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UNDERSTANDING THE INVESTMENT ADVISER CUSTODY RULE: PART I – DETERMINING CUSTODY

Stung by its failure to uncover long-running Ponzi schemes by registered investment advisers in time to prevent massive losses to customers, the SEC has devoted new attention to the client safeguards of its custody rule. What constitutes custody under the rule is the principal subject of Part I of this article. In Part II, which will appear in a forthcoming issue, the author addresses in detail the four principal safekeeping requirements of the rule.

By Robert E. Plaze *

An adviser as a fiduciary has a duty to act with reasonable care to protect the interest of his or her clients, including the care of client assets entrusted to the adviser. Failure to exercise such care is considered a form of fraud under the Investment Advisers Act of 1940 ("Advisers Act"). In 1960, the U.S. Securities and Exchange Commission ("SEC") was given authority to write rules designed to prevent fraud, and among the first it adopted was rule 206(4)-2 (the "custody rule"), which requires advisers that have custody of client funds and securities to implement a set of controls to insulate those assets from "any unlawful activities or financial reverses, including insolvency of the adviser."[1]

The original rule was designed to stop advisers from practices such as holding client stock certificates in unlocked file cabinets — a practice that seems quaint today. As custodial practices have evolved so has rule 206(4)-2. The rule was amended extensively in 2003, primarily to codify and resolve years of SEC staff interpretations that, among other things, addressed how the rule applies when client securities are held in book-entry form with broker-dealers and other financial institutions.[2] In 2009, the rule was once again amended in response to the scandals involving Bernie Madoff's Ponzi scheme.[3]

Today, rule 206(4)-2 represents a fairly complex body of law that the SEC enforces vigorously. No SEC compliance examiner wants to be responsible for missing the next Ponzi scheme, and one of the characteristics of a Ponzi scheme is that the client assets

[1] Adv. Act Rel. No. IA 123 (Feb. 27, 1962).

[2] Adv. Act Rel. No. IA 2176 (Sep. 25, 2003) ("2003 Adopting Release").

[3] Adv. Act Rel. No. IA 2968 (Dec. 30, 2009) ("2009 Adopting Release").

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are gone — having been used to pay off withdrawing clients and line the pockets of the promoter. More common frauds involving misappropriation of client assets will typically also involve violations of the custody rule.[4] As a result, safety of client assets is perennially a priority for SEC examiners, and most SEC examinations today involve a review of whether the adviser has custody of client assets, and, if so, whether it has complied with rule 206(4)-2.[5]

The SEC expects advisers subject to the custody rule to develop and implement robust compliance controls designed to prevent violation of the rule.[6] In 2013, the SEC's Office of Compliance Inspections and Examinations ("OCIE") issued a "Risk Alert" in which the staff identified custody-related deficiencies observed by examiners.[7] The Risk Alert was followed later that year by a press release announcing three enforcement actions by advisers for infractions of the custody rule.[8]

More cases continue to be brought. This article is intended to provide legal and compliance professionals with an understanding of how rule 206(4)-2 operates and some of the issues it presents for investment advisers.

I. SUMMARY OF SAFEGUARDS

Rule 206(4)-2 applies only to registered advisers with "custody" of client funds or securities, as defined in the rule.[9] The rule, subject to certain exceptions, requires registered investment advisers having custody of client assets to adopt four primary safeguards.

1. *Maintenance with a Qualified Custodian*. Maintain those assets with broker-dealers, banks, commodity futures merchants, and certain foreign custodians. Under the rule, these are called "qualified custodians."

2. *Client Notification*. Notify clients of the name of the custodian that is holding their assets (when the account is opened by the adviser on a client's behalf) and when changes are made to the custodial arrangements.

3. *Quarterly Account Statements*. Have a reasonable belief that each qualified custodian sends an account statement at least quarterly to each client for which it holds funds or securities.

