



NATIONAL EXAM PROGRAM

RISK ALERT

By the Office of Compliance Inspections and Examinations¹

Volume III, Issue 1

March 4, 2013

In this Alert:

Topic: NEP staff observations regarding ways in which advisers fail to comply with the Advisers Act custody rule.

Key Takeaways: Advisers should review their practices in light of the deficiencies noted in this Risk Alert and their responsibilities under the custody rule to protect client assets.

Significant Deficiencies Involving Adviser Custody and Safety of Client Assets

One of the most critical rules under the Investment Advisers Act of 1940 (“Advisers Act”) is the custody rule,² which is designed to protect advisory clients from the misuse or misappropriation of their funds and securities. Yet, the SEC’s National Examination Program (“NEP”) has observed widespread and varied non-compliance with elements of the custody rule.³ The NEP reviewed recent examinations that contained significant deficiencies. Approximately one-third of them (over 140) included custody-related issues.

In this Risk Alert, the NEP staff shares the custody deficiencies observed, which we hope will assist investment advisers in complying with the custody rule. When the NEP staff identifies the risk priority areas to focus on during an examination of an adviser, it often includes a review of the adviser’s books and records, business, and operations as they relate to the safety of its clients’ assets. The findings from these examinations have resulted in a range of actions. These have included remedial measures taken by advisers, including among other things, drafting, amending or enhancing their written compliance procedures, policies, or processes; changing their business practices; or devoting more resources or attention to the area of custody. Moreover, the NEP has also made

referrals to the SEC’s Division of Enforcement where appropriate.

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² Rule 206(4)-2 under the Advisers Act, 17 CFR 275.206(4)-2, as amended.

³ The rule was first adopted in 1962. *See* Adoption of Rule 206(4)-2 under the Investment Advisers Act of 1940, Investment Advisers Act Release No. 123 (Feb. 27, 1962), 27 FR 2149 (Mar. 6, 1962). Major amendments were made in 2003 and 2009. *See* Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Rel. 2176 (Sept. 25, 2003), 68 FR 56692 (Oct. 1, 2003); Custody of Funds or Securities by Investment Advisers, Investment Advisers Act Rel. 2968 (Dec. 30, 2009), 75 FR 1456 (Jan. 11, 2010). The staff of the SEC’s Division of Investment Management has published responses to frequently asked questions about the custody rule, *available at* http://www.sec.gov/divisions/investment/custody_faq_030510.htm.

Background of the Custody Rule

SEC-registered investment advisers with custody of client assets must comply with the custody rule. An adviser has custody if it or its related person holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them.⁴ For example, an adviser that serves as the general partner of a pooled investment vehicle (“PIV”)(or holds a comparable position) generally has custody of client assets because the position of general partner gives legal ownership or access to client funds and securities.⁵ The custody rule prescribes a number of requirements designed to enhance the safety of client assets by insulating them from any possible unlawful activities or financial reverses of the investment adviser, including insolvency.⁶ The custody rule’s key safeguards include:

- *Use of “qualified custodians” to hold client assets.* An adviser with custody generally must maintain client funds and securities at a qualified custodian (*e.g.*, a bank or a broker-dealer), either in a separate account for the client under the client’s name or in an account under the adviser’s name as agent or trustee for the adviser’s clients that contains only client assets (*i.e.*, client assets may not be commingled with the adviser’s assets).⁷
- *Notices to clients detailing how their assets are being held.* An adviser that opens an account with a qualified custodian on the client’s behalf must notify the client in writing and provide the client with certain information.⁸
- *Account statements for clients detailing their holdings.* An adviser must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends account statements to clients at least quarterly.⁹

⁴ Rule 206(4)-2(d)(2).

⁵ Rule 206(4)-2(d)(2)(iii).

⁶ *See* Adoption of Rule 206(4)-2 under the Investment Advisers Act of 1940, Investment Advisers Act Rel. 123 (Feb. 27, 1962), 27 FR 2149 (Mar. 6, 1962).

⁷ Rule 206(4)-2(a)(1).

⁸ Rule 206(4)-2(a)(2). The client must be provided with the name and address of the qualified custodian and the manner in which the client funds or securities are being held. The adviser must promptly inform the client when the account is opened and following any change in this information.

