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SEC Custody Rule ‘No-Action’ Letter and Additional Guidance – Frequently Asked Questions

On February 21, 2017, the Securities and Exchange Commission (SEC) released a ‘no-action’ letter providing additional guidance on how the Custody Rule applies to third-party money movement authority. This guidance outlines a set of conditions that, when followed, allow RIAs to avoid the annual surprise examination requirement of the rule (aka ‘no-action relief’). The letter also clarified that a standing letter of authorization (SLOA) granting third-party money movement authority is deemed custody.

In addition, while the ‘no-action’ letter did not directly address the standing authority which allows an advisor to wire money between a client’s own accounts at different financial institutions (first-party money movement), the SEC did provide additional guidance on this topic in its revised FAQ II.4, which can be found on its website.

Collectively, this guidance provides new perspective on the Custody Rule as it applies to first-party and third-party money movement. Key takeaways include:

- The guidance directly affects RIAs moving money on behalf of their clients.
- Previously commonplace transactions may now implicate the Custody Rule.
- The most important distinctions have to do with authority to initiate first- and third-party wires.

Schwab created the following FAQs to help advisors understand the implications of the SEC custody guidance in regards to both first-party and third-party money movement authority, and identify whether or not they may need to consider amending some practices and procedures related to money movement, in order to comply with new guidance.

Additional information can also be found in the Investment Adviser Association FAQs on this topic.

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Q1. What is custody?

A. An investment advisor is said to have custody when they are holding a client's funds or securities, directly or indirectly, or have the authority to obtain possession of them. For example, advisors have custody when the advisor has possession of client funds and securities or has power of attorney to sign checks on a client's behalf, to withdraw funds or securities from the client's account, including fees, or to otherwise dispose of a client's assets for any purpose other than authorized trading. Schwab cannot tell advisors which specific arrangement qualifies as custody, and we suggest you seek guidance from a compliance or legal advisor. You can also review the information on the SEC website.

Q2. How does the SEC define first-party money movements and third-party money movements?

A. At the time of writing, the SEC has not provided explicit definitions for first-party money movements or third-party money movements.

Schwab is continuing to define first-party and third-party money movements in the same way that we have traditionally. Below we have outlined Schwab's definitions. These definitions may vary from those used by other institutions or regulatory bodies.

Q3. How does Schwab define first-party money movements and third-party money movements?

A. Advisors will need to make their own determination about whether a money movement is first-party or third-party for the purpose of complying with the new guidance. Schwab defines these as follows:

- First-party refers to money movements where cash or assets are disbursed between two of the client's accounts, where both accounts have the same-named registration. Similarly, a first-party check would be one in which the funds are sent from an account where the name on the registration is identical to the payee, and sent to the address of record for the account. For example, a money movement from John Smith's Schwab account to John Smith's XYZ bank account would be considered first-party at Schwab. Schwab's definition for first-party may be different from yours or other institutions, so please consult with your legal and compliance professionals.
- Third-party refers to money movement where cash or assets are disbursed between two accounts with different named registrations—for example, a money movement from Jane Doe's Schwab account to John Smith's XYZ bank account. In this case, John Smith is considered a third party. Schwab also considers a money movement from an individual account to a joint account and vice versa to be a third-party money movement—for example, Jane Doe's Schwab account to Jane Doe's joint account at XYZ bank. Schwab's definition for third-party may be different from yours or other institutions, so please consult with your legal and compliance professionals. Specifically, the SEC may not consider money movement from an individual account to a joint account and vice versa to be third-party money movement, although Schwab does. Similarly, the SEC may not consider money movement between an IRA account and a brokerage account in the same name to be third-party, but Schwab does.

Q4. My firm handles a wide variety of money movements on behalf of my clients. How can I know whether or not a given disbursement would constitute custody?

A. The SEC has provided guidance clarifying when first- and third-party money movement authority may implicate the Custody Rule. However, since we cannot be certain that the SEC's determination on whether a disbursement was first-party and third-party would be identical to Schwab's, we can only provide guidance based on Schwab's definitions of these terms. As Schwab's definitions may be different than yours or other institutions, please consult with your legal and compliance professionals.