4. *Surprise Annual Verification*. Undergo an annual surprise verification of those funds or

[4] *See*, *e.g.*, *Vero Capital Mgmt., LLC,* Adv. Act Rel. No. IA 3991 (Dec. 29, 2014) (enforcement action alleging that adviser diverted assets of liquidating fund through purported bridge loans, transfers).

[5] Examination Priorities of 2014, SEC Office of the Compliance Inspections and Examinations (Jan 9, 2014)("[S]taff will continue to test compliance with [rule 206(4)-2] and confirm the existence of assets through risk-based verification processes."). The topic was left off of the 2015 priority list, which was shortened, but there is every reason to believe the SEC examination staff will continue to focus on custody.

[6] Adv. Act Rel. No. 2204 (Dec. 17, 2003) at Section II.A.1. In the 2009 Adopting Release, at Section II.G., the SEC provided detail guidance on the types of policies and procedures the SEC expected of advisers with custody of client assets. Most of the SEC enforcement actions involving violations of the custody rule also involve violations of rule 206(4)-7 (the "compliance rule").

[7] *Significant Deficiencies Involving Adviser Custody and Safety of Client Assets,* National Exam Program Risk Alert, Volume III, Issue 1 (Mar. 4, 2013), *available at* http://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf.

[8] Press Release: *SEC Charges Three Firms with Violating Custody Rule* (Oct. 28, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540098359.

[9] The custody rule thus does not apply to so-called "exempt reporting advisers" that must file Form ADV with the SEC, but are not registered with the SEC in reliance on sections 203(l) (venture capital fund adviser) or 203(m)(private fund adviser) of the Advisers Act. For convenience, the term "adviser" is used to mean an adviser that is registered with the SEC, unless the context suggests otherwise. The rule does apply, however, with respect to clients that are provided advice without compensating the adviser. Question II.9 of SEC Staff FAQs. of *Staff Responses to Questions About the Custody Rule* ("SEC Staff FAQs"), *available at* http://www.sec.gov/divisions/investment/custody_faq_030510.htm.

securities by an independent public accountant.

If the assets are maintained by a qualified custodian that is a "related person" the adviser must also obtain from the custodian a report of the internal controls relating to custody of client assets from an accountant that is registered and inspected by the Public Company Accounting Oversight Board (PCAOB).[10] Rule 206(4)-2 provides special treatment for advisers to pooled investment vehicles (including private funds), waiving the reporting and surprising verification requirements with respect to client funds that are subject to annual audits, *i.e.*, the "audit approach" to compliance with the rule.[11]

II. DETERMINING WHETHER THE ADVISER HAS CUSTODY

Most advisers do not have custody and do not want custody of their client's assets. But some types of advisory businesses find it hard to avoid having custody because of the nature of the services they provide, the SEC's broad definition of custody, or both. A broker-dealer/adviser will ordinarily have custody of client assets that are held in its brokerage accounts, and a trust company will have custody of trust assets it holds.[12] For different reasons an adviser to a private fund that acts as general partner to the private fund will ordinarily have custody.

An adviser that does not accept custody of client assets will typically include statements in its client brochure and include provisions in its advisory contracts admonishing clients not to send them cash or securities. But even such an adviser needs to remain vigilant that it does not unintentionally acquire custody of client assets as a result of some new business arrangement or affiliation.[13] The SEC staff observed in its 2013 Risk Alert that advisers sometimes fail to recognize that they have custody of client assets. This is at least partially because the SEC's definition is not intuitive inasmuch as custody is not limited to physical custody of client assets and sometimes treats more than one person having custody of the same asset. Simply using a third-party custodian to hold client assets does not mean an adviser does not also have custody.

Whether an adviser will be deemed by the SEC to have custody of client assets turns not on the disclosure it makes to its clients, but on the application of the definition of "custody" in rule 206(4)-2. An adviser is only subject to the rule if it has custody of client assets, and is subject to the rule only with respect to those assets over which it has custody. As a consequence, an adviser may be subject to the rule with respect to some clients and not others, and may be subject to the rule with respect to some of a single client's assets it manages and not others.

