Client Alert

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SEC Finds Investment Adviser Custody Rule Compliance Deficiencies

The staff of the Securities and Exchange Commission (the "SEC") recently issued a Risk Alert announcing that it has observed widespread compliance deficiencies related to Rule 206(4)-2 under the Investment Advisers Act of 1940 (the "Advisers Act"). This rule sets forth requirements for SEC-registered investment advisers that have "custody" of client funds or securities. The SEC found that among recent examinations that contained deficiencies, approximately one third included custody rule-related issues. The SEC highlighted four categories of custody rule deficiencies:

- failure by an adviser to recognize that it has "custody" as defined under the custody rule;
- failure to comply with the "surprise exam" requirements;
- failure to comply with the "qualified custodian" requirements; and
- failure to comply with the "audit approach" for pooled investment vehicles.

Investment advisers should review their practices in light of the deficiencies identified by the SEC. The SEC Risk Alert and related information is available at http://www.sec.gov/news/press/2013/2013-33.htm. For more information regarding the custody rule, please see our Client Alert entitled "SEC Amends Investment Adviser Custody Rules" available at http://www.chapman.com/media/publication/126_2818727.01.00.pdf.

Overview of the Custody Rule

The Advisers Act custody rule generally requires advisers that have "custody" of client securities or funds to implement controls designed to protect client assets. An adviser generally has "custody" when the adviser or a related person holds client funds or securities, directly or indirectly, or has any authority to obtain possession of client funds or securities. This includes having actual possession of client funds or securities and also arrangements under which an adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian. For example, a general power of attorney granted in an advisory agreement can cause an adviser to have custody for this purpose (even if the adviser does not intend to rely on the power of attorney that broadly). An adviser also has custody of client funds or securities if the adviser acts in any capacity that gives it or a supervised person legal ownership of or access to client funds or securities. For example, this includes acting as general partner or managing member of a pooled investment vehicle, such as a hedge fund or other private fund.

Failure by an Adviser to Recognize That It Has Custody

The SEC staff found several situations where advisers had custody of client assets without recognizing they had custody. These situations included cases where adviser personnel served as trustee or had been granted power of attorney for clients' accounts, or when the adviser provided bill-paying services or maintained check-writing authority for clients. In addition, the SEC observed that advisers who acted as general partner of a limited partnership (or a comparable position in a different type of pooled investment vehicle) frequently failed to recognize

that they had custody of client assets. Other instances of failed recognition included the adviser managing portfolios by directly accessing a client's online accounts, receiving checks for a client, and taking physical possession of client assets.

"Surprise Exam" Requirements

The SEC staff observed two common deficiencies related to the "surprise exam" requirements under the custody rule. The staff found cases where advisers failed to file a Form ADV-E within 120 days after the date of the exam. The staff also found evidence that exams were not conducted on a genuinely "surprise" basis, such as where exams took place at the same time every year.

"Qualified Custodian" Requirements

The SEC staff found a number of common deficiencies related to the "qualified custodian" requirements under the rule. These deficiencies included commingling client assets in one account with proprietary and employee assets, holding client assets in a safe deposit box controlled by the adviser, and holding client assets in the adviser's name in a manner not permitted by the custody rule. In addition, the SEC observed that some advisers did not have a reasonable basis for believing that a qualified custodian was sending required quarterly statements to clients, and other instances where the adviser sent account statements to clients without including a statement urging clients to compare the account statements from the custodian with those from the adviser.

"Audit Approach" for Pooled Investment Vehicles

The Advisers Act custody rule provides an "audit approach" exception to the "surprise exam" and certain other requirements for advisers to pooled investment vehicles, such as hedge funds and other private funds. This approach generally requires that the fund be subject to annual audit by an independent accountant registered with the Public Company Accounting Oversight Board ("PCAOB"). The SEC indentified deficiencies related to this "audit approach" that include the accountant not being "independent" as required under the rule, the audited financial statements not being prepared in accordance with GAAP, and the auditor not being PCAOB registered and subject to PCAOB inspection. Furthermore, the SEC observed that advisers failed to show that the audited financial statements were distributed to all fund investors as required under the rule, instead finding that advisers had only made such statements available upon request. The SEC staff also found that advisers to funds failed to comply when they requested investor approval to waive the annual financial audit but did not obtain a surprise examination, and when advisers failed to obtain a final audit on a liquidated pooled investment vehicle as required under the rule.

What Should I Do Now?

Advisers should consider whether it makes sense to review their current policies and procedures, as well as actual practices, to determine whether changes in policy or practice could be beneficial in light of the SEC staff's findings. You should feel free to contact us if we can be of any assistance.

To discuss any of the topics covered in this Client Alert, please contact an attorney in our Investment Management Group or visit us online at chapman.com.