



STATE OF TENNESSEE
DEPARTMENT OF COMMERCE AND INSURANCE
SECURITIES DIVISION
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Policy Statement

Custody and Standing Letters of Authorization

The Securities Division of the Tennessee Department of Commerce and Insurance (“Division”) sets forth this Statement of Policy regarding custody as it pertains to an investment adviser’s use of Standing Letters of Authorization or other similar transfer authorization arrangements (collectively, “SLOAs”) under the Tennessee Securities Act of 1980, as amended, (“Act”) and the Tennessee Securities Rules promulgated pursuant to the Act (“Rules”). This Statement of Policy issues as a result of numerous inquiries to the Division on this issue.

I. Preliminary Definitions

As used within this document, the following terms are assigned the accompanying definitions:

1. First-party asset transfer – an asset transfer from an account in the client’s name to another account in the client’s name.
2. Third-party asset transfer – an asset transfer from an account in the client’s name to an account not registered in the client’s name. This includes, but is not limited to, transfers to grantor revocable trusts where the client is the trustee and tax reporter for the trust.

II. “Custody” Under the Act and Rules

Tennessee adopts the Form ADV - Uniform Application for Investment Adviser Registration (“Form ADV”) as the proper form for investment adviser registration. Tenn. Comp. R. & Regs. 0780-04-01-.04(4)(a)11. The Rules incorporate the instructions contained in the Form ADV verbatim, unless explicitly provided elsewhere in the Rules. Tenn. Comp. R. & Regs. 0780-04-01-.04(4)(b). Appendix C of the Form ADV provides the following definition:

8. **Custody:** Holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. You have custody if a *related person* holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services you provide to clients. Custody includes:
- 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;
 - Any arrangement (including a general power of attorney) under which you are authorized or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian; and
 - Any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives you or your supervised person legal ownership of or access to client funds or securities.¹

With regards to custody, no other provision in the Act or Rules explicitly makes the Form ADV's definition of custody inapplicable. Accordingly, Tennessee considers the Form ADV's definition for "custody" as the applicable definition of "custody" under the Act and Rules.

III. Analysis

Custody includes arrangements under which an 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. SLOAs allow clients to give the investment adviser the authority to withdraw the client's funds or securities and make a first-party asset transfer or a third-party asset transfer on a recurring basis. While the client is instructing the investment adviser to execute a specific transfer of assets, the investment adviser is ultimately the one providing the instruction to a custodian to effect the asset transfer. Additionally, a SLOA authorizes an investment adviser to have access to client funds. Therefore, an investment adviser using and relying on SLOAs has custody of client funds or securities under the Act and Rules. Investment Advisers having custody of client funds or securities are subject to the provisions of Tennessee's custody rule provided in Tenn. Comp. R. & Regs. 0780-04-03-.07, including the reporting requirements of 0780-04-03-.02(4)(a)2., unless otherwise exempted by statute or rule.

¹ The definition of "custody" provided in Appendix C of Form ADV comes from the SEC's Custody Rule, 17 C.F.R. § 275.206(4)-2

The Commissioner maintains discretion over the decision of whether to adopt SEC guidance contained in interpretive releases. Specifically, Tenn. Comp. R. & Regs 0780-04-01-.03(2)(e) provides that:

In construing terms used in these Rules and in the Act, the commissioner, to the extent consistent with the purposes fairly intended by the policy and provisions of the Act, will consider definitions, case law, SEC rules, and interpretive releases under the following federal statutes:

(e) The Investment Advisers Act of 1940 (the “Investment Advisers Act”).