⁹ Rule 206(4)-2(a)(3). *See* In re Gerasimowicz, Advisers Act Rel. 3464 (instituted Sept. 14, 2012)(administrative and cease-and-desist proceedings instituted against a registered adviser and its principal in connection with allegations of misappropriation of assets and repeatedly making material misrepresentations and omissions to clients). Among the charges in this case, in addition to fraud, were allegations that (1) the advisers and principal, not the custodian, sent quarterly statements to fund investors; (2) the adviser did not obtain an annual surprise examination; and (3) the principal and the adviser did not distribute annual audited financial statements, prepared in accordance with GAAP and audited by an independent public accountant that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board (“PCAOB”), within 120 days of the end of fiscal year (thus failing to satisfy the “audit approach” exception to the custody rule on which the adviser was purporting to rely).

- *Annual surprise exams.* Advisers that have custody of client assets in many cases must undergo an annual surprise examination by an independent public accountant that verifies client funds and securities.¹⁰
- *Additional protections when a related qualified custodian is used.* If the adviser’s related person (or the adviser itself) acts as the qualified custodian, then the annual surprise examination must be conducted by an independent accountant registered with, and subject to regular inspection by, the PCAOB, and the adviser must obtain from the accountant at least once each year a report of the internal controls relating to the custody of client assets.¹¹
- *The audit approach for advisers to pooled investment vehicles.* With the “audit approach,” the adviser, at least annually, distributes audited financial statements to investors in the pooled investment vehicles. If using the “audit approach,” advisers to pooled investment vehicles do not have to comply with the notice and account statement delivery obligations of Rule 206(4)-2(a)(2) and (a)(3) and are deemed to have satisfied the surprise examination requirement of Rule 206(4)-2(a)(4).¹²

Deficiencies Identified

The custody-related deficiencies NEP staff observed can be grouped into four categories: failure by an adviser to recognize that it has “custody” as defined under the custody rule;¹³ failures to comply with the rule’s “surprise exam” requirement;¹⁴ failures to comply with the “qualified custodian” requirements;¹⁵ and failures to comply with the audit approach for pooled investment vehicles.¹⁶

➤ Failure By Advisers To Recognize They Have Custody

In its review, NEP staff observed the following situations where an adviser failed to recognize that it has custody under the rule:

¹⁰ Rule 206(4)-2(a)(4). *See also* paragraphs (b)(3),(b)(4), and (b)(6) of Rule 206(4)-2. The independent accountant must file Form ADV-E in accordance with Rule 206(4)-2(a)(4) following a surprise examination. *See also* In re Gerasimowicz, *supra* note 10 (alleging adviser did not obtain an annual surprise examination under the custody rule and failed to meet the “audit approach” exception to the surprise examination requirement).

¹¹ Rule 206(4)-2(a)(6).

¹² Rule 206(4)-2(b)(4).

¹³ Rule 206(4)-2(d)(2). As noted above, an adviser has custody if it or its related person holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them. As one example, an adviser who serves as the general partner (or holds a comparable position) to a pooled investment vehicle has custody of client funds/securities.

¹⁴ Rule 206(4)-2(a)(4). *See* “Annual surprise exams” above.

¹⁵ The term “qualified custodian” is defined in Rule 206(4)-2(d)(6) to mean certain banks and savings associations, broker-dealers registered with the SEC, futures commission merchants registered with the Commodity Futures Trading Commission, and foreign financial institutions that meet certain criteria. *See* “Use of ‘qualified custodians’ to hold client assets” above.

¹⁶ *See* “The audit approach for advisers to pooled investment vehicles” above.

- **The Role of Employees or Related Persons**¹⁷: The adviser’s personnel or a “related person” serve as trustee or have been granted power of attorney for client accounts.¹⁸
- **Bill-Paying Services**: The adviser provides bill-paying services for clients and, therefore, is authorized to withdraw funds or securities from the client’s account.¹⁹
- **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 the clients’ accounts.²⁰
- **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.²¹
- **Physical Possession of Assets**: The adviser has physical possession of client assets, such as securities certificates.²²
- **Check-Writing Authority**: The adviser or a related person has signatory and check writing authority for client accounts.²³
- **Receipt of Checks Made to Clients**: The adviser received checks made out to clients and failed to return them promptly to the sender.²⁴

➤ **Surprise Exam Requirement**

NEP staff observed deficiencies regarding surprise exams when:

- A Form ADV-E was not filed within 120 days after the date of the exam chosen by the accountant.²⁵

¹⁷ A “related person” is defined in Rule 206(4)-2(d)(7) to mean “any person, directly or indirectly, controlling or controlled by the adviser, and any person that is under common control with the adviser.”