Under rule 206(4)-2, an adviser has custody when it holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them.[14] An adviser may have custody indirectly when an investment vehicle it controls has custody or when an employee or a "related person" has custody of its client's securities or funds. This definition is fleshed out in examples contained in the rule itself, SEC releases, and staff interpretations discussed below.

a. Possession of Client Funds or Securities

An adviser has custody when it (or its related person) has possession of client funds or securities.[15] Thus, an adviser has custody if it physically holds client stock certificates, bonds, or cash, even if it holds them temporarily. An adviser that controls a cash account in which the proceeds from the sale of client securities are held briefly before distribution to the clients will have custody of those assets.[16] There are a few significant exceptions to this general rule.

Inadvertent Receipt. Sometimes an adviser will inadvertently come into possession of client funds and

[10] Section III.a of the second part of this article discusses provisions of the custody rule that apply when an adviser itself maintains client assets or maintains client assets with a related person who is a qualified custodian.

[11] Section II of the second part of this article discusses provisions of the rule that apply with respect to assets of a pooled investment vehicle.

[12] For convenience, this article uses the term "client assets" interchangeably with "client funds and securities" which, as discussed in the second part of this article, are the only client assets subject to the protections of the rule.

[13] *Barclays Capital, Inc*., Inv. Adv. Act Rel. No. IA 3929 (Sept. 23, 2014) (after acquisition adviser failed to identify client accounts maintained with related persons).

[14] Rule 206(4)-2(d)(2).

[15] Rule 206(4)-2(d)(2)(i).

[16] *SEC v. Sentinel Management Group, Inc., et al,* 2012 WL 1079961 (N.D. Ill. 2012).

securities, for example, as a result of opening up the daily mail and discovering stock certificates or cash. To prevent the adviser from immediately being in violation the rule, it contains an exclusion that deems an adviser not to have custody if it returns such assets *to the sender* within three business days of receiving them.[17]

However, with two exceptions discussed below, the inadvertent receipt exception does not permit an adviser to forward client funds or securities to a custodian; it must return them to whoever sent them to the adviser. This provision of the rule is designed to discourage advisers (and their employees) from offering to help a client arrange for custody of their assets, providing an opportunity to misuse them. It requires that an adviser has in place policies and procedures that extend to its mail room to make sure that it does not inadvertently obtain possession of client funds or securities.

Tax Refunds and Settlement Proceeds. The strict application of the inadvertent custodian provision of the rule created problems when advisers received tax refunds, settlement proceeds, or other checks from third parties for payment to the client. In such situations, return of the check to the person sending it would result in almost certain losses for the client, thus turning a rule designed to protect client assets on its head.

To prevent such losses, in 2007 the SEC staff issued a no-action letter stating that it would not recommend enforcement action under rule 206(4)-2 if an adviser forwards client assets inadvertently received from third parties either to its client or a qualified custodian within five business days of its receipt of such assets, and maintains appropriate records.[18] The letter is limited to inadvertent receipt by an adviser of (i) client tax refunds from tax authorities or (ii) client settlement proceeds from administrators in connection with class action lawsuits and other legal actions, or stock certificates, dividends, or evidence of new debt from issuers in connection with class action lawsuits involving bankruptcy or business reorganization.

Checks. As noted above, the adviser's physical possession of a client's check would generally give it custody of the check and thus client funds. This general rule is subject to some significant exceptions. First, an adviser's possession of a check drawn *by the client* and made payable to a third party would not give the adviser custody of client assets.[19] As a result, advisers that do not accept custody of client assets may nonetheless forward their own client's checks to, for example, the client's custodian, but must return checks from third parties even if the check is made payable to the client (unless either the tax refunds and settlement proceeds exception is available). An adviser would have custody if it holds a check made payable to the adviser with instructions to use the proceeds to invest on behalf of the client. Second, an adviser's receipt of a check in payment for its services would not give the adviser custody because the funds would no longer be the client's.[20]

b. Authority to Withdraw Funds or Securities from a Client's Account

An adviser has custody if it has authority to withdraw the client's funds or securities that are maintained with a custodian.[21] An adviser might, for example, have this authority as a result of a power of attorney, password access to a client's account, or check-writing authority granted by the terms of a bank account.[22] This is the most complicated of the three circumstances set forth in the rule under which an adviser may have custody, and the one with the most qualifications.

