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ARKANSAS SECURITIES DEPARTMENT

February 28, 2019

Todd Sadowski
StrongTower Wealth Management
450 West Grand Avenue
Hot Springs, AR 71901

RE: Standing Letters of Authorization
No Action Letter No. 19-NA-0001

Dear Mr. Sadowski:

The Staff of the Arkansas Securities Department (Staff) is in receipt of your request for clarification regarding the applicability of the Arkansas Securities Act, codified at Ark. Code Ann. §§ 23-42-101 through 23-42-509 (Act), and the Rules of the Arkansas Securities Commissioner (Rules) to the custody requirements for investment advisers with standing letters of authorization arrangements (SLOA) or similar arrangements established by a client with a qualified custodian.

Facts

Investment advisory clients may want to establish standing letters of instruction or other similar asset transfer authorization arrangements with their qualified custodians to grant their investment advisers the power to disburse funds to accounts specifically designated by the client. The investment adviser's authority is limited by the terms of the client's instruction and the adviser is authorized to act merely as an agent for the client. The client retains full power to change or revoke the arrangement.

Applicable Statute and Rules

Rule 102.01(14) of the Rules defines custody as holding, directly or indirectly, client funds or securities, having any authority to obtain possession of them, or having the ability to appropriate them. An investment adviser has custody if a related person, as defined in Rule 307.02, holds directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services the investment adviser provides to clients. Custody includes any arrangement (including general power of attorney) under which the investment adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the investment adviser's instruction to the custodian.

Ark. Code Ann. § 23-42-307(c) states that is unlawful for any investment adviser to take or have custody of any securities or funds of any client if the Commissioner by rule prohibits

custody, or in the absence of a rule prohibiting custody, the investment adviser fails to notify the Commissioner that he or she has or may have custody. Rule 307.02(a) states that it is unlawful and deemed to be a fraudulent, deceptive, or manipulative act, practice, or course of business for an investment adviser, registered or required to be registered, to have custody of client funds or securities unless certain requirements are met. According to the requirements set out by Rule 307.02(a) an investment adviser with custody of client funds or securities must: (1) notify the Commissioner on Form ADV that the investment adviser has or may have custody; (2) maintain all client funds and securities with a qualified custodian; (3) notify all clients of the identity of the qualified custodian; (4) send, or have the qualified custodian send account statements to all clients pursuant to the Rule; (5) comply with a special rule for limited partnerships and limited liability companies; and (6) have the client funds and securities of which the investment adviser has custody verified by examination, without prior notice to the investment adviser, at least once during each calendar year, by an independent certified public accountant.

Rule 302.02(b)(3)(B)(iii) requires an investment adviser with custody of client funds to file annual audited financial statements. In addition, Rule 302.02(b)(1)(B) states that if an applicant for registration as an investment adviser has custody of any client funds or securities, he or she must submit to the Commissioner proof of corporate surety bond coverage of fifty thousand dollars ($50,000.00). The investment adviser must file proof of corporate surety bond coverage each year under Rule 302.02(b)(3)(B).

Discussion

If an investment adviser enters into an SLOA with a client which permits the investment adviser to transfer the client's funds or securities to a third party's account, the investment adviser has custody under the Act and Rules. [i] Notwithstanding this view, the Staff will not recommend enforcement action against an investment adviser that does not comply with the following requirements for having custody: (1) filing an audited balance sheet as set forth in Rule 302.02(b)(3)(B)(iii)(a), (2) obtaining a surprise audit set out in Rule 307.02(a)(6), or (3) complying with the bonding requirement set out in Rule 305.01(b),if the investment adviser complies with Rule 302.02(b)(3)(B)(iii)(d), the remaining safekeeping requirements in Rule 307.02(a), and the following conditions:

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 adviser, 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 adviser 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 adviser maintains records showing that the third party is not a related party of the investment adviser or located at the same address as the investment adviser.
7. The client's qualified custodian sends the client, in writing, an initial notice confirming the instruction and an annual notice reconfirming the instruction.
8. In addition to including the client funds and securities that are subject to an SLOA that result in custody in its response to Item 9 of Form ADV and explaining the arrangement(s) in Item 15 of Form ADV Part 2, the investment adviser must specify in Schedule D – Miscellaneous of Form ADV Part 1 and Item 15 of Form ADV Part 2: (a) both the amount and number of clients included in the Item 9 custody figures solely because of the SLOA(s); and (b) attest that the investment adviser is complying with each of the requirements and conditions enumerated in this policy statement.

Please note that the position of the Staff is based solely upon the representations made in your request and applies only to the facts as set out therein. Different facts or circumstances might and often would require a different response or opinion from the Staff. The position of the Staff expressed in this letter only deals with anticipated enforcement action by the Department. Further, the position of the Staff does not purport to be and should not be interpreted to be a legal opinion.

Sincerely,

Aislinn Andrews

Aislinn Andrews
Staff Attorney

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[i] Whether an SLOA for third-party transfers falls within the definition of Custody under the Act and Rules depends on the extent of the investment adviser's discretion to act. For example, a SLOA arrangement would not fall within the definition of Custody if: (1) the client's SLOA with the qualified custodian specifies the (a) amount, (b) the payee, and (c) the timing of the transfers; and (2) the investment adviser cannot provide any instructions to the qualified custodians regarding the SLOA.