¹⁸ Rule 206(4)-2(d)(2)(ii).

¹⁹ Rule 206(4)-2(d)(2). *See* Custody of Funds or Securities of Clients by Investment Advisers, Section II. A., Investment Advisers Act Rel. 2176 (Sept. 25, 2003), 68 FR 56692 (Oct. 1, 2003).

²⁰ Rule 206(4)-2(d)(2).

²¹ Rule 206(4)-2(d)(2)(iii).

²² Rule 206(4)-2(d)(2)(i).

²³ Rule 206(4)-2(d)(2).

²⁴ Rule 206(4)-2(d)(2)(i).

²⁵ Rule 206(4)-2(a)(4)(i).

- Evidence suggested that examinations were not being conducted on a “surprise” basis (e.g., exams were conducted at the same time each year).²⁶

➤ **Qualified Custodian Requirements**

Certain advisers did not satisfy the “qualified custodian” requirements when:

- Client assets were held in the adviser’s name, but not in an account that was under the adviser’s name as agent or trustee for the client and that held only client assets.²⁷
- The adviser commingled client, proprietary, and employee assets into one account.²⁸
- Certificates of securities²⁹ held by the adviser’s fund were held in a safe deposit box controlled by the adviser at a local bank.³⁰
- The adviser did not have a reasonable basis, after due inquiry, for believing that a qualified custodian was sending quarterly account statements to the client.³¹
- In instances where the adviser opened a custodial account on behalf of a client and sent account statements to the client, the statements sent by the adviser failed to include

²⁶ Rule 206(4)-2(a)(4).

²⁷ Rule 206(4)-2(a)(1) requires the qualified custodian to maintain client assets in a separate account for each client under the client’s name or in accounts under the name of the adviser as agent or trustee for the clients (which is permitted only if the accounts contain only clients’ funds and securities). *See SEC v. Commonwealth Advisors, Inc.*, (M.D. La.) (filed Nov. 8, 2012) (adviser alleged, among other things, to have engaged in a scheme to hide losses from certain hedge funds it managed and to have violated the qualified custodian requirements of the custody rule because it held fund assets in an account in its name, rather than in an account in the client’s name or in the adviser’s name as agent or trustee for the client).

²⁸ Rule 206(4)-2(a)(1).

²⁹ Although Rule 206(4)-2(b)(2) excepts certain privately offered securities from the requirement that client securities be held by a qualified custodian, this exception is subject to several conditions, including that the privately issued securities must be uncertificated and their ownership must be recorded only on the books of the issuer or its transfer agent. In addition, the securities must have been acquired from the issuer in a transaction or chain of transactions not involving any public offering and must be transferable only with the prior consent of the issuer or holders of the issuer’s outstanding securities.

³⁰ As the SEC has explained, because client funds and securities must be held on behalf of the client by the qualified custodian so that the qualified custodian can provide account information to the clients, keeping stock certificates in the adviser’s bank safe deposit box, for example, would not satisfy the requirements of the rule. *See Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Rel. 2176 (Sept. 25, 2003), 68 FR 56692 (Oct. 1, 2003) at note 18.

³¹ Rule 206(4)-2(a)(3).

notification urging clients to compare the account statements from the custodian with those from the adviser.³²

➤ **Audit Approach Issues**

Some advisers that relied on the “audit approach” with respect to pooled investment vehicles were not in compliance because:

- The accountant that conducted the financial statement audit was not “independent” under Regulation S-X, as required by the custody rule.
- The audited financial statements were not prepared in accordance with GAAP (*e.g.*, organizational expenses were improperly amortized rather than expensed as incurred, resulting in a qualified audit opinion; financial statements were prepared on a federal income tax basis; the adviser could not substantiate fair valuations and the accountant therefore could not issue an unqualified opinion on the financial statements).³³
- The adviser failed to demonstrate that the audited financial statements were distributed to *all* fund investors. Rather, it appeared that in many instances the statements were only made available “upon request.”³⁴
- The audited financial statements were not sent to investors within 120 days of the private funds’ fiscal year ends (or 180 days for fund of funds).³⁵
- The auditor was not PCAOB-registered and subject to PCAOB inspection.³⁶
- A final audit was not performed on liquidated pooled investment vehicles.³⁷

³² Rule 206(4)-2(a)(2). The custody rule does not require an adviser that opens a custodial account on the client’s behalf to send account statements to the client separate and apart from those the qualified custodian sends. If the adviser does send clients its own account statements, however, the adviser must include a notice in the statement, when opening an account for a client and when sending subsequent account statements to the same client, urging the client to compare the account statements from the qualified custodian with those from the adviser.