Implications of new Custody Rule guidance: First-party money movements

Q5. How does the guidance from SEC impact first-party wires?

A. According to the updated guidance provided by the SEC in its FAQs, advisors with standing first-party wire authority may have custody. For an advisor to avoid having custody, his or her client must provide the sending custodian a signed first-party wire authorization specifying the receiving account number(s) at the outside financial institution at the time the authorization is granted. We have additional information and resources throughout this document providing more detail on how your firm can avoid custody.

Q6. I have standing first-party money movement authority to wire my client's assets between their accounts at Schwab to other /financial institutions. Based on the guidance, could this be considered custody?

A. Yes, the SEC clarified that an advisor who has standing first-party money movement authority to send wires (found under Trading and Disbursement Authorization on the Schwab account application) has custody. To avoid custody, you will need to remove the wire authorization given to you by your client or have them provide signed written authorization stating the name and account numbers on the sending and receiving accounts in advance of the transaction. See additional information below on when you will be able to make these changes if you wish to do so.

Q7. Will you be updating Schwab forms so they can include their account number, in order to help me avoid custody?

A. Yes, Schwab will be amending its forms to allow advisors to capture the necessary information. By fall 2017, we will roll out changes to systems and forms that will allow advisors to meet these requirements, while still supporting their clients' need to make disbursements.

Q8. I use Schwab MoneyLink (aka ACH) to move money from my client's account at Schwab to his or her account at a different custodian or financial institution. Could this be considered custody?

A. Since the MoneyLink form requests the name and account numbers on the client's sending and receiving accounts as part of the initial authorization, outgoing first-party money movement would not be considered custody at Schwab. MoneyLink may also be used for third-party EFT/ACH transactions at Schwab, which have different custody implications than first-party. (Please see below under 'Implications of the new guidance: Third-party.')

Q9. How long do I have to make changes?

A. While the SEC did not specify a deadline by which advisors and custodians must make any necessary changes, they do understand that it will require a "reasonable period of time" to implement new processes and procedures. In discussions with SEC staff in February, it was suggested that 6-12 months may be required for most firms to make the change, and that some firms and custodians may require more time, based upon their own facts and circumstances. Given this guidance, advisors should make a good faith effort to comply with these requirements with the understanding that the SEC staff views implementation timing with some flexibility. With regard to first-party money movement, Schwab is targeting late summer to have the necessary changes in place that will allow you to take action.

With regard to third-party wires, Schwab has already updated our processes to help advisors comply with these requirements, and we began implementation in March 2017. We are currently in process of developing new MoneyLink summary reports that will differentiate first-party and third-party transactions.

For more information on how Schwab's process and procedures can help you meet the seven conditions, please read SEC 'no-action' relief conditions and how Schwab helps you satisfy them.

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Q10. What is Schwab doing as a result of the new guidance on first-party money movements?

A. Currently, when an account is opened at Schwab a client may opt to authorize his or her advisor to move money on their behalf to their own accounts in the future ***without*** an additional client signature. This could be via check, journals between Schwab accounts, or wires to other financial institutions.

Because of the new guidance, Schwab is making changes that will help advisors meet these requirements. Schwab will provide options that will make it easy for an advisor to take custody or avoid it, while still supporting their clients' need to move cash or assets. By fall 2017, we will roll out changes to systems and forms. Look for future announcements from Schwab on these changes.

Q11. If I have custody under the SEC's new FAQ II.4, what are my options?

A. You should consult your compliance and legal professionals for help. Schwab is currently planning to offer advisors the following options for all or a subset of accounts that have existing, ongoing first-party wire authority *without* designated account numbers given at the time the authorization was granted:

(1) Keep your current authority, as reflected on the Schwab account applications. Accounts with first-party wire authority—without destination account numbers designated—require full compliance with the Custody Rule, including the surprise examination.

