

The Custody Conundrum

By Bill Winterberg*

April 14, 2009

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Reporting on held-away assets is a way of life for many wealth managers as they position themselves to be the “trusted advisor” by collecting information for the full range of their clients’ assets. Cost-effective account aggregation solutions, interfaced with portfolio management systems, make this eminently possible and practical.



Account aggregation is a powerful tool, but it raises important questions for advisors: Will they be considered custodians of their clients’ assets and, if so, what duties does that impose?

Tim Simons, Senior Managing Director of the Jacksonville, Oregon-based compliance firm Ashland Compliance Group, has researched this issue on behalf of advisors. “Advisors may be classified as custodians,” he says, “but the requirements are not onerous and, more importantly, there are several easy ways to avoid taking custody.”

Advisors have a fiduciary responsibility to report accurately on their clients’ overall financial holdings under the advisor’s management. Some accounts are available to the advisors through a direct feed into their portfolio management system, but many accounts do not support direct access, particularly 401(k), 529 and other qualified accounts. To obtain information on held-away accounts, advisors often ask for their client’s login and password credentials to access data on custodian websites. Advisors then turn to account aggregation tools when the number of held-away accounts grows beyond what can be managed by manual processes.

Account aggregation tools allow advisors to meet their reporting obligations efficiently, by automating the collection of data for those accounts. Advisors’ use of client login credentials, however, may cross the line from having discretion over assets to having custody over assets.

Custody versus discretionary control

Understanding the distinction between discretion and custody is critical:



- An advisor has **custody** if it directly or indirectly *holds* client funds or securities, has any authority to *obtain possession* of them, or has the *ability to appropriate* them.
- An advisor has **discretion** if it has the authority to *decide* which securities to purchase and sell for the client or what investment advisors to retain on behalf of the client.
- If an advisor has custody, it almost always has discretion, but if it has discretion it does not necessarily have custody.
- An advisor *has* custody when it has possession of client funds, *even if temporarily*. There are exceptions:
 - Inadvertent receipt of client assets, if returned to the sending party within three business days.
 - Inadvertent receipt of client assets from a third party, if forwarded to the client or custodian within five business days.
- An advisor *has* custody when it has the authority to withdraw funds/securities from client account, authority such as:
 - Power of attorney
 - Directly debit fees
- An advisor *has* custody when it has legal capacities that provide ownership or access to funds/securities, capacities such as:
 - General partner of limited partnership
 - Managing member of limited liability company
 - Trustee of a trust

If an advisor is able to place trades, but not change the address of record or transfer assets to an account with a non-matching registration, the SEC considers this discretionary and not custody.

If an advisor takes possession of the login credentials to a client's account website, the SEC may consider it as having custody:

- **Yes**, if an advisor has the same authority that the client does and can buy and sell securities and have the proceeds sent to an address of your firm's choosing.



- **No**, if an advisor cannot direct that the proceeds be sent to an address of your firm's choosing

Look at the custodial websites to see whether they offer the ability to change the address of record. If so, then the advisor has *custody with physical possession* for those accounts and would have to meet all of the requirements discussed below.

An advisor has custody when it can *control* client funds or securities for purposes other than authorized trading. So, if the advisor has access to the custodian's website and the ability to make changes in the address of record in the client account, it has custody. If the advisor does not have access to the custodian's website, or has access but not the ability to make changes to the client's address of record, it does not have custody.

Requirements of custody

If your firm has custody of accounts, you must meet certain SEC requirements:

- Design and implement a set of controls to protect client assets from being lost, misused, misappropriated, or available to the advisor's creditors.
- Accounts must be maintained at a "qualified" custodian held in client's name. *Qualified Custodians* are banks and savings associations, registered broker-dealers, registered futures commissions merchants, and foreign financial institutions.
- Advisors must have a *reasonable* belief that the qualified custodian is providing statements, at least quarterly, directly to their clients. Direct delivery from the custodian is designed to ensure the integrity of the information and permit clients to identify any erroneous or unauthorized transactions.
- A general partner in a limited partnership does not have to comply with these reporting requirements if
 - The partnership is audited annually; and
 - The audited statements are distributed to all partners within 120 days after fiscal year end.
- Advisors must disclose on Form ADV if they have custody *only* because they can direct-debit fees, in which case they are allowed to mark "no" on Item 9 in Form ADV Part 1.



- The SEC may select a sample of clients and have the advisor ask the custodian to send those statements for those accounts, as of a specific date, directly to the SEC office.
- If the custodian is affiliated with the advisor, the SEC may send requests directly to clients to confirm the assets reported to clients by the advisor are the same as those reported to the SEC.

Advisors using a custodian that does *not* provide quarterly statements to their clients or has the ability to obtain physical possession of client assets must meet the following additional requirements:

- The advisors must provide quarterly statements to the client; and
- The advisors must undergo an annual surprise audit by an independent accounting firm, which would report the results of the surprise audit to the SEC on Form ADV-E.

Implications for using account aggregation systems

Advisors who manage and report on clients' held-away assets must always be conscious of custody issues, particularly when advisors retain client login credentials. If your firm stores client credentials for a website that allows a change to the address of record, it may unknowingly be subject to all the requirements of custody, including custody with physical possession, described above.

Advisors must also be able to prove that there are controls to maintain the security of client credentials saved in the advisor's systems. Credentials should be kept in password-protected and encrypted formats and should only be available to appropriate individuals, including the Chief Compliance Officer and designated trading personnel.

As an alternative to obtaining the client's credentials, some account aggregation systems, such as [ByAllAccounts](#), give an advisor the ability to allow clients to enter credentials for online-accessible accounts directly into the account aggregation engine, without exposing those credentials to the advisor. Using such a solution, your firm then has read-only access to the client's account information, as it has been aggregated from the online sources, without having online access to the accounts themselves. The custody issue and the associated compliance requirements are thus eliminated.

Advisors need to understand custody and its implications before implementing an account aggregation system. While these requirements can be onerous, they can be sidestepped:

- By using custody websites that provide read-only access; or



- By using custody websites that do not provide trading or cash movement functionality; or
- By requiring that clients enter login credentials themselves, and not taking possession of these credentials;

"Custody is an important concern," says Simon, "but the issues it poses are clearly outweighed by the benefits of an account aggregation system."

** Bill Winterberg, CFP®, is a Portland, OR-based operations and efficiency consultant to independent financial advisors, and blogs at FPPad.com.*

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