November 4, 2014

Custody Rule Information Delays Lead to Enforcement against Investment Adviser

Securities and Exchange Commission (SEC) enforcement actions have moved out of the realm of punishing wrongdoers for harm caused and into preemptive measures apparently designed to enhance full technical compliance with Rule 206(4)-2 of the Investment Advisers Act of 1940, as amended, more commonly known as the "Custody Rule."

Despite the lack of any demonstrated harm to any client, the SEC has charged an SEC-registered investment adviser (RIA), its cofounders and its chief compliance officer for failing to comply with the Custody Rule, alleging audited financial statements sent out by the RIA did not meet the time deadline required by the Custody Rule. This demonstrates the willingness of the SEC to publicly chastise a chief compliance officer and others over technical noncompliance with the Custody Rule. In the SEC's announcement of the initiation of the administrative proceeding, Andrew M. Calamari, director of the SEC's New York Regional Office, stated that the RIA "and its senior-most officers have persistently disregarded their obligations under the law and left their clients waiting for months at a time to have the materials they need to verify the existence and value of fund assets." However, the SEC does not allege any deficiency with the RIA's safekeeping of the actual fund assets.

The Custody Rule is designed to safeguard client funds from possible theft or misappropriation. Per the Custody Rule, any RIA that has the authority to withdraw funds or securities from a client account is deemed to have custody over that client account. An RIA that has custody over a client account is required to (a) hold that client's funds and securities with a "qualified custodian" and notify clients of the arrangement with the custodian, (b) have a reasonable basis for believing the custodian sends clients quarterly account statements, and (c) submit to a surprise exam of the client account each calendar year. However, there is a special rule for an RIA that is the general partner of a hedge fund or other pooled vehicle that constitutes a "private fund." A private fund general partner may, in lieu of the surprise audit and other requirements of the Custody Rule, have GAAP-compliant audited financial statements of the fund sent to all investors in the fund within 120 days of the end of the fund's fiscal year (or 180 days in the case of a fund of funds).

SEC Allegations Against Sands Brothers Asset Management LLC

The SEC announced on October 29 it was charging Sands Brothers Asset Management LLC (Sands Brothers), as well as the cofounders and the chief compliance officer/chief operating officer of Sands Brothers, with violations of the Custody Rule. The SEC's order instituting an administrative proceeding alleges that Sands Brothers, with respect to distributing audited financial statements to the investors in its private funds, was at least 40 days late for fiscal year 2010, between six and eight months late for fiscal year 2011, and approximately three months late for fiscal year 2012.

In 2010, the SEC censured Sands Brothers for violation of the Custody Rule as well as other reporting and recordkeeping requirements, and censured the cofounders of Sands Brothers for aiding and abetting such violations by Sands Brothers.

Charging of the Chief Compliance Officer

The administrative proceeding announced by the SEC is not only against Sands Brothers and the cofounders, but it is also against the chief compliance officer/chief operating officer personally. It is unclear if the chief compliance officer had any control over the required audits or their dissemination. This action should serve as a warning to compliance officers at RIAs that compliance with the Custody Rule is specifically a responsibility of compliance officers, according to the SEC, and such compliance officers may be held personally liable for any deficiencies.

Conclusion

With the filing of administrative proceedings against Sands Brothers and its principals, the SEC has publicly expressed its willingness to proactively enforce breaches of the Custody Rule, regardless of the impact of such breaches on the client. While the Custody Rule is in place to safeguard client funds, most fund investors may not see much value in receiving annually the GAAP-compliant audited financial statements of the fund. Reporting to investors on a fund's financial performance typically occurs quarterly, so information in the annual audits, sent 120 days after the end of the fiscal year, may be seen as unnecessary for an investor's evaluation of the fund and its performance. Regardless of whether or not compliance with the Custody Rule actually protects investors, RIAs and their principals, such as chief compliance officers, are advised to ensure they are in strict compliance with the rule.

Please contact the Day Pitney attorneys listed to the right to discuss any questions you may have about RIAs, the Custody Rule, or any other SEC reporting or recordkeeping requirements.