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SEC Finds Fault with Adviser Custody Practices

On March 4, the Office of Compliance Inspections and Examinations of the U.S. Securities and Exchange Commission ("SEC") issued a Risk Alert on investment adviser custody and related matters. The Risk Alert identifies particular custody-related deficiencies and warns investment advisers to review their practices in order to comply with their duty to safeguard their clients' assets. An Investor Bulletin encouraging investors to ask questions relating to custody arrangements was issued in conjunction with the Risk Alert.

In a review of recent examinations of investment advisers in which widespread noncompliance with the custody rule [1] was observed, the SEC's National Examination Program ("NEP") found that:

(1) Certain investment advisers failed to recognize they had custody of a client's assets. This occurred in instances in which:

- the adviser's personnel or a "related person" [2] served as a trustee;
- the adviser was authorized to withdraw (or direct the withdrawal of) funds or securities from the client's account as part of bill-paying services (including payment of management fees to the adviser) or had such ability by managing portfolios through direct and unrestricted online access to client accounts;
- the adviser had signatory or check-writing authority for client accounts; or
- the adviser had physical possession of client assets, such as securities certificates.

(2) Certain investment advisers failed to meet the "surprise exam" requirements. Unless an exception applies, investment advisers that have custody of client assets must engage an independent public accountant to conduct an annual surprise examination to verify client assets. The NEP noted that these examinations were not being conducted on a "surprise" basis (e.g., in instances where the exam was performed at the same time each year). Further, the NEP observed that in certain cases, the required Form ADV-E was not filed within 120 days after the exam date. (3) Certain investment advisers did not satisfy the "qualified custodian" requirements. Generally, an adviser with custody must maintain client funds and securities with a third-party custodian, such as a bank. The NEP found that certain advisers failed to satisfy the requirements in instances in which:

- client, proprietary and employee assets were commingled into a single account;
- certificates of securities issued in the name of the adviser's fund were held in a safe deposit box controlled by the adviser at a local bank; or
- the adviser lacked a reasonable basis to believe the client's quarterly account statements were sent to the client by the custodian.

(4) Certain investment advisers relying on the "audit approach" with respect to pooled investment vehicles were not in compliance with applicable requirements. Investment advisers to pooled investment vehicles (such as hedge funds and private equity funds) are exempt from the surprise exam requirement so long as the fund is already subject to an annual financial audit by an independent public accountant that is registered with the Public Company Accounting Oversight Board and the audited financial statements are delivered to the investors in such fund within 120 days of the fund's fiscal year-end (or within 180 days of the fund's fiscal year-end for a fund-of-funds). The NEP noted a failure to comply in instances in which:

- the accountant was not "independent" under the SEC's Regulation S-X;

- the audited financial statements were not prepared in accordance with U.S. Generally Accepted Accounting Principles (GAAP);
- the audited financial statements were made only "upon request" rather than to all fund investors;
- the audited financial statements were not delivered to the fund investors within 120 days of the fund's fiscal year-end (or within 180 days of the fund's fiscal year-end for a fund-of-funds); or
- the adviser requested investor approval to waive the annual audit but did not obtain a surprise examination.

The Risk Alert underscores that the SEC considers the safeguarding of client assets fundamental to investor protection. In light of the SEC's focus on custody-related deficiencies, investment advisers should closely review their policies and procedures in order to assess whether those policies and procedures adequately address client custody requirements. The Risk Alert noted the prevalence of custody-related deficiencies, which accounted for approximately one-third of all deficiencies observed in recent examinations. The consequences of such deficiencies have ranged from immediate remediation to enforcement referrals and subsequent litigation.

[1] Rule 206(4)-2 under the Investment Advisers Act of 1940, as amended. The custody rule is designed to protect the funds and securities of advisory clients from misuse and misappropriation. The rule was strengthened following the 2008 financial crisis (see Day Pitney Release: *SEC Issues Amendments to Investment Adviser Custody Rule*).

[2] Rule 206(4)-2(d)(7) defines "related person" as "any person, directly or indirectly, controlling or controlled by the adviser, and any person that is under common control with the adviser."