Trading Authority. Common arrangements under which an adviser has limited trading authority to instruct a client's custodian to transfer securities or cash out of an account upon a corresponding transfer of securities or cash into an account "delivery versus payment" ("DVP"), does not result in the adviser having custody.[23] Accordingly, an adviser may manage a portfolio of client assets held by third-party custodians without having custody of those assets. Instruments such as a power of attorney under which an adviser is granted trading authority need to be drafted narrowly to avoid

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[17] Rule 206(4)-2(d)(2)(i); Question II.1of SEC Staff FAQs.

[18] *Investment Adviser Association*, Sept. 20, 2007. The IAA letter stated that the SEC staff expected an adviser that inadvertently received client assets from third parties in more than rare or isolated instances would adopt and implement policies and procedures reasonably designed to meet the terms of the letter.

[19] Rule 206(4)-2(d)(2)(i).

[20] 2003 Adopting Release, *supra* note 2 at n. 8.

[21] Rule 206(4)-2(d)(2)(ii).

[22] *GW & Wade, LLC*, Adv. Act Rel. No. IA 3706 (Oct. 28, 2013) (settled enforcement action involving an adviser that maintained blank pre-signed letters from clients authorizing transfers of assets).

[23] 2003 Adopting Release, supra note 2 at n. 10 and accompanying text.

any implication that the adviser has more than trading authority.

Password Access. Many custodians provide advisers with password access to client accounts that permit the adviser to direct trading instructions, check client balances, create client reports, and perform other functions. If, however, that password access provides the adviser (or its employee) with the ability to withdraw or transfer assets the adviser will be deemed to have custody of those assets.[24] To avoid these consequences, an adviser should avoid obtaining client login credentials to access a web site of a custodian without investigating the scope of the access granted.

Standing Authority to Transfer. Sometimes clients ask advisers to direct the client's custodian to make payments to a third person, for example, to a parent, a child at college, or a mortgage company. Such authority provides the adviser with custody under the rule even if so circumscribed.[25] The adviser is providing a bill-paying service, in addition to its advisory activities. Advisers wishing to avoid having custody should direct a client requesting this service to the client's custodian.

Transfers Between Client Accounts. An adviser's limited authority to transfer securities or cash between accounts of the same client maintained with one or more qualified custodians would not give the adviser custody of those assets, but only if the client has authorized the adviser in writing to make such transfers and a copy of such authorization is provided to the qualified custodians.[26] The SEC staff hasn't addressed whether authority to transfer assets from an account owned by a single individual to an account jointly held with a third person, such as a parent or spouse, would give the adviser custody. However, at least where the third person has a general power of attorney or otherwise has authority to act on behalf of the client (such as a minor child), such a transfer should be treated as nothing more than a transfer between the same client accounts.

Remitting Proceeds to Client. Clients may submit a request to the adviser (rather than their custodians) to sell securities and return the proceeds to the client, which raised questions under the rule when the adviser *also* has authority to change the address of record of the client with the custodian to which those funds will be remitted. The SEC staff has advised that an adviser's authority to instruct the qualified custodian to remit funds or securities from a client's account to the same client at his address of record does not give the adviser custody of client assets if (i) the client has granted such authority in writing and provided a copy to the qualified custodian and (ii) the adviser has neither the authority to open an account on behalf of the client nor the authority to designate or change the client's address of record.[27] If the adviser does have authority to change the client's address, it must have a reasonable belief that the custodian follows procedures (required of broker-dealers and other custodians) pursuant to which the custodian sends a confirming letter to both the client's old and new addresses.[28]

