

September 20, 2007

Via U.S. and Electronic Mail

Douglas J. Scheidt
Associate Director and Chief Counsel
Division of Investment Management
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

**Re: Request for no-action relief relating to Rule 206(4)-2 under the
Investment Advisers Act of 1940**

Dear Mr. Scheidt:

The Investment Adviser Association¹ is writing to request no-action relief under Section 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-2 thereunder.² In particular, we request your assurance that the Division of Investment Management will not recommend that the Commission take enforcement action under Rule 206(4)-2 of the Advisers Act if a registered investment adviser forwards certain funds or securities it receives for its client to the client or the client's custodian in accordance with the procedures and conditions described below. In our view, the operation of these procedures will ensure that the provisions and policy goals of Rule 206(4)-2 will be met and that the interests of clients relating to the appropriate deposit of such funds and securities will be better protected.³

¹ The Investment Adviser Association (formerly the Investment Counsel Association of America) is a non-profit organization that represents the interests of the investment advisory profession. Founded in 1937, the IAA's current membership consists of nearly 500 SEC-registered investment advisory firms that collectively manage in excess of \$8 trillion for a wide variety of individual and institutional clients. More information regarding the IAA, including a list of member firms, is available on our web site: www.investmentadviser.org.

² *Custody of Funds or Securities of Clients by Investment Advisers*, Advisers Act Release No. 2176 (Sept. 25, 2003) (Adopting Release); *Custody of Funds or Securities of Clients by Investment Advisers*, Advisers Act Release No. 2044 (July 18, 2002) (Proposing Release).

³ This request for no-action relief is without prejudice to potential additional requests for relief regarding other aspects of the custody rule, certain of which we have previously discussed with Division staff.

Applicable Law

Section 206(4) of the Advisers Act generally makes it unlawful for an investment adviser to engage in any act, practice or course of business that is fraudulent, deceptive or manipulative. Rule 206(4)-2 under the Advisers Act generally makes it a fraudulent, deceptive or manipulative act, practice or course of business within the meaning of Section 206(4) of the Advisers Act for a registered investment adviser to have custody of client funds or securities unless a “qualified custodian” maintains the funds or securities in a separate account for each client under that client’s name or in accounts that contain only the client’s funds and securities under the investment adviser’s name as agent for the client.

The Commission initially adopted Rule 206(4)-2 in 1962 to require “an investment adviser who has custody of funds or securities of any client to maintain them in such a way that they will be insulated from and not be jeopardized by financial reverses, including insolvency, of the investment adviser.”⁴ Rule 206(4)-2, in its current form, is a result of amendments proposed in 2002 and adopted in 2003 to “reflect modern custodial practices and clarify circumstances under which an investment adviser has custody of client assets.”⁵ The amended rule defines “custody” as “holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them,”⁶ and includes three examples designed to illustrate circumstances under which an investment adviser has custody of client funds or securities, of which only the following is relevant for purposes of this no-action request:

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.⁷

The release adopting the amendments noted that this example clarifies that an adviser has custody when it has possession of client funds or securities, even briefly, as those assets may be at risk of misuse or loss. The Commission, however, explicitly excluded from the definition of “custody” instances when an adviser inadvertently received a client’s funds or securities and returns them to the sender promptly.⁸

⁴ *Adoption of Rule 206(4)-2 Under the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 123 (Feb. 27, 1962).

⁵ Adopting Release, *supra* note 2.

⁶ Rule 206(4)-2(c)(1).

⁷ Rule 206(4)-2(c)(1)(i).

⁸ This exclusion appears to have been based generally on a staff position under which a registered investment adviser is deemed not to have custody or possession of client funds or securities as a result of procedures developed by the adviser intended to ensure that the adviser’s clients did not deliver funds or securities to the adviser and, if a client did deliver funds or securities to the adviser, to require the adviser to

Shortly after the Commission amended Rule 206(4)-2, the Commission staff provided informal commentary about the Rule in its Staff Responses to Questions about Amended Custody Rule (“Staff Q&A”).⁹ Of particular relevance, Question II.1 of the Staff Q&A states:

Q: If an adviser inadvertently receives securities from a client, under the amended rule may the adviser forward the securities to the qualified custodian instead of returning the securities to the client?