Accordingly, where guidance from the SEC aligns with the purposes intended by the policy and provisions of the Act, the commissioner will consider such SEC guidance in construing terms used in the Act and the Rules. However, SEC guidance will not be considered when such guidance is to take a position of non-enforcement that is not adopted by a provision in the Act or Rules.²

In a 2017 no-action letter addressed to the Investment Adviser Association, the SEC provided the following guidance on its custody rule:

An investment adviser with power to dispose of client funds or securities for any purpose other than authorized trading has access to the client’s assets. We believe that a letter of instruction or other similar asset transfer authorization arrangement established by a client with a qualified custodian would constitute an arrangement under which an investment adviser is authorized to withdraw client funds or securities maintained with a qualified custodian upon its instruction to the qualified custodian. An investment adviser that enters into such an arrangement with its client would therefore have custody of client assets and would be required to comply with the Custody Rule. (internal citations omitted.)

This same no-action letter indicated that, if seven (7) specific safeguards were met, the SEC would not recommend an enforcement action against investment advisers who failed to comply with audit requirements under the custody rule. The SEC did not determine that use of the specific safeguards created an exception to audit requirements under their custody rule. Instead, the SEC indicated only that they would not recommend enforcement action for failure to comply with audit requirements required by the SEC’s custody rule, so long as those specific safeguards were in place.

The Division does not adopt the SEC’s policy of circumstantial non-enforcement. The Commissioner is vested with the authority to enforce the Act and Rules pursuant to Tenn. Code Ann. § 48-1-115. The Commissioner is not vested with the discretion to promulgate guidelines for non-enforcement of any provision of the Act or Rules.³ Additionally, circumstantial non-

² See generally, Tenn. Code Ann. §§ 48-1-101 – 201 (noting the repeated use of the phrase “necessary for the protection of investors”).

³ See generally, Tenn. Code Ann. § 48-1-116(a) vesting the commissioner the authority to ‘make, promulgate, amend, and rescind such rules, forms, and orders as are necessary...and defining any terms...insofar as the definitions are not inconsistent with this part.’ See also Tenn. Code Ann. § 48-1-116(e)(1) providing that any amendment to any rule

enforcement of Tennessee's custody rule does not ensure robust and secure capital markets in Tennessee and does not ensure the protection of investors in Tennessee. As such, failure to comply with Tennessee's custody rule constitutes a violation of the Act's anti-fraud statute as provided in Tenn. Code. Ann. § 48-1-121.

The requestor of this policy interpretation has asked the Division to draw distinctions between first-party asset transfers and third-party asset transfers for purposes of enforcing Tennessee's custody rule. Distinguishing between these two types of asset transfers focuses only on the payee. However, there is no focus on the payee in determining whether an investment adviser has custody of a client's funds or securities. The determining factor is only whether there is an arrangement under which the investment adviser is authorized or permitted to withdraw the client's funds or securities. Therefore, the Division makes no distinction between first-party asset transfers and third-party asset transfers for purposes of enforcing Tennessee's custody rule.

IV. Conclusion

The Division is not bound to adopt SEC guidance relative to custody and will not adopt SEC guidelines of custody that are contrary to or inconsistent with the purposes intended by the policies and provisions of the Act and Rules. Adopting the SEC's interpretation of circumstantial non-enforcement for violations of the custody rule would be outside the authority of the Commissioner and be contrary to the intended purpose of the Act and the Rules. Investment Advisers registered in Tennessee who use and rely on SLOAs have custody of client funds or securities under the Act and Rules, regardless of whom the payee is on the SLOA. They are subject to the provisions of Tenn. Comp. R. & Regs. 0780-04-03-.07, including the reporting requirements of 0780-04-03-.02(4)(a)2., unless otherwise exempted by statute or rule.

V. Applicability

Investment advisers who rely on any provision of this Statement of Policy shall keep a copy of this Statement of Policy in their records to document their reliance on it. This Statement of Policy shall remain in effect until rescinded.

Any questions about the positions set forth in or the intent of this Statement of Policy should be directed to the Tennessee Securities Division, Davy Crockett Tower, 11th Floor, 500 James Robertson Parkway, Nashville, TN 37243, or by telephone number (615) 741-2947 or email at Securities1@tn.gov.

(including a definition of such), must be done in compliance with the Uniform Administrative Procedures Act, compiled in title 4, chapter 5.