Unwanted Access. One of the peculiarities of rule 206(4)-2 is that an adviser may have custody if it is granted authority to withdraw securities or funds from a client account by a client custodial agreement, even if it has not accepted such authority and is not even a party to the custodial agreement.[29] Advisers have recently discovered that the custodial agreement of one large custodial bank has included such authority. It is unclear whether contract language under which an adviser disclaims such authority would be sufficient to permit it to avoid application of the custody rule. Thus, as a precaution, advisers should consider reviewing client custodial agreements or other grants of authority from clients.

Deduction of Fees. An adviser authorized to deduct advisory fees or other expenses directly from a client's

[24] Question II.6 of SEC Staff FAQs. In the *GW & Wade* enforcement action, *supra* note 22, the adviser was determined to have custody for a number of reasons, including its possession of log-in information and passwords for brokerage accounts.

[25] The SEC staff has not issued a FAQ on the point, but it can be inferred from its response to Questions II.6 where the staff explained that an adviser has custody if it has authority to transfer assets to an account not in the client's name.

[26] Question II.4 of SEC Staff FAQs.

[27] Question II.5.A of SEC Staff FAQs.

[28] Question II.5.B of SEC Staff FAQs. The staff positions permit advisers who are also qualified custodians to follow the same procedures for changing client addresses under the different regulatory regimes to which they are subject. *See. e.g.*, rule 17a-3(a)(17)(i)(B)(2) (requiring broker-dealers to send customers notification of a change of address to old address before changing address).

[29] Rule 206(4)-2(d)(2)(ii). The peculiarity results from the passive construction of this portion of the rule text: "any arrangement (including a general power of attorney) under which [the adviser is] authorized or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian."

account has custody of the client funds and securities in that account. Again, this result is not intuitive, but it stems from the common practice of advisers submitting invoices for advisory fees that custodians will pay without verifying whether the amount is proper under the terms of the advisory contract, permitting the adviser or its personnel to misappropriate client assets.[30] In this circumstance, however, rule 206(4)-2 requires in most cases only that qualified custodians send quarterly account statements to clients.[31] The account statement, which must reflect all account transactions during the period, permits clients to monitor amounts deducted from their account to pay advisory fees.[32]

c. Capacity That Gives the Adviser Legal Ownership of, or Access to, Client Funds or Securities

An adviser will have custody if it serves in a capacity that gives it legal ownership of, or access to, client funds or securities.[33] Advisers commonly acquire legal ownership of client assets by acting as a general partner of a pooled investment vehicle, or as a trustee or executor.

Acting as General Partner. An adviser that acts as general partner to a limited partnership (or as manager to a limited liability company) generally has legal authority over and access to funds and securities in the limited partnership's account, and thus has custody of client assets even though the fund's securities are held by a prime broker and all funds are held in bank accounts.[34] The rule contains a number of provisions designed to accommodate advisers to private funds that distribute audited financial statements to investors that will be discussed in Part II of this article.[35]

Acting as Trustee or Executor. If an adviser is the trustee of a trust or an executor of an estate for which the adviser provides advisory services, the adviser will generally have custody of the trust or estate's assets. There are a few important exceptions to this rule.

If a supervised person has custody of client assets, custody will be imputed to the adviser.[36] But if the employee becomes a trustee as a result of a family or personal relationship, the SEC will not impute custody to the adviser.[37] The custody rule thus permits an adviser that will not accept custody of client assets to manage the assets of a family trust or estate of an

[30] The SEC has suggested a number of policies and procedures that an adviser with authority to deduct fees should have in place to address the risk that fees are deducted from client accounts to which the adviser is not entitled. 2009 Adopting Release, *supra* note 3 at Section II.G. The agency has recently brought enforcement actions against advisers deducting fees in excess of those authorized by the advisory contract. *See*, *e.g.*, *Equitas Capital Advisors, LLC,* Adv. Act Rel. No. IA 3704 (Oct. 23, 2013).