A: No. If the adviser does not return the securities to the sender within three business days, the adviser not only has custody but has also violated the amended rule’s requirement that client securities be maintained in an account with a qualified custodian.¹⁰

Although this Staff Q&A refers only to securities, the language of Rule 206(4)-2 and other staff interpretations may suggest that an investment adviser could, when it receives client settlement checks, tax refund checks or other assets, be deemed to have custody of these assets.¹¹ As a result, an adviser could be out of compliance with the Rule if the adviser receives client assets and forwards those assets to a client or its custodian. An adviser’s only available remedy under the Rule would be to return the funds or securities to the sender within three business days.

Facts

Our member firms have identified the following situations where they may receive clients’ securities or funds inadvertently and it would be in clients’ best interests to forward the securities or funds to the client or custodian rather than return them to sender:

1. *Settlement checks from class action lawsuits.* Advisers may receive checks from commercial class action administrators distributing funds in settlement of class

return immediately the funds or securities to the client. Proposing Release, *supra* note 2, at n. 18 (citing *Hayes Financial Services*, SEC No-Action Letter, (Apr. 2, 1991)).

⁹ Staff Responses to Questions about Amended Custody Rule, available at http://www.sec.gov/divisions/investment/custody_faq.htm (updated as of Jan. 10, 2005).

¹⁰ *Id.*

¹¹ Indeed, temporary possession of a check made out to the client or a former client arguably is not “possession” of “funds” in that the check is not negotiated to the adviser and is not available for the adviser to cash or deposit. The adviser can only pass it along to a person or entity with authority to negotiate the instrument – the client or its custodian. Similarly, the money represented by the check would not be “funds available” to the adviser in case of insolvency, a stated concern of the custody rule.

action lawsuits.¹² These lawsuits are brought by others in situations where neither the client nor adviser initiates the class action legal proceedings. In fact, clients are required to waive their own rights to bring suit in order to receive payments under most of these settlements. Typically, the amounts of such checks are relatively small.

2. *Fair Funds.* By way of example, late last year, a number of investment adviser firms began receiving checks referencing the SEC Specialist Settlement Fund without having submitted proofs of claim or other documentation related to the Fund. The checks were delivered in connection with the Commission's 2004 action charging seven NYSE specialist firms with certain trading violations. As part of the settlement, the firms made payments to a fund that, in turn, was to be distributed to "injured customers" harmed by the trading violations. A fund administrator was appointed to identify injured clients and issue reimbursement checks. It is unclear how the fund administrator identified investment adviser firms to whom it issued checks, but many of the checks were made payable to the adviser with a custodial master account indicated on the check. Since then, this situation has occurred in a number of additional Fair Fund actions.
3. *Tax refund checks from the IRS, state or other governmental taxing authorities.* Advisers sometimes receive tax refund checks because they may have sent or forwarded required tax payments at the direction of their clients or the clients' agents such as tax lawyers, accountants, or others. They may have also completed tax forms and filed them with a taxing authority. Under the Rule, an adviser must return the check to the taxing authority rather than forwarding the check to the client or the client's custodian.
4. *Dividend payments and stock certificates.* Sometimes advisers receive stock certificates or dividend checks in the name of their clients. On occasion, an adviser may receive stock certificates (or evidence of new debt) in a class action involving bankruptcy where shares are issued in a newly organized entity, or as a result of a business reorganization.

Most of the checks received by advisers in these contexts are made out to the client or the client's account. Checks payable to the client's account may also include the adviser's name as agent for the client.¹³ Less frequently, checks are made payable to the

¹² This situation of inadvertent receipt often arises because class action administrators have the adviser's name and address where the adviser has assisted in filing proofs of claim on behalf of clients. Further, proofs of claim and related forms often have room for only one address and telephone number or request the name of a person to be contacted for further information. This role is frequently filled by the adviser.