(2) Remove current first-party wire authority without destination account numbers, but retain check and journal authorization to potentially avoid application of the Custody Rule. You will not be able to wire funds from these accounts without a client-signed authorization.

(3) Take the step described in option 2. Then, if you need first-party wire authority on a particular account, you can provide Schwab with a client-signed standing authorization that specifies the destination account number.

Please note: You will be able to choose different options for different accounts, or apply a uniform approach to all of your accounts. Schwab will provide additional details in the coming months on the particular steps you should take if you choose options (1), (2) or (3). Schwab is currently updating applicable forms and systems, and you'll be able to choose your option in the fall of 2017.

Q12. What if I decide that I want to keep custody over these accounts?

A. Schwab will offer an option for advisors who want to keep their current standing first-party wire authority 'as is' on existing accounts. In addition, Schwab will offer an option for new accounts where advisors can have their clients grant them the standing authority to initiate first-party wires without obtaining the required destination account numbers. Of course, advisors may be deemed to have custody over these accounts and will need to meet the requirements of the Custody Rule, including the annual surprise exam requirement.

Q13. When will I be required to disclose custody on my Form ADV if I decide to keep my existing standing first-party wire authority 'as is,' and not supply destination account numbers?

A. Firms that intend to maintain custody should disclose custody for all accounts that they continue to have standing first-party wires without destination account numbers after October 1, 2017. Firms will need to disclose this on their next ADV filing after that date.

Q14. If I decide to keep standing first-party wire authority 'as is' for some accounts (and don't supply destination account numbers) do I have to keep authority for all of my firm's accounts?

A. If your firm decides to keep authority on certain accounts, you are not required to do so for all accounts.

Implications of the new guidance: Third-party

Q15. What is third-party money movement authority, and how is it impacted by the guidance?

A. Third-party money movement authority is a standing letter of authorization (SLOA) or other similar asset transfer authorization that allows an advisor to disburse funds on behalf of her clients to third parties. SLOAs can be established by having the client sign a Schwab form—either electronically or via paper—that includes the third party's name and address, or account number.

The disbursements may include checks, journals, wires, and MoneyLink (ACH). The client instructs the qualified custodian that maintains the client's account to transfer funds from time to time to a designated third party upon the future request of the advisor in accordance with the limited authority the client grants to the advisor. Many advisors have this authority on some client accounts—for example, to help a client pay recurring expenses.

The SEC guidance clarified that SLOAs granting third-party money movement do constitute custody. The guidance also outlined a set of conditions that, when followed, allow RIAs to avoid the need for the annual surprise examination requirement of the Custody Rule.

Q16. What are the conditions the SEC requires advisors to meet to avoid the Custody Rule's annual surprise exam requirement, if I have an SLOA and/or MoneyLink established for third-party money movement?

A. The seven conditions are as follows:

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 advisor, 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 advisor 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 advisor maintains records showing that the third party is not a related party of the investment advisor or located at the same address as the investment advisor.
7. The client's qualified custodian sends the client, in writing, an initial notice confirming the instruction and an annual notice reconfirming the instruction.

Because six of the seven conditions necessitate an advisor's reliance on a qualified custodian, Schwab has updated our processes and procedures for all SLOAs except MoneyLink to help advisors comply with these conditions so they can benefit from the 'no-action' relief. We are currently in the process of updating our systems for MoneyLink.

For more information on how Schwab's process and procedures can help you meet the seven conditions, please read SEC 'no-action' relief conditions and how Schwab helps you satisfy them.

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Q17. How is Schwab helping me meet the seven conditions above so that I can avoid an annual surprise exam?

A. Currently Schwab accepts SLOAs on paper and electronic forms that meet the conditions in #1 and #2; Schwab performs appropriate verification and sends a transfer of funds notice within one to two business days to the client promptly after each transfer as required in #3; the client has the ability to terminate or change the instruction to Schwab as required in #4; Schwab does not permit advisors to change payee information (without a new signature from the account holder) as required in #5; and Schwab has recently announced a new program to send account holders initial and annual notices regarding SLOAs to comply with #7 above. We are currently in process of updating our systems for MoneyLink.

