

March 10, 2017 | Insights, Investment Management & Private Funds

Clarification of the Custody Rule and Standing Letters of Instruction

By: Rich May, Thomas H. Bilodeau, III, David Glod, Scott A. Stokes

Many investment adviser clients seek to facilitate payments and disbursements to third parties through a standing letter of instruction or other asset transfer authorization established with a qualified custodian (an "SLOI").

Often, the SLOI will allow the qualified custodian to accept the investment adviser's instructions to move money to third parties on the client's behalf. This authority is limited to the terms of the SLOI and may generally be revoked by the client at any time.

For some time, there has been confusion in the industry as to whether the authority granted to the investment adviser by such a SLOI would mean that the investment adviser had "custody" of those assets under Rule 206(4)-2 ("Custody Rule") under the Investment Advisers Act of 1940 (the "Advisers Act"). Generally, if the investment adviser is deemed to have custody of such client funds or securities, then it must obtain a surprise examination of client assets by an independent public accountant in order to comply with the Custody Rule.

A recent SEC No-Action Letter dated February 21, 2017 has provided some clarification and may require all advisers to revisit the SLOIs which may grant them such discretion.

The SEC indicated that since an investment adviser with power to dispose of client funds or securities for any purpose other than authorized trading generally has access to the client's assets, an SLOI under these circumstances would constitute an arrangement under which an investment adviser is authorized to withdraw client funds or securities maintained with a qualified custodian upon its instruction to the qualified custodian. Thus, an investment adviser that enters into such an arrangement with its client would therefore have custody of client assets and would be required to comply with the Custody Rule.

Notwithstanding this view, staff of the Division of Investment Management indicated it would not recommend enforcement action to the Commission under Section 206(4) of, and



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Thomas H. Bilodeau, III

David Glod

Scott A. Stokes

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Rule 206(4)-2 under, the Advisers Act against an investment adviser if that adviser does not obtain a surprise examination where it acts pursuant to such an arrangement under the following circumstances:

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.
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.

In order to allow investment advisers to review any SLOIs relating to client funds or securities, the SEC indicated that beginning with the adviser's next annual updating amendment after October 1, 2017, it should include client assets that are subject to a SLOI that result in custody in its response to Item 9 of Form ADV.

Investment advisers (especially those advising SMAs) should immediately review any standing letters of instruction or other asset transfer authorizations established with a qualified custodian by their clients which grant authority to the adviser. Existing SLOIs which are implicated by this guidance from the SEC should be amended or terminated prior to the adviser's next annual updating amendment (and ideally before October 1, 2017).

Please don't hesitate to contact your Rich May Investment Management team if you have any questions or need assistance with SLOI issues

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