[31] Specifically, an adviser that has custody solely as a result of authority to deduct its advisory fees (but not other expenses) does not have to obtain a surprise examination of client assets unless those assets are maintained with a related person that is not "operationally independent" of the adviser. Rule 206 (4)-2(b)(3). Moreover, Form ADV does not require the adviser to report that it has custody if the sole reason that it has custody under rule 206(4)-2 is that it has authority to deduct advisory fees. Instruction to Item 9.A.(1) of Form ADV.

[32] Where, however, someone else, such as the qualified custodian, determines the amount of the fees due and the custodian remits the amount to the adviser, the adviser does not have custody of client assets. *See* Question III.1 of the SEC Staff FAQs.

[33] Rule 206(4)-2(d)(2)(iii). Arguably, this third "example" in the rule is redundant, because an adviser with legal authority as described below would have access to client assets under the second example.

[34] Private funds offered to taxable investors are typically organized as limited partnerships, while those offered to tax exempt investors are more likely to be corporations, often organized in the Cayman Islands or some other jurisdiction for tax reasons. While advisers to the former will likely have custody as a result of the form of organization, those organized as corporations may also have custody because a related person of the adviser controls the corporation or serves on its board of directors, which, under Cayman Islands law, gives the director executive authority and access to fund assets. In contrast, a sub-adviser to either type of private fund may be able to avoid having custody of fund assets if it (or a related person) does not serve as a general partner or is not otherwise granted authority to access fund assets.

[35] *Infra* Section II of the second part of this article.

[36] Question II.2 of SEC Staff FAQs. *See Gofen and Glossberg,* Adv. Act Rel. No. 1400 (Jan. 11, 1994) (adviser deemed to have constructive or indirect custody of assets of trusts for which the employees acted as trustees).

[37] 2009 Adopting Release, *supra* note 3 at n. 139. Similarly, the SEC staff has expressed the view that an adviser that provides advisory services to an account owned by its own employee (or other related person) does not have custody simply because the employee has the ability to withdraw his or her own assets. *See* Question II.7 of SEC Staff FAQs. The staff position is available only to natural persons owning accounts to which the adviser provides advisory services.

employee-trustee/executor without complying with the requirements of the custody rule or reporting on its Form ADV that the adviser has custody of client assets. In such cases, the employee is in a position (and has the legal obligation) to protect the assets of the trust or estate.

In some cases, the adviser will have a co-trustee that itself has duties to protect the assets of the trust and thus provide a meaningful check on the adviser or its personnel. The SEC has stated that in such cases, it will not treat an adviser as having custody solely because it acts as a trustee if the adviser cannot withdraw assets without the prior written consent of a co-trustee that (i) is a bank or a trust company that itself is a qualified custodian; (ii) is not a related person of the adviser; and (iii) the bank or trust company co-trustee delivers account statements directly to each other co-trustee that has custody.[38]

Revocable grantor trusts are trusts that are established for estate planning and other purposes, control of which, for all intents and purposes, remains with the grantor (typically, the client) because the adviser cannot act without permission of its client. In recognition of this, the SEC staff has stated that it will not treat an adviser as having custody of a revocable grantor trust if (i) the adviser is prohibited from withdrawing assets from the trust without prior written consent of all of its co-trustees; (ii) each grantor who has contributed assets to the trust acts as a co-trustee; and (iii) the qualified custodian delivers account statement directly to each co-trustee.[39]

d. Through Related Persons

An adviser may indirectly have custody (and thus be subject to the rule) if its client assets are held by a "related person," – *i.e.*, a person that controls the adviser, or that is controlled by the adviser, or is under common control with the adviser.[40] Related-person custody arises commonly when an adviser is affiliated with a broker-dealer or other type of qualified custodian, in which case special provisions of the rule apply that require the adviser to obtain a report on custodial controls from the related person.[41] It also arises when the adviser advises a private fund for which the adviser's subsidiary serves as the fund's general partner. The subsidiary (a "related person") is deemed to have custody of the fund assets, which custody is attributed to the adviser. A recent enforcement action brought by the SEC involved an affiliate of the adviser that was a record-keeper that had access to the adviser's client's assets.[42]