For more information on how Schwab's process and procedures can help you meet the seven conditions, please read SEC 'no-action' relief conditions and how Schwab helps you satisfy them.

*Please see questions within the "Taking Action" section to understand your options if you have custody by virtue of having an SLOA.

Q18. Can you provide documentation stating how Schwab has complied with each of the requirements?

A. Schwab will make a certification available for download on Schwab Advisor Center®. The certification should be available with our systems upgrades in fall 2017.

Q19. Does Schwab have a form where my client can grant me authorization to act pursuant to an SLOA?

A. Yes. Standing investment advisor authorizations are contained in a variety of Schwab money movement forms, such as forms related to wire instructions, MoneyLink or IRA distributions.

Q20. How do I confirm I have third-party money movement authority, or an SLOA, for an account?

A. Log in to Schwab Advisor Center®, select your firm's master account, and click on the "Move Money" heading. Next, click on the "On-Request SLOAs/MoneyLinks" heading. You'll see a report that contains all SLOAs associated with the advisor's master account. You can also contact your service team to request a report. Schwab's definition and reporting of first-party vs third-party money movement may be different than your own. Consult your legal and compliance professionals if you have questions.

Q21. What are my options if I have custody under the SEC's no-action letter because I have SLOAs on certain accounts?

A. You have two options:

(1) Comply with the requirements of the Custody Rule (except for the surprise exam assuming the 7 conditions previously mentioned are met), or

(2) Modify or terminate the SLOAs.

Advisors should consult their compliance or legal professionals on how best to comply with the Custody Rule.

Q22. For SLOAs and third-party money movement, if I have custody under the SEC's no-action letter, but I do not want to be subject to the Custody Rule, how long do I have to comply?

A. While the SEC did not specify a deadline by which advisors and custodians must make any necessary changes, they do understand that it will require a "reasonable period of time" to implement new processes and procedures. In discussions with SEC staff, it was suggested that 6-12 months may be required for most firms to make the change, and that some firms and custodians may require

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more time, based upon their own facts and circumstances. Given this guidance, advisors should make a good faith effort to comply with these requirements with the understanding that the SEC staff views implementation timing with some flexibility.

Schwab has already updated our processes to help advisors comply with these requirements, and we began implementation in March 2017.

Q23. When will I need to include client assets subject to an SLOA that result in custody (also including MoneyLink) in my response to Item 9 of Form ADV?

A. Advisors should include assets subject to SLOAs in their ADV in the next annual updating amendment after October 1, 2017. See the example below.

FORM ADV
UNIFORM APPLICATION FOR INVESTMENT ADVISER REGISTRATION

Studebaker Financial

Item 9 Custody

In this Item, we ask you whether you or a *related person* has *custody* of *client* (other than *clients* that are investment companies registered under the Investment Company A
custodial practices.

A. (1) Do you have *custody* of any advisory *clients*'
(a) cash or bank accounts?
(b) securities?

If you are registering or registered with the SEC, answer "No" to Item 9.A.(1)(a) and (b) if you have *custody* solely because (i) you deduct your advisory fees directly from y
person has custody of *client* assets in connection with advisory services you provide to *clients*, but you have overcome the presumption that you are not operationally in
206(4)-(2)(d)(5)) from the *related person.*

(2) If you checked "yes" to Item 9.A.(1)(a) or (b), what is the approximate amount of *client* funds and securities and total number of *clients* for which you have *custody*:
U.S. Dollar Amount — Total Number of *Clients*
(a) $ 6,540,008,698 — (b) 34,566

If you are registering or registered with the SEC and you have custody solely because you deduct your advisory fees directly from your *clients'* accounts, do not include th

