests that preparing these documents with a client gives the adviser "custody."

⁸ Checks payable to an adviser for payment of advisory or similar fees due to the adviser also do not represent "client funds" within the meaning of the custody rule and therefore advisers would not have custody as a result of receiving those checks. An adviser would, however, have custody of client funds if it holds a check drawn by the client and made payable to the adviser with instructions to pass the funds through to a custodian or to a third party.

⁹ Amended rule 206(4)-2(c)(1)(ii).

¹⁰ 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.

¹¹ Some commenters asked whether they could, instead of complying with the amended rule, continue following procedures established under certain no-action letters, *e.g., Investment Counsel Association of America, Inc.*, SEC Staff Letter (June 9, 1982); *John B. Kennedy*, SEC Staff Letter (June 5, 1996); and *Securities America Advisers Inc.*, SEC Staff Letter (Apr. 4, 1997). The staff is withdrawing those letters. Advisers, including those firms that have relied on these letters in the past, must comply with the amended rule.