

SEC Adviser Examinations Focus on Custody Rule Compliance

The SEC's Office of Compliance Inspections and Examinations ("OCIE") found that approximately one-third of recent examinations that identified significant deficiencies involved custody-related issues. To signal the high level of concern that OCIE attaches to custody of client assets, OCIE has issued a [Risk Alert](#) and an [Investor Bulletin](#) regarding compliance with Rule 206(4)-2 under the Investment Advisers Act of 1940 (the "Custody Rule"). The Risk Alert provides a summary of common exam deficiencies to help investment advisers comply with the Custody Rule and the Investor Bulletin is intended to inform investors of the need to be proactive ensuring the safety of their assets. While the Risk Alert provides little new guidance on the relative importance of different elements of the Custody Rule, it clearly indicates that OCIE is closely scrutinizing adviser compliance with the rule and expecting advisers to be in strict compliance with all of its technical requirements.

Background of the Custody Rule

The Custody Rule requires SEC-registered investment advisers who have custody over client assets to comply with certain requirements in order to protect advisory clients from misuse or misappropriation of their funds and securities by the investment adviser. The term "custody" is defined very broadly to pick up any instance where an investment adviser or its related person holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them.

Deficiencies Identified

Failure by Advisers to Recognize they have Custody

The National Examination Program ("NEP") staff observed several situations where advisers failed to recognize they had custody over client assets:

- *Employees Acting as Trustees or Under Power of Attorney.* The adviser's personnel or a "related person" serve as trustee or have been granted power of attorney for client accounts.
- *Bill-Paying Services.* The adviser provides bill-paying services for clients and, therefore, is authorized to withdraw funds or securities from clients' accounts.
- *Online Access to Client Accounts.* The adviser manages portfolios by directly accessing online accounts using clients' personal usernames and passwords without restrictions and, therefore, has the ability to withdraw funds and securities from clients' accounts.
- *Adviser Acts as a General Partner.* The adviser serves as the general partner of a limited partnership or holds a comparable position for a different type of pooled investment vehicle.
- *Physical Possession of Assets.* The adviser has physical possession of clients' assets, such as securities certificates.
- *Check-Writing Authority.* The adviser or a related person has signatory and check-writing authority for clients' accounts.
- *Receipt of Checks Made to Clients.* The adviser receives checks made out to clients and has failed to return them promptly to the sender.

Surprise Exam Requirement

The following two main deficiencies regarding surprise exams were cited:

- *Filing Form ADV-E.* Failure to file Form ADV-E within 120 days of the date of the exam.
- *“Surprise” Element of Exam.* NEP staff observed evidence that suggests the examinations were not true “surprises”; for example, the exams were conducted at the same time every year.

Qualified Custodian Requirement

NEP staff noted that that advisers failed to satisfy certain requirements related to the use of a “qualified custodian,” including such areas as:

- *Account in Adviser’s Name.* Client assets were not held in accounts with only client assets or were held in accounts under the adviser’s name, but not as agent or trustee.
- *Commingling Assets.* The adviser commingled client, proprietary and employee assets.
- *Safe Deposit Box.* The adviser retained control over certificates of securities held by the adviser’s fund in a safe deposit box.
- *Due Inquiry Regarding Quarterly Account Statements.* The adviser did not have a reasonable basis, after due inquiry, for believing the custodian was sending quarterly account statements to the client. The Risk Alert does not provide further context or guidance for what constitutes “due inquiry.”
- *Proper Notice on Statements from Adviser.* Statements sent by the adviser to the client failed to include a notice “urging” clients to compare the custodian’s account statements with the adviser’s statements.

Audit Approach Issues

NEP staff reported that certain advisers who relied on the “audit approach” for pooled investment vehicles were not in compliance with the Custody Rule because:

- *Accountant Not Independent.* The accountant was not “independent” as defined by Regulation S-X and required by the Custody Rule.
- *Noncompliance with Generally Accepted Accounting Principles.* The audited financial statements were not prepared in accordance with generally accepted accounting principles (“GAAP”). Additionally, advisers to some pooled investment vehicles may be using financial statements that are not in compliance with the [2003 Custody Rule Adopting Release](#), which allows financial statements to be audited in accordance with U.S. GAAP or International Financial Reporting Standards so long as the financial statements contain information “substantially similar to financial statements prepared in accordance with U.S. GAAP.” For example, the Schedule of Investments or Financial Highlights were omitted, or included but were labeled as unaudited.
- *Financial Statements to Investors Were Not Sent.* The financial statements were made available only upon request and/or were not sent to investors within 120 days of the funds’ fiscal year-end. The Risk Alert makes clear that statements need to be sent to all investors. The Risk Alert also reaffirms prior no-action guidance that statements for “funds of funds” can be sent up to 180 days after the fund’s fiscal year-end.
- *Unregistered Auditor.* The auditor was not registered with the PCAOB and not subject to inspection by the PCAOB.

- *Final Audits Not Performed.* A final audit was not performed on liquidated pooled investment vehicles.
- *Waiver of Annual Financial Audit.* The adviser sought investor approval to waive the annual financial audit of the fund and did not subsequently obtain a surprise examination (private fund advisers must comply with either the annual audit or surprise examination provisions of the Custody Rule; investors cannot waive both requirements, notwithstanding waiver provisions in a private fund agreement to the contrary).

Investor Bulletin

The Investor Bulletin advises that when an investor is setting up an account, the investor should ask its adviser to identify the custodian and provide the custodian's contact information. Investors are further encouraged to check whose name is on the account and make sure they are receiving quarterly account statements from a qualified custodian. Additionally, the SEC advises clients to contact the investment adviser and the custodian if they discover a discrepancy between an account statement from the investment adviser and an account statement from the custodian. If the discrepancy is not resolved satisfactorily, the Investor Bulletin suggests that the client contact the SEC or state securities regulator. The Investor Bulletin reminds investors that the Custody Rule is not a substitute for investor due diligence and care.

Implications

The Risk Alert provides a comprehensive review of the many technical requirements of the Custody Rule with no guidance as to the number or seriousness of deficiencies found with respect to any of the various items listed. The issuance of the Risk Alert and the linkage OCIE specifically makes between the most serious exam deficiencies and custody problems suggests that OCIE is taking a rigorous and painstaking approach on examinations regarding technical Custody Rule violations as a means of gauging the risk that more serious problems may exist. This observation is consistent with our experience with presence exams of newly registered advisers; although generally these exams are narrower in scope than regular exams, a substantial number of recent presence exams of our clients have focused in part on Custody Rule compliance. In order to steer clear of heightened scrutiny that may arise if OCIE finds a Custody Rule compliance problem, investment advisers may want to review the adequacy of their compliance with the Custody Rule in light of the deficiencies noted in the Risk Alert. An adviser's ability to present organized and well-documented compliance with each relevant aspect of the Custody Rule may help an examination go more smoothly.