¹³ Checks may be construed as payable to the client if the client is identified in "any way, including by name, identifying number, office, or account number." Uniform Commercial Code Article 3 – Negotiable Instruments, Section 3-110. Similarly, checks payable to a person identified as agent for another would be payable to the represented person. *Id.*

adviser without reference to a client or client account on the check itself but are for the benefit of an identifiable client.¹⁴

In each of these situations, the investment adviser has not directly or indirectly caused the third party to deliver client assets to it and has no control over whether it receives client assets because the third party payor or sender is not connected to the adviser-client relationship. The involvement of the adviser as the client's fiduciary may create uncertainty on the part of the third party as to the correct destination of funds or securities. However, because the third party is not a part of the advisory relationship, the adviser cannot compel the third party to send assets directly to the correct destination. In addition, advisers have, in good faith, used their reasonable best efforts to cause third parties to deliver client assets to their clients or clients' custodians. Despite such efforts, some third parties continue to deliver client assets to the advisers without regard to the advisers' instructions to address and send such client assets to the relevant client or a qualified custodian. For example, advisers have requested third parties such as Fair Fund administrators to send distribution checks directly to clients or their custodians. The administrators nevertheless continue to send the distributions to advisers without regard to these requests. Thus, an adviser controls only its own procedures to safeguard client assets, as discussed below. We believe that in the situations and under the circumstances described above, an investment adviser inadvertently receives client assets.

Scope of Relief Requested

In the circumstances described above, returning funds or securities to the sender may work to the detriment of clients' interests, for example, by creating additional and unnecessary delays or even risking loss of such funds or securities.¹⁵ Nor does returning funds or securities to the sender make sense from a cost-benefit perspective. In general, the amounts involved are very small. Thus, the administrative costs of returning these inadvertent items to the sender would impose significantly more effort and related transactional and tracking costs than many or most of the transactions are worth in the first place. To address these issues, we seek no-action relief under the following circumstances:

1. The adviser inadvertently receives client securities or funds from a third party.
2. The adviser forwards the client securities or funds to the client or the client's custodian promptly, but in no event later than five business days following receipt by the adviser of the client assets.

¹⁴ The adviser would be able to ascertain that the check is for the benefit of a client rather than the adviser based on a cover letter, accompanying documents, or other surrounding circumstances.

¹⁵ To illustrate the difficulty and potentially large magnitude of resolving misdirected items, see the SEC's enforcement matter *In Re Bank of New York*, SEC Rel. No. 53709, File No. 3-12269 (Apr. 24, 2006), available at <http://www.sec.gov/litigation/admin/2006/34-53709.pdf>. That case involved declaring "lost" client funds and securities sent to the client whose correspondence was returned as undeliverable, resulting, in part, in \$11.5 million escheating to the State of New York from 1998 to 2004 affecting over 14,000 individuals.

3. The adviser performs the function of forwarding the securities or funds without imposing any additional service charges other than the fees charged for managing the clients' funds under the client advisory agreement.
4. The adviser provides written disclosure to its client of the practice of forwarding such securities or funds in the advisory agreement, or in notice given or mailed to the client, or in the adviser's Form ADV Part II disclosure.
5. The adviser establishes and implements policies and procedures reasonably designed to protect client funds and securities from loss and to track receipt and transmittal of these assets, including procedures reasonably designed to ensure that the adviser: (1) promptly identifies client assets that it inadvertently receives; (2) promptly identifies the client (or former client) to whom such client assets are attributable; (3) promptly forwards client assets to its client (or former client) or a qualified custodian, but in no event later than five business days following the adviser's receipt of such assets; (4) promptly returns to the appropriate third party sender any inadvertently received client assets that the adviser does not forward to its client (or former client) or qualified custodian, but in no event later than five business days following the adviser's receipt of such assets; and (5) maintains and preserves appropriate records of all client assets inadvertently received by it, including a written explanation of whether (and, if so, when) the client assets were forwarded to its client (or former client) or a qualified custodian, or returned to the third party sender.

Analysis

Safeguards Provided by Proposed Conditions

The conditions and procedures discussed above would significantly mitigate the risks and concerns that the custody rule is intended to address. These procedures are designed to minimize receipt of such assets where feasible, require advisers to monitor and document the receipt of any checks or securities, to deliver any check to the custodian or client promptly,¹⁶ and to provide full notice to clients regarding the firm's practice of forwarding funds and securities. Indeed, the procedures provide more protection against misappropriation than the return-to-sender policy adopted by the Commission.