The activities of a related person will be attributed to the adviser only if and to the extent that the assets held by the related person are held "in connection with advisory services provided by the adviser." An adviser will thus have custody of the securities in a brokerage account held with an affiliated broker-dealer if the adviser provides the client advice about those assets (regardless of whether the advice is provided on a discretionary basis), but the adviser will not have custody over an account owned by the same client with the broker-dealer that the client trades himself without the advice or assistance of the adviser.

An adviser that is part of a larger financial services company needs to pay particularly close attention to acquiring custody of client assets as a result of a remote corporate transaction. This might happen when an adviser's corporate affiliate acquires a company that owns a custodian which provides custodial services for some of the adviser's clients.[43] Upon consummation of the transaction, the adviser may be deemed to have custody of those client assets.

In many cases the adviser and the related person may share offices and personnel, in which case the rule operates to treat them as a single firm. In cases where the adviser can demonstrate that the two firms are

[38] Question XII.2 of SEC Staff FAQs.

[39] Question XII.3 of SEC Staff FAQs.

[40] A "related person" is any person, directly or indirectly "controlling" the adviser, controlled by the adviser, or under common control with the adviser, and includes parent companies and wholly owned subsidiaries. Rule 206(4)-2(d)(7). The term "control" is defined in Rule 206(4)-2(d)(1) to mean "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company." A related person can be a corporation, partnership, or trust, as well as an individual. An officer, partner, or other person

footnote continued from previous column…

having similar position is presumed to control the firm. A person is presumed to control a corporation if it has authority to vote 25 percent of a class of voting securities, or has similar rights with respect to a limited liability company or partnership. Rule 206(4)-2(d)(1)(ii).

[41] *See* rule 206(4)-2(b)(6) discussed in Part II of this article.

[42] *Mark M. Wayne*, Adv. Act Rel. No. IA 3737 (Dec. 12, 2013).

[43] *Barclays Capital, Inc.*, *supra* note 13 at n.7 (after acquisition, adviser's sole basis for having custody was that a related person held them).

"operationally independent" (as discussed in the second part of this article), the adviser will be deemed to have custody of client assets, but will not be required to obtain a surprise verification of client assets.[44]

e. Multiple Lines of Business

An adviser may have custody if it has access to a client's funds through another line of business. For example, an adviser may also offer a separate bill-paying service that gives its employees signatory power over a customer's checking account. If the customer is not also an advisory client of the adviser, the adviser will not be deemed to have custody for purposes of the rule. If, however, the customer is also an advisory client, the adviser has access to the client's assets, and therefore has custody, even if its access to client funds arises through a separate line of business.[45]

III. CONCLUSION

The importance to an adviser of understanding when it acquires obligations under the custody rule cannot be overstated. Failure to recognize that the adviser has custody of client assets will likely result in a violation of one or more provisions of the custody rule. Because the adviser will have reported to its clients and the SEC that it did not having custody, it will also have violated provisions of the Act prohibiting false and misleading statements to clients and the SEC.[46] The Commission will also assert a violation of the compliance rule if it concludes that the adviser had inadequate policies and procedures to identify when it had custody in violation of the custody rule.[47] The SEC may impose severe penalties for these violations, but none may be as painful to the adviser as having to explain them to clients. ■

[44] *See infra* Section III.a of Part II of this article.

[45] 2003 Adopting Release, *supra* note 2 at n. 4.

[46] *See, e.g., Further Lane Asset Management, LLC.,* Inv. Adv. Act Rel. No. IA 3707 (Oct. 28, 2013).

[47] *See*, e.g., *Barclays Capital, supra* note 13.