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## RECENT STAFF GUIDANCE ON THE CUSTODY RULE UNDER THE INVESTMENT ADVISERS ACT OF 1940

*SEC staff guidance issued last year addresses the risk of “inadvertent custody,” the effect of standard letters of authorization, and first-party transfers. The author discusses the staff’s views on these subjects, suggests some appropriate procedures for advisers, and notes some open questions for which guidance is sought.*

By Christopher S. Petito \*

In early 2017, the Office of Compliance Inspections and Examinations (“OCIE”) of the SEC issued a Risk Alert flagging deficiencies in compliance with the Custody Rule under the Investment Advisers Act of 1940<sup>1</sup> as one of the five most frequent compliance issues identified in examination deficiency letters sent to SEC-registered investment advisers.<sup>2</sup> Among the types of common Custody Rule deficiencies identified in the Risk Alert was the failure of advisers to recognize that they may have custody of client assets for purposes of the rule, as a result of “having (or related persons having) powers of attorney authorizing them to withdraw client cash and securities.”<sup>3</sup>

The Custody Rule is one of the principal customer protection rules under the Advisers Act. Under the Custody Rule, it is illegal for an SEC-registered investment adviser to have “custody” of client funds or securities unless they are maintained in accordance with the requirements of the rule. The purpose of the Custody Rule is to protect client funds and securities from loss, misuse, or misappropriation, including loss due to the adviser’s insolvency.<sup>4</sup> Failure to comply with the Custody Rule can result in findings of significant deficiencies in SEC examinations and may lead to SEC enforcement action.<sup>5</sup>

In addition to the Risk Alert, in February 2017 the Staff of the SEC’s Division of Investment Management issued three guidance documents as to the application of the Custody Rule to custody agreements, standing letters

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<sup>1</sup> Rule 206(4)-2 under the Advisers Act.

<sup>2</sup> OCIE Risk Alert: *The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers* (Feb. 7, 2017). OCIE had previously provided guidance as to the types of issues observed in examinations in OCIE Risk Alert: *Significant Deficiencies Involving Custody and Safety of Client Assets* (March 4, 2013).

<sup>3</sup> *Id.* at 4.

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<sup>4</sup> Investment Adviser Association, Feb. 21, 2017, text at n.2, citing *Adoption of Rule 206(4)-2 Under the Investment Advisers Act of 1940*, Adv. Act Rel. No. 123 (Feb. 27, 1962).

<sup>5</sup> See, e.g., *In re Morgan Stanley Smith Barney, LLC*, Adv. Act Rel. No. 4609 (Jan. 13, 2017).

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