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# Rule 206-4(2) Custody Webinar

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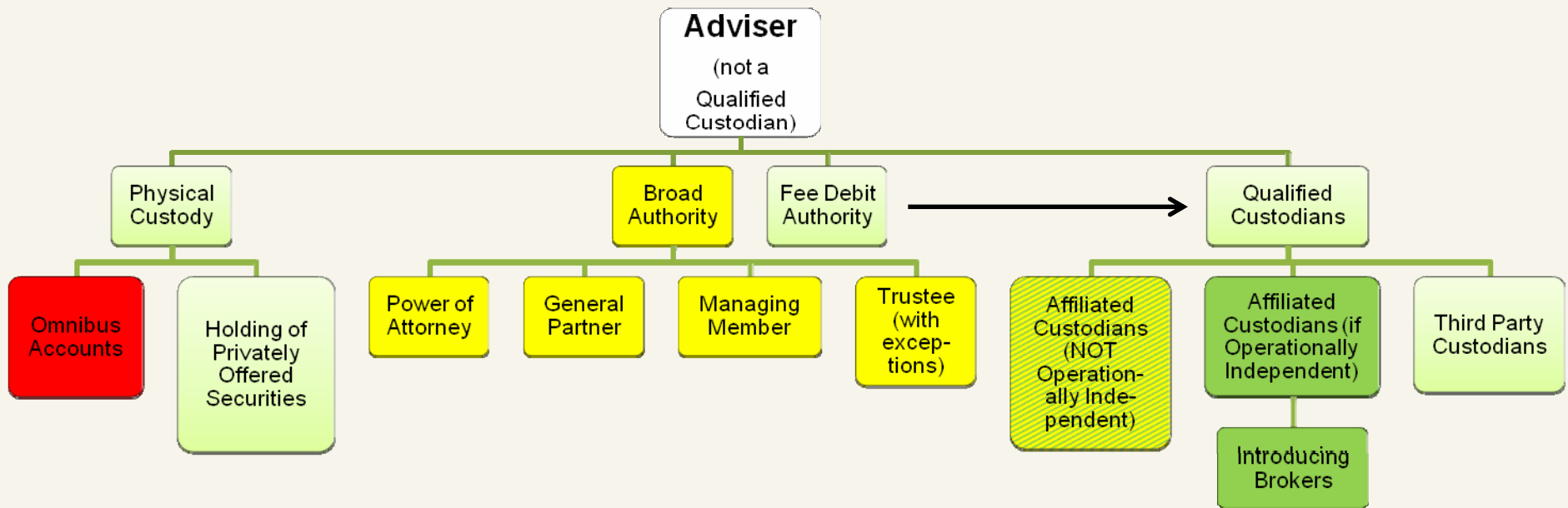


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# Rule 206-4(2) Custody Webinar

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- Account Statements
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# Sources of Custody



No Longer Allowed for Non QCs

Surprise Exam

Internal Control Review

# Custody Timeline

**3/12/10**

- Rule Effective
- "Due Inquiry"
- Client notice of adviser established custodial arrangements

**9/30/10**

- Omnibus account conversions

Here  
We  
Are  
11/18

**1/1/11**

- Form ADV updates (in first annual update)

**9/12/10**

- Control Reviews (or within 6 months of becoming subject to requirement)

**12/31/10**

- Surprise exams to commence (and be completed within 120 days)

# Key Definitions

## ■ Custody

- Direct or indirect holding client funds or securities or having authority to obtain possession of them
  - Physical possession of client funds or securities
  - Any arrangement (including power of attorney) where an adviser is authorized or permitted to withdraw client funds or securities with a custodian on the adviser's instruction to the custodian
    - ▶ Clarification on transfers between & among accounts for the same client
  - Any capacity (i.e., GP, managing member, trustee or comparable position) giving adviser (or supervised person) legal ownership of or access to client funds or securities

## ■ Qualified Custodian

- A bank, broker-dealer, FCM and foreign financial institution that customarily holds financial assets for its customers and keeps advisory client assets in customer accounts segregated from its proprietary assets

# Account Statements

- Basic Rule
  - Advisers with custody must have a “reasonable basis,” after due inquiry, for believing that the qualified custodian sends an account statement, at least quarterly, to each client for which it maintains funds or securities.
- Required Information
  - “The account statements must identify the amount of funds and of each security in the account at the end of the period and set forth all transactions in the account during that period.”
    - TD AMERITRADE account statements show all of the data points required by the custody rule as well as SRO rules: amount of funds and value of each security in the account at the end of the period, and all transactions during that period.
- Reasonable Belief Concept
  - The SEC has stated that an adviser could form a “reasonable basis” for believing that the custodian sent account statements to clients by receiving copies of those statements.
    - ▶ Although this is not the only manner in which an adviser could form such a reasonable belief.

# Reasonable Basis – Possible Examples

- Periodic certifications from qualified custodian that it is sending account statements to clients
  - TD AMERITRADE makes such a letter available to advisers
- Representations and warranties from qualified custodian that it is sending account statements to clients
- Representations and warranties from clients that they know they are to receive account statements directly from qualified custodian and that they will promptly inform adviser if they don't
- Receipt from the qualified custodian of an electronic notice specific to the adviser, confirming that statements have been sent to clients with a link to the statements or listing of specific client accounts
- Delivery of periodic or episodic requests to clients asking them to alert adviser if they have not received account statements
- Periodic confirmation with selected clients that they have received account statements
- Confirming that qualified custodians are independently subject to requirements under applicable law or regulation to send periodic account statements directly to clients
  - TD AMERITRADE is required to send account statements to clients under SEC Rules 15c3-3 and 10b-16, NASD Rule 2340 and NYSE Rule 409.
  - TD AMERITRADE sends account statements to clients monthly (or quarterly if there is no activity) as required.

