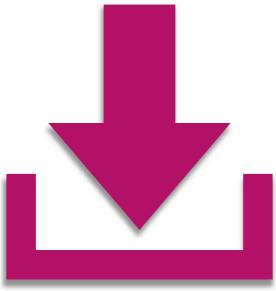
Custody Rule Developments

AUGUST 14, 2025



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https://www.ria-compliance-consultants.com/custody_rule_dev



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Limitations & Exclusions

- This course is focused on SEC requirements and does not necessarily cover additional requirements and differences for state-registered investment adviser firms. If you are with a state-registered firm, you are encouraged to review the custody requirements of your home state and other states where your firm is registered.
- This not an exhaustive review of all custody considerations. Although this course covers the minimum requirements and the more common custody situations, there could be additional issues and requirements that apply to your firm that are not covered in this course.

Learning Objectives / Course Overview

- Understand what constitutes 'custody' under Rule 206(4)-2
- Best practices for fee deduction and fee audit procedures
- Distinguish between first-party and third-party SLOAs
- Identify types of custody that trigger a surprise verification exam
- Understand custody implications for private fund sponsors
- Questions & Answers

Resources

- 206(4)-2 - Custody of funds or securities of clients by investment advisers.
  - https://www.law.cornell.edu/cfr/text/17/275.206(4)-2
- Staff Responses to Questions About the Custody Rule
  - https://www.sec.gov/rules-regulations/staff-guidance/division-investment-management-frequently-asked-questions/staff-responses-questions-about-custody-rule
- SEC Investment Management Guidance Update: *Inadvertent Custody: Contract Versus Custodial Contract Authority*
  - https://www.sec.gov/investment/im-guidance-2017-01.pdf
- SEC No-Action Letter to Investment Adviser Association (Feb. 21, 2017)
  - https://www.sec.gov/divisions/investment/noaction/2017/investment-adviser-association-022117-206-4.htm

Proposed Safeguarding Rule - Withdrawn

The proposed rule sought to broaden the scope of assets covered by the custody rule, requiring registered investment advisors to maintain all client assets, including crypto assets, with qualified custodians.

It also aimed to impose new requirements on qualified custodians and to explicitly include discretionary trading authority within the definition of custody.

The new rule was proposed on February 15, 2023

It was formally withdrawn in June 2025

Proposed Safeguarding Rule – Withdrawn (continued)

The SEC does not intend to issue a final rule based on the 2023 proposal.

The SEC stated that if they decide to pursue future regulatory action in this area, they will issue a new proposed rule.

Therefore, existing Rule 206(4)-2 remains the governing regulation for investment advisers with custody of client funds or securities.

Definition of Custody

Custody means holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. You have custody if a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services you provide to clients. Custody includes:

- (i) Possession of client funds or securities (**but not** of checks drawn by clients and made payable to third parties) unless you receive them inadvertently and you return them to the sender promptly but in any case within three business days of receiving them;
- (ii) Any arrangement (including a general power of attorney) under which you are authorized or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian; and
- (iii) Any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives you or your supervised person legal ownership of or access to client funds or securities.

Minimum Requirements for Investment Advisers with Custody

1. Client funds and securities must be held by a qualified custodian (include banks, broker/dealers, and future commission merchants).
2. Clients must know the name/location of the qualified custodian.
3. Clients must receive quarterly account statement directly from the qualified custodian. Investment adviser firm must have a reasonable belief, upon due inquiry, the client is receiving account statements.
    - Performance/position reports/statements provided by the investment adviser must include a disclosure urging clients to compare against account statements from the qualified custodian.
4. Investment advisers must hire third-party accountant to perform surprise verification examinations.



Consequences for Failing to Comply with the Custody Rule



Non-Compliance can lead to:

- SEC examination deficiencies
- SEC enforcement actions
- Fines and penalties

Need to get Custody RIGHT!

Fee Deduction and Custody Implications

Fee deduction authority is considered custody, but does not require surprise verification examination

If fee debit authorization is the only type of custody, do not need to answer "yes" to Item 9 of Form ADV Part 1. However, it is still custody and should be explained at Item 15 of Form ADV Part 2A.

Fee Deduction and Custody Implications (continued)

Investment adviser firm must attain written authorization from the client to debit advisory fees.