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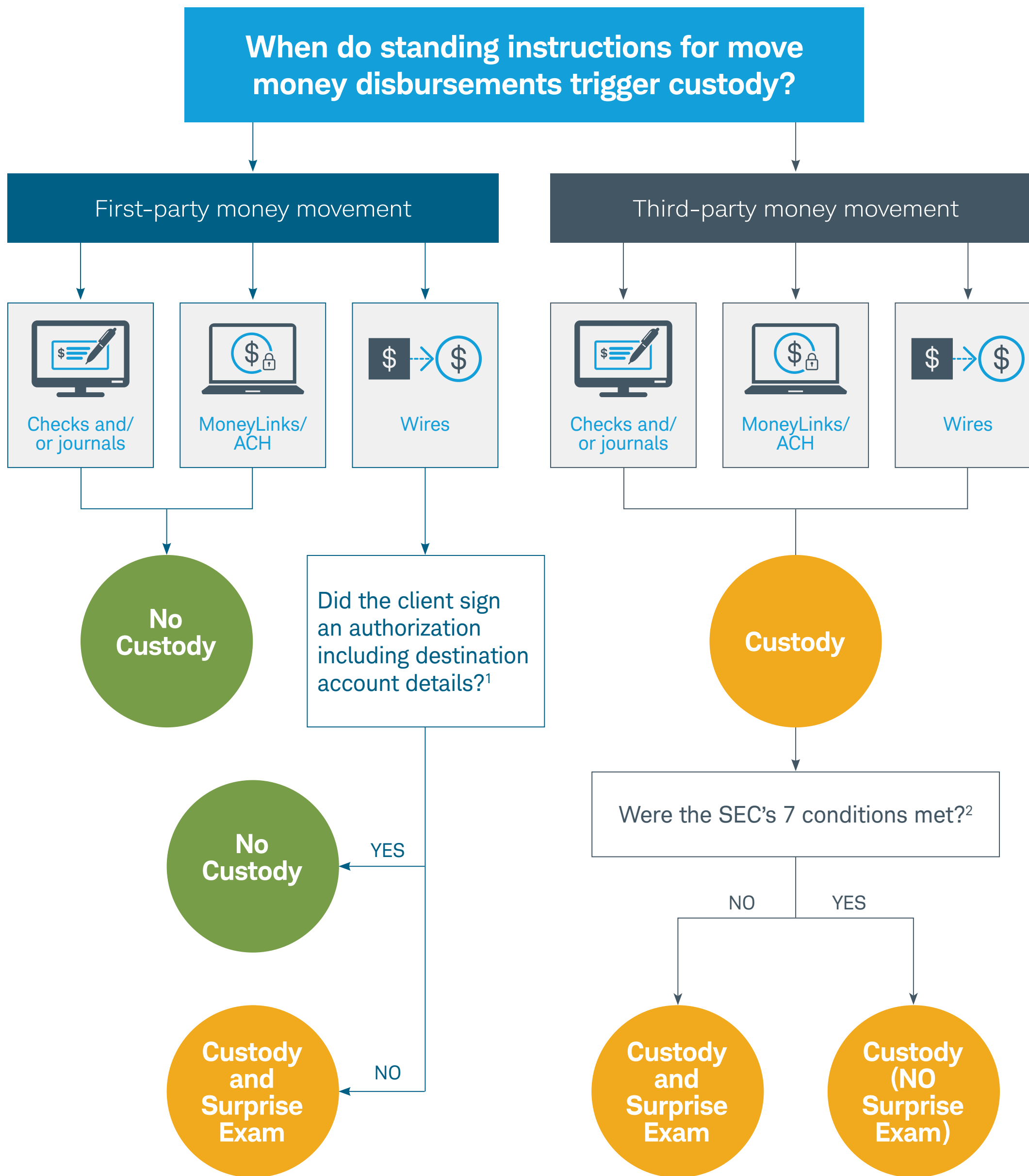
Money movement At-a-glance: Do I have custody?

The chart below outlines the various first- and third-party transaction authorities based on the SEC's custody guidance.



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1. Information should include the name and account numbers on receiving accounts, including the ABA routing number(s) or name(s) of the receiving custodian.
2. See question 16 on page 5 in this document.