## Account Transfers – from Client Account to Client Address (Address Changes)

### ▪ Q&A II.5.A:

– We do not interpret the authority to instruct the qualified custodian maintaining a client's account to remit the funds or securities from the account from time to time to the same client at his or her address of record as having custody if:

1. The client has granted such authority to the adviser in writing and a copy of that authorization is provided to the qualified custodian;
2. Adviser has no authority to open an account on behalf of the client; and
3. Adviser has no authority to designate or change the client's address of record with the qualified custodian.



## Account Transfers – from Client Account to Client Address (Address Changes)

### ▪ Question II.5.B:

- Many qualified custodians are subject to regulatory requirements designed to protect against improper or unauthorized changes of address. For example, broker-dealers must send a customer who is a natural person a notification of a change of address to the customer's old address on or before the 30th day after receiving a notice of the requested change. Similarly, . . .banks should send confirmation of a customer request for a change of address to both the old and new address on record.
  - If an adviser has a reasonable belief that the qualified custodian, upon receiving the request for change of address, sends a notice of such change to the client at the client's old address of record, may the adviser change a client's address of record with the qualified custodian and still rely on the answer to Question II. 5. A?

– **Answer:** Yes.

- TD AMERITRADE may accept a change of address on an adviser's instruction but will send a notice of change of address to the client at its old address per SEC Rule 17a-3, and the new address (as an added precaution).

## Account Transfers – From Client Account to Client Account

- **Question II.4:**

- Does an adviser have custody if it has authority to transfer client funds or securities between two or more of a client's accounts maintained with the same qualified custodian or different qualified custodians?

- **Answer:**

- Under rule 206(4)-2(d)(2)(ii), an adviser has custody if it has the authority to withdraw client assets maintained with a qualified custodian upon the adviser's instruction to the custodian. We do not interpret the authority to withdraw assets to include the limited authority to transfer a client's assets between the client's accounts maintained at one or more qualified custodians if 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.

## Account Transfers – From Client Account to Client Account

- TD AMERITRADE will accept an adviser's instruction to transfer funds from a client's account to another account in the client's name at TD AMERITRADE or other qualified custodian with appropriate written client authorization.
- SEC staff guidance states that the adviser must obtain from the client a written authorization to make such transfers and provide a copy of that authorization to the qualified custodian.
- This written authorization may be provided on a "blanket consent" basis.
- TD AMERITRADE will identify all transfers from clients' accounts in the transactional history section of the account statement delivered in the month following the transfer.

## Account Transfers – From Client Account to Third Party

- No SEC Guidance on whether this is deemed custody
- TD AMERITRADE will accept an adviser's instruction to transfer funds from a client's account to a third party account at TD AMERITRADE or another institution only with appropriate written client authorization.
- TD AMERITRADE has controls in place, in accordance with FINRA Regulatory Notice 09-64, to verify instructions from investment advisers or other third parties to transfer assets from a client's account.
- TD AMERITRADE will identify all transfers from clients' accounts in the transactional history section of the account statement delivered in the month following the transfer.

## Account Transfers – From Client Account to Third Party

- New third party disbursement procedures.
- TD AMERITRADE will send a confirmation notice to the underlying client when funds are issued from their account to a third-party or when standing third-party instructions are established. This includes wires, checks, internal transfers, and ACHs, but not adviser management fee billings.
- TD AMERITRADE Institutional will also require verbal authorization from underlying clients when funds are to be distributed internationally, mailed to their adviser, or issued to an entity with a common address or location to their adviser.
- If the funds are to be delivered to a third-party via international wire, TD AMERITRADE will also verify the client phone number with the adviser.

# Introducing Brokers

- An adviser would have custody of client funds or securities maintained by a related person introducing broker
- But, an adviser with a related person introducing broker would not have custody if
  1. Client funds and securities are maintained with a carrying broker that is not a related person of the adviser
  2. The related person introducing broker does not receive client funds or securities (other than checks drawn by clients and made payable to third parties such as the carrying broker)
  3. Neither the adviser nor its related persons has authority to withdraw client funds or securities maintained by the carrying broker

# Surprise Examinations

## ■ Covered

- Client accounts for which adviser has custody
  - Physical custody by adviser (where allowed) or by related person qualified custodian
    - ▶ Independent public accountant must be PCAOB registered and inspected
  - Authority, including power of attorney, acting as GP or trustee, or similar legal authority
    - ▶ Independent public accountant need not be PCAOB registered and inspected
- Compliance date for commencement of exams:  
December 31, 2010

## ■ Not covered

- Client accounts for which adviser has custody solely because the adviser can debit fees
- Client accounts with a related person qualified custodian where adviser can demonstrate “operational Independence”
- Pooled vehicles governed by special rule

# Internal Control Reviews

- If an adviser is a qualified custodian or a related qualified custodian maintains client assets, the adviser must obtain an annual written internal control report (e.g., a Type II SAS 70 report) with respect to the controls for custody of client funds and securities
- Compliance date: September 12, 2010
- Advisers who merely have constructive (but not physical) custody, such as through check-writing ability or acting as trustee, do not need internal control reviews.



# Form ADV Disclosure

- Report number of accounts and AUM for which “custody” exists
- Month in which the last surprise security examination occurred
- Identity of related person custodians and whether “operationally independent”
- Identity of accountant performing surprise examination, control examination, audits of private investment funds, including PCAOB status
- Notice of accountant resignations and dismissals (Form ADV-E) within 4 business days of event