

SEC Waives Custody Rule Requirements for Certain Affiliated Sub-Advisers

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Under the SEC Rule 206(4)-2, the “custody rule,” registered investment advisers with custody of client funds or securities are required to take a number of steps designed to safeguard those client assets. One such step is that an adviser that has custody of client assets generally must undergo an annual surprise examination by an independent public accountant to verify the client funds and securities. In addition, where the qualified custodian of client assets is a related person to the adviser, the adviser must also obtain a written internal controls report from an independent public accountant that is registered with and subject to examination by the Public Company Accounting Oversight Board (“PCAOB”), which demonstrates that appropriate custodial controls are in place. The custody rule is designed to provide additional safeguards for investors against the possibility of theft or misappropriation by registered investment advisers.

In general, the custody rule requirements will apply to a sub-adviser to client assets in the same manner as the primary adviser. However, on April 25, 2016, the U.S. Securities and Exchange Commission (“SEC”) issued a no-action letter to the Investment Adviser Association that will provide relief from both the surprise examination and internal controls requirements for certain sub-advisers. The relief applies to affiliated sub-advisers where the sub-advisory services are being provided pursuant to a program in which a related person of the sub-adviser is the qualified custodian for the account assets, and such related person is also the primary investment adviser, as long as the related primary adviser is in compliance with Rule 206(4)-2. This no-action relief relies on the following considerations:

1. The only reason for the sub-adviser having custody is its affiliation with the qualified custodian and the primary adviser;
2. The primary adviser must comply with Rule 206(4)-2, including by having client funds and securities in the investment advisory program verified by a surprise examination conducted by an independent public accountant registered with the PCAOB pursuant to an agreement entered into by the primary adviser;
3. The sub-adviser does not (i) hold client funds or securities itself; (ii) have authority to obtain possession of clients’ funds or securities; or (iii) have authority to deduct fees from clients’ accounts; and
4. The sub-adviser will continue to be required to obtain from the primary adviser or qualified custodian annually a written internal control report prepared by an independent public accountant registered with and subject to regular inspection by the PCAOB as required by Rule 206(4)-2(a)(6).

The full text of the No Action Letter is available [here](#).

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