³³ Rule 206(4)-2(b)(4)(i).

³⁴ Rule 206(4)-2(b)(4)(i).

³⁵ Rule 206(4)-2(b)(4)(i). *See* Investment Advisers Act Release No. 2968 (Dec. 30, 2009) 75 FR 1456 (Jan. 11, 2010) at footnote 45 (stating that, although the custody rule requires an adviser relying on the audit approach to distribute financial statements to investors within 120 days, the Commission’s most recent custody rule amendments did not affect the staff’s views expressed in a 2006 no-action letter in which the staff stated it would not recommend enforcement action against an adviser to a fund of funds that distributed the financial statements within 180 days). *See* ABA Subcommittee on Private Investment Entities, SEC Staff Letter, Aug. 10, 2006.

³⁶ Rule 206(4)-2(b)(4)(ii).

³⁷ Rule 206(4)-2(b)(4)(iii). In order to use the audit approach, an adviser to a pooled investment vehicle must distribute audited financial statements to the pooled investment vehicle’s investors upon the pool’s liquidation.

- The adviser requested investor approval to waive the annual financial audit of a fund—but did not obtain a surprise examination.³⁸ The adviser, therefore, failed to either undergo a surprise exam or comply with the audit approach.

In addition to the deficiencies found in this set of examinations, registrants should also be aware that the staff has observed that advisers to some PIVs may be using financial statements for those PIVs to satisfy the custody rule’s audit approach that are not prepared in accordance with U.S. GAAP or audited in accordance with U.S. Generally Accepted Auditing Standards as described in the 2003 Custody Rule Adopting Release, without satisfying the conditions set out in that guidance.³⁹ For example, the staff has observed instances in which the PIV’s audit was not conducted in accordance with U.S. Generally Accepted Auditing Standards and/or the financial statements prepared in accordance with International Financial Reporting Standards did not contain information substantially similar to statements prepared in accordance with U.S. GAAP (e.g., the Schedule of Investments or Financial Highlights were omitted, or included but were labeled as unaudited).

Conclusion

The Advisers Act custody rule is designed to protect and safeguard client assets. Advisers may want to consider their policies and procedures and their compliance with the custody rule in light of the deficiencies noted in this Alert. Deficiencies in this area have resulted in actions ranging from immediate remediation to enforcement referrals and subsequent litigation.

³⁸ Rule 206(4)-2(b)(4).

³⁹ See Footnote 41 of the 2003 Custody Rule Adopting Release; See also Staff Responses to Questions About the Custody Rule, Question VI 5, available at http://www.sec.gov/divisions/investment/custody_faq_030510.htm (providing staff guidance to pooled vehicles organized outside of the United States, or having a general partner or other manager with a principal place of business outside the United States, to allow them to use the “audit approach” even if they have their financial statements prepared in accordance with accounting standards other than U.S. GAAP so long as they contain information substantially similar to statements prepared in accordance with U.S. GAAP and meet certain other conditions).

NEP staff also welcomes comments and suggestions about how the Commission's examination program can better fulfill its mission to promote compliance, prevent fraud, monitor risk, and inform SEC policy. If you suspect or observe activity that may violate the federal securities laws or otherwise operates to harm investors, please notify us at http://www.sec.gov/complaint/info_tipscomplaint.shtml.

This Risk Alert is intended to highlight for firms risks and issues that the staff has identified in the course of examinations regarding investment advisers' obligations when they maintain custody of client assets. In addition, this Risk Alert describes factors that firms may consider to (i) assess their supervisory, compliance and/or other risk management systems related to these risks and issues, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. These factors are not exhaustive, and they constitute neither a safe harbor nor a "checklist." Other factors besides those described in this Risk Alert may be appropriate alternatives or supplements to consider. The risks, issues and associated factors described are for informational purposes only. They do not necessarily represent legal or regulatory requirements. They do not present any legal opinion or advice. Moreover, future changes in laws or regulations may supersede some or all of the discussion in this Alert. Some of these risks, issues and associated factors may not be applicable to a particular firm given the characteristics of its business or operations. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.