The sample scenarios below are designed to help you understand the SEC guidance clarifying when various first- and third-party money movement authority may implicate the Custody Rule. However, we cannot be certain that the SEC's determination on whether a specific disbursement was first-party and third-party would be identical to Schwab's. As our definitions may be different than yours or other institutions, please consult with your legal and compliance professionals.

CHECKS AND JOURNALS

Q24. Do I have to disclose custody if...

- ...I have authority to transfer or journal my client's assets between the client's same-named accounts at the same custodian?
- ...I have authority to instruct Schwab to write a check to my client at my client's address on file with Schwab?
- ...my client mails me a check payable to my firm to pay fees?

A. Assuming the custodian receiving funds is a separate entity not affiliated with the advisor, these scenarios probably would not constitute custody. Always consult your compliance and legal professionals for guidance.

SLOAS

Q25. Do I have to disclose custody if...

- ...I have a standing letter of authorization (SLOA) to transfer assets out of my client's account to a third party specified by the client, and I have discretion as to amount and/or timing of transfers?
- ...I have an SLOA to journal funds to a third party at Schwab such as a spouse or child's account?
- ...I have MoneyLink established to transfer assets from my client's account to a third party specified by the client?
- ...I have an SLOA in place that allows me to issue checks from a Trust to a beneficiary of the Trust?

A. These scenarios would likely constitute custody.[3] However, the SEC also outlined seven specific conditions that will help the advisor avoid the Custody Rule's surprise annual exam requirement. See Question 16 above. Always consult your compliance and legal professionals for guidance.

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Q26. Do I have custody if I have the authority to make tax payments on behalf of clients from their Schwab account?

A. Yes. This is a third-party SLOA and falls within the guidance in the February 21, 2017, No-Action Letter. You can avoid the surprise examination requirement of the Custody Rule if you meet the seven requirements in the No-Action Letter.

Q27. If I am a trustee to a client, do I have custody?

A. If a supervised person serves as a trustee on a client's account, the role of the supervised person as trustee is imputed to the advisory firm, thus the firm has custody.

Q28. I am a state-registered advisor. Does any of the new guidance apply to me?

A. The SEC's Custody rule applies to investment advisors who are registered with the SEC. However, many state securities administrators have rules that are substantially the same as the SEC's Custody Rule, so many states may follow the SEC's lead on this interpretive clarification.

Q29. What is inadvertent custody within the meaning of the IM Guidance Alert, and how does it relate to the recent no-action letter and update to FAQ II.4?

A. Inadvertent custody occurs when a custodial agreement between an adviser's client and the custodian automatically assumes or gives the adviser authority to withdraw securities or funds on behalf of the client. The Guidance Alert suggests ways in which the adviser can address the inadvertent custody situation if they only want or need trading authority on an account. This is in contrast to Schwab's application that gives the client the option to designate, by checking or initialing a box, whether the adviser has authority to receive or send securities or funds on behalf of the client. That would not be an inadvertent custody situation and, instead, the adviser should consider the 'no-action' letter for addressing standing letters of authorization (SLOAs) if the client has given the adviser third-party money movement authority, and Custody Rule FAQ II.4 if the client has given the adviser first-party money movement authority to move money between the client's own accounts.

Q30. Why does Schwab deactivate my SLOA if it is inactive for 3 years?

A. FINRA and other regulators have suggested that standing letters of authorization present a risk of fraud and should expire after a specified period of time. In light of this, and in an effort to maintain current money movement records, SLOAs on accounts at Schwab may be deactivated if they have been unused for three years or more, if the account has been closed, or if the client or advisor has requested it. Advisors will be notified one month in advance if an SLOA is to be deactivated because it has not been used for three years or more. If an SLOA is deactivated and you wish to reestablish it, your client must submit a new SLOA with his or her signature.

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3. An arrangement that is structured so that the investment advisor does not have discretion as to the amount, payee, and timing of transfers under an SLOA would not implicate the custody rule.

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