- Can be provided in the client agreement or separate authorization.

Many state regulators require delivery of an invoice or statement at the same time the fee is deducted from the account. Not an SEC requirement but some firms choose to send invoices.

- Must ensure invoices are accurate.

Custody Rule Enforcement Action

Enforcement Action Against Large IA and BD Firm (Sept. 2023)

Facts: Overcharged **10,900 advisory accounts** more than $26.8 million due to incorrect fee calculations and failure to apply agreed-upon discounts.

Results: Firm agreed to pay **$40 million** in penalties and restitution.

Key Lesson: Systemic billing errors can lead to massive restitution. Firms must implement automated controls and periodic fee audits.

Citation & URL: In the Matter of Wells Fargo Clearing Services & Wells Fargo Advisors Financial Network, LLC (Sept. 2023) https://www.sec.gov/newsroom/press-releases/2023-159

Compliance Practices for Automated Controls and Fee Audits

- Accuracy of fee billing and procedures is always an examination focus.
- Implement sufficient policies and procedures for ensure the accuracy of fee calculations and develop fee audit procedures.
- Involve multiple staff members.
- Conduct back-end reviews.
- Maintain written documentation and records of fee audits.
- When there are errors, take action to correct and resolve the error in the best interest of the client.

Standing Letters of Authorization (SLOAs)

- **First-party transfers**: between accounts owned by same client is not custody if the conditions outlined in the SEC's February 21, 2017, frequently asked question are followed.
  - The client has authorized the adviser in writing to make such transfers and a copy of that authorization is provided to the qualified custodians, specifying the client accounts maintained with qualified custodians.
  - In the SEC's view, "specifying" would mean that the written authorization signed by the client and provided to the sending custodian states with particularity the name and account numbers on sending and receiving accounts (including the ABA routing number(s) or name(s) of the receiving custodian) such that the sending custodian has a record that the client has identified the accounts for which the transfer is being effected as belonging to the client. That authorization does not need to be provided to the receiving custodian.
  - Moreover, in the SEC's view, an adviser's authority to transfer client assets between the client's accounts at the same qualified custodian or between affiliated qualified custodians that both have access to the sending and receiving account numbers and client account name (e.g., to make first-party journal entries) does not constitute custody and does not require further specification of client accounts in the authorization.

Standing Letters of Authorization (SLOAs) (continued)

- Third-party transfers: are custody requiring a surprise verification examination.
- Third-party transfers include the ability, whether invoked or not, to transfer/wire/move money from a client's account to an account not owned by the client.
- The SEC issued a no-action letter to the Investment Adviser Association (dated February 21, 2017), setting forth seven conditions that if followed allow an investment adviser to avoid surprise exam

Standing Letters of Authorization (SLOAs) (continued)

- Seven conditions to avoid surprise verification examination when using third-party SLOAs.
  1. The client provides an instruction to the qualified custodian, in writing, that includes the client's signature, the third party's name, and either the third party's address or the third party's account number at a custodian to which the transfer should be directed.
  2. The client authorizes the investment adviser, in writing, either on the qualified custodian's form or separately, to direct transfers to the third party either on a specified schedule or from time to time.
  3. The client's qualified custodian performs appropriate verification of the instruction, such as a signature review or other method to verify the client's authorization, and provides a transfer of funds notice to the client promptly after each transfer.

Standing Letters of Authorization (SLOAs) (continued)

4. The client has the ability to terminate or change the instruction to the client's qualified custodian.
5. The investment adviser has no authority or ability to designate or change the identity of the third party, the address, or any other information about the third party contained in the client's instruction.
6. **The investment adviser maintains records showing that the third party is not a related party of the investment adviser or located at the same address as the investment adviser.**
7. The client's qualified custodian sends the client, in writing, an initial notice confirming the instruction and an annual notice reconfirming the instruction.

Standing Letters of Authorization (SLOAs) (continued)

- Additional "Condition"
  - Investment adviser firms relying on the no-action letter are required to disclose the amount of clients and dollar amount at Item 9.A. of Form ADV Part 1A.