These procedures would also ensure that an adviser upholds its fiduciary duty to safeguard its clients' assets. Question II.1 of the Staff Q&A addresses an adviser's receipt of securities sent by the client. This Q&A, however, does not appear to contemplate the situation of client assets that are sent to an adviser by someone other than the client. In this context, the staff's guidance would require an adviser to return client assets not to its client or the custodian, but to the sender – an unrelated party – who would not be in a position to safeguard the assets and could lose or misuse the assets. Unlike advisers, these third parties are unlikely to be fiduciaries of the clients. If an

¹⁶ This direct delivery to clients is consistent with the result of the *Hayes* no-action letter, *supra* note 8.

adviser were to follow the staff's interpretation and return settlement and refund checks and other client assets to a claims administrator or taxing authority, the adviser may be deemed not to be acting in the best interest of its clients, as such entities do not necessarily have procedures in place to ensure that client assets are properly safeguarded. These entities are not necessarily responsive to requests from investment advisers, nor are they subject to Commission examination. As a result, the adviser would have no assurance that the claims administrator or taxing authority would properly forward client assets to those clients or their custodians, as neither the claims administration nor the taxing authority may have the clients' or custodians' addresses and contact information as part of its official records. Thus, returning such securities or funds to the sender may work to the detriment of clients and create more problems than it solves.¹⁷ Under the proposed procedures for handling settlement and refund checks and other assets, however, an adviser would take the safer course of forwarding these assets directly to its client or its client's custodian.

Comparison to Checks Drawn by a Client

The Commission, in adopting the recent amendments to Rule 206(4)-2, stated that “an adviser’s possession of a check drawn by the client and made payable to a third party is not in possession of client funds for purposes of the custody definition.”¹⁸ The Commission also stated that an investment adviser may receive checks payable to the adviser for advisory or similar fees, but an adviser that “holds a check drawn by the client and made payable to the adviser with instructions to pass the funds through to a custodian or third party” would be deemed to have custody of client funds.¹⁹ It would appear that Rule 206(4)-2 permits an investment adviser to receive a check drawn by a client and made payable to third party without being deemed to have “possession” or “custody” of client funds for two reasons: (1) the client would have knowledge that the check is in the adviser’s possession, presumably because the client had written the check and forwarded it to the adviser; and (2) the client is protected from potential misappropriation by the adviser because the check is made payable to a third party and is subject to additional banking regulation protection.²⁰

¹⁷ This situation is distinguishable from that in which the *client* sends its own assets to the adviser. In that case, requiring the adviser to return the assets to the client would deter clients from sending their assets to their advisers, with little risk of loss or delay of funds. See *Hayes*, *supra* note 8. On the other hand, requiring advisers to return client assets to a third-party sender would not deter such third parties from sending client assets to advisers in the future and would expose clients to increased risk of loss.

¹⁸ Adopting Release, *supra* note 2.

¹⁹ *Id.*

²⁰ Under the Uniform Commercial Code (UCC or state law), section 3-403, a person such as an adviser holding a negotiable instrument (*e.g.* a check made out to someone else or that person’s account) would not be a *holder in due course* because the instrument would not have been negotiated to the adviser and the adviser would have no means to endorse, cash, or otherwise transfer the check. Any endorsement or attempted endorsement by the adviser to itself would be an “unauthorized signature.” See *supra* note 13.

We believe this reasoning should apply to permit the adviser to forward client securities or funds from third parties to the client or the client's custodial account under the conditions discussed above. Many of the same protective factors that are present when an investment adviser receives a check from its client made payable to a third party would apply to a check from a third party, such as a settlement or refund check. Like a check written by the client to a third party, a check written by a third party to the client provides an adviser no means to endorse, cash, or otherwise transfer the check to itself. The client is protected against misappropriation by the adviser because the check is made payable to the client/client's account or endorsed to the client's account and is subject to banking protocols designed to identify and detect forgery. Finally, the client will have knowledge of the adviser's practices in this regard because advisers would disclose in writing the circumstances under which it may forward funds or securities to the client or custodian.

Conclusion

Accordingly, we request your assurance that the Division of Investment Management will not recommend that the Commission take enforcement action under Rule 206(4)-2 of the Advisers Act if a registered investment adviser forwards certain funds or securities it receives for its client to the client or the client's custodian in accordance with the procedures and conditions described above.

We appreciate your consideration of this request and look forward to further discussion with you. Please do not hesitate to contact us if we may provide any additional information or assistance in this regard.

Sincerely,



Karen L. Barr
General Counsel

cc: Andrew Donohue, Director, Division of Investment Management
Robert E. Plaze, Associate Director, Division of Investment Management

Similarly, the broker-dealer regulatory structure has extensive safeguards and procedures for assuring proper identity and handling of securities.