Standing Letters of Authorization (SLOAs) (continued)

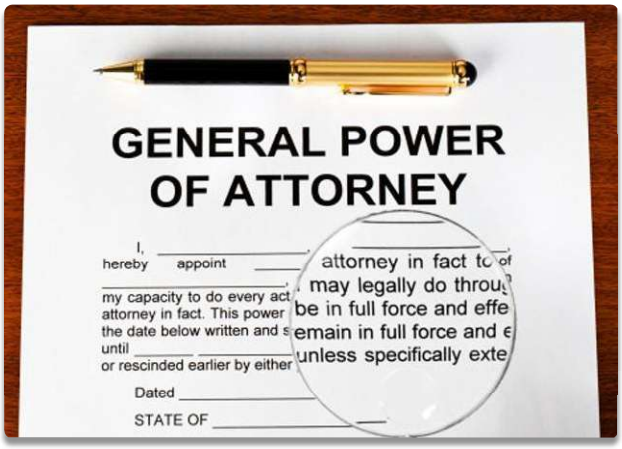
Have there been enforcement actions specifically for SLOAs?

- **Direct enforcement for SLOAs alone is rare**, but SLOAs often appear in broader custody-related cases where advisers failed to:
  - Obtain surprise exams
  - Deliver audited financials
  - Maintain proper controls over disbursements

The SEC has pursued enforcement where **weak controls over third-party disbursements** enabled misappropriation.

Example: The SEC charged a firm in 2018 for failing to adopt policies to prevent misuse of client funds. Adviser personnel could initiate third-party transfers up to $100,000/day based on verbal confirmations, which allowed a particular advisory personnel to steal client funds. The firm paid penalties and implemented remedial measures.

Other Types of Custody that Require Surprise Verification Exams



- Surprise Verification Exams are required when adviser has custody and no exception applies.
- Different Types of Custody
  - Serving as trustee, executor and other similar legal capacities for clients.
  - Bill pay services
  - Full Power of Attorney (POA)
  - Client login access

Other Types of Custody that Require Surprise Verification Exams (continued)

- Different Types of Custody
  - Serving as investment adviser **and** trustee for your investment adviser firm's company retirement plan.
  - **Inadvertent Custody**
    - Depending on the facts and circumstances, custodial agreements, client agreements, and other written authorizations could impute advisers with custody they otherwise did **not** intend to have.

Other Types of Custody that Require Surprise Verification Exams (continued)

- Inadvertent Custody
  - Adviser 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.

Surprise Verification Exams

- Surprise verification exams must be conducted annually by a third-party, independent accountant
- Name and contact information of the independent account must be disclosed at Section 9.C. of Form ADV Part 1A.
- Accountants are required to immediately (within one business day) notify the SEC if discrepancies are discovered.
- Results of the surprise verification exam must be reported to the SEC and made available to the public (via IAPD), by filing Form ADV-E.
- The accountant is required to upload the Form ADV-E.

Surprise Verification Exams (cont.)

- **Form ADV-E is required** not only after the completion of the surprise examination, but also:
  - **Within four business days** of the accountant's **resignation, dismissal, or termination**.
  - The filing must include:
    - The date of the change.
    - The name, address, and contact information of the accountant.
    - An explanation of any problems related to the examination scope or procedure that contributed to the change
- This requirement applies regardless of whether the adviser is switching to another accountant or terminating the engagement entirely.
- The written agreement between the adviser and the accountant must explicitly require the accountant to:
  - File Form ADV-E after the examination.
  - Notify the SEC of any discrepancies or termination

Custody Rule Enforcement Action

Facts: From 2018 through 2024, **an investment adviser firm's president** served as co-trustee of two advisory client trusts, had signatory authority on four client accounts, and acted with power of attorney on five client accounts. These roles established **custody**, and therefore triggered surprise-examination obligations under Rule 206(4)-2(a)(4).

The firm **did not arrange** any required surprise examinations during that period.

Results: Settlement included a **cease-and-desist order** and a **$50,000 civil penalty** (no admission or denial of wrongdoing).

Key Lesson: Even without client harm, failing to conduct surprise examinations when custody exists is a violation—custody can arise from roles that may not initially appear risky, such as trustee or POA.

Citation & URL: *In the Matter of Munakata Associates LLC*, SEC Administrative Proceeding, File No. 3-22500 (Aug. 1, 2025). Access the SEC order here: https://www.sec.gov/enforcement-litigation/administrative-proceedings/ia-6901-s

Custody via Private Fund Sponsorship

- Serving as general partner/managing member/similar legal capacity and investment adviser to a private fund or other pooled investment vehicle is custody
- Private Fund Advisers must comply with the Rule 206(4)-2 requirements:
  - Maintain all funds and securities with a qualified custodian
  - Ensure all investors are provided the qualified custodian's name/contact information.
  - Ensure all investors receive account statements ***directly from the*** qualified custodian
  - Attain annual surprise verification exam



Custody via Private Fund Sponsorship (continued)

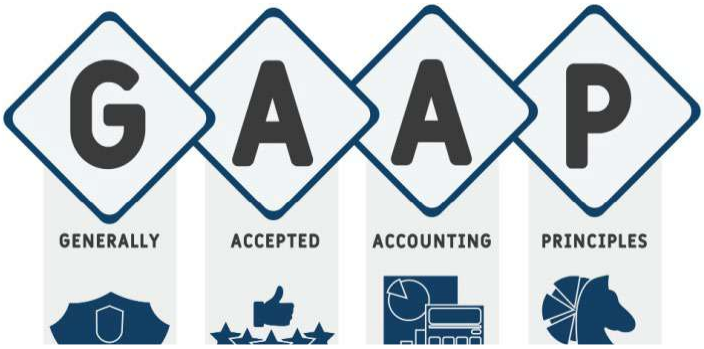


- For many private funds, compliance with the primary requirements is not feasible or too burdensome
- However, they can **avoid the annual surprise examination requirement** and **avoid the qualified custodian requirement** under the Custody Rule by meeting the **audit exception** criteria.

Custody via Private Fund Sponsorship (continued)

- The audit exception allows advisers to avoid the annual surprise examination requirement if specific conditions are met.
- 1. Annual audit by an independent public accountant registered with PCAOB.
- 2. Audit must comply with U.S. GAAP.

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Custody via Private Fund Sponsorship (continued)

- 3. Audited financials must be completed and distributed to all investors:

  - Within 120 days of fiscal year-end for most funds.
  - Within 180 days for fund-of-funds.
  - Upon liquidation (i.e., closing)



Private Fund Custody Enforcement

SEC Charges Five Advisory Firms for Custody Rule Violations

Facts: Five firms—Lloyd George Management (HK) Limited, Bluestone Capital Management LLC, The Eideard Group LLC, Disruptive Technology Advisers LLC, and Apex Financial Advisors Inc.—failed to comply with safekeeping requirements. Violations included:

- Not performing required audits
- Failing to deliver audited financials to investors on time
- Not ensuring a qualified custodian maintained client assets
- Failing to update Form ADV disclosures regarding audits

Results: All firms agreed to **censure**, **cease-and-desist orders**, and **civil penalties ranging from $50,000 to $225,000**, totaling over $500,000.

Key Lesson: Timely audits and accurate Form ADV updates are critical. The SEC views these as core investor protections, and enforcement sweeps target systemic failures.

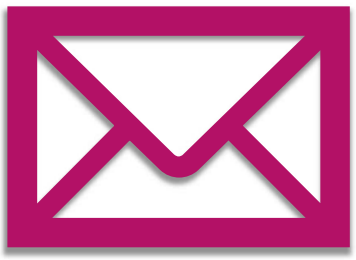
Citation & URL: *SEC Press Release No. 2023-168 (Sept. 5, 2023). Access the Press Release here: https://www.sec.gov/newsroom/press-releases/2023-168*

Key Takeaways

- Custody is broader than physical possession.
- It includes the ability to move (e.g., transfer, wire, move, withdraw) funds and securities from a client's account to a third-party.
- Understand custody triggers and maintain accurate policies, procedures and documented testing/compliance reviews.
- Limit custody to fee debit authorization to avoid surprise verification exams and needing to report the number of custody clients and dollar amount on Form ADV Part 2A
- Use the SEC's February 21, 2017 no-action letter to the Investment Advisers Association for SLOA framework to avoid surprise verification examinations.
- Private fund advisers can use the audit exception to reduce compliance burden related to private funds they sponsor.

Questions

Please submit any question online or email with any questions about the content of this course.



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Thank You

