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SEC Alert Highlights Common Deficiencies in Compliance with the Custody Rules for Registered Investment Advisers

Rule 206(4)-2 under the Investment Advisers Act of 1940 imposes requirements on SEC registered investment advisers who have custody of client funds or securities. Under the custody rule, advisers with custody are generally required to use a "qualified custodian" to hold clients' assets, assure that appropriate notices are provided to clients regarding their holdings and arrange for annual surprise examinations of the assets by an independent public accountant. The custody rule is designed to protect advisory clients from the misuse or misappropriation of their funds and securities. On March 4, 2013, the staff of SEC's National Examination Program (NEP) issued a risk alert describing deficiencies it has observed in compliance with the custody rule. The alert highlights a number of issues that registered investment advisers should consider to ensure that they comply with the custody rule.

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Failure by Advisers to Recognize Custody

Under Rule 206(4)-2, an investment adviser has custody if it or a related person holds, directly or indirectly, client funds or securities, or has any authority to possess them. Any arrangement that may allow an adviser or a related person to access client funds or securities should be analyzed to determine if it results in custody. The NEP's alert describes a number of situations where investment advisers failed to recognize that they have custody.

- **Activities of Employees or Related Persons**. An investment adviser's employees or related persons serve as trustee or have been granted power of attorney for client accounts.
- **Bill-Paying Services**. An investment adviser provides bill-paying services for a client and, therefore, is authorized to withdraw funds or securities from the client's account.
- **Online Access to Client Accounts**. An investment adviser has access to clients' personal usernames and passwords for online accounts without restriction and, therefore, has the ability to withdraw funds and securities from the clients' accounts.
- **Adviser Acts as General Partner**. An investment adviser serves as the general

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partner of a limited partnership or holds a comparable position for a different type of pooled investment vehicle.
- **Physical Possession of Assets**. An investment adviser has physical possession of client assets, such as securities certificates.
- **Check-Writing Authority**. An investment adviser or a related person has signature and check writing authority for client accounts.
- **Receipt of Checks Made to Clients**. An investment adviser received checks made out to clients and failed to return them promptly to the sender.

Surprise Exam Requirement

Rule 206(4)-2 generally requires that an investment adviser with custody of client assets undergo an annual surprise examination by an independent public accountant that verifies client funds and securities. A Form ADV-E must be filed with the SEC within 120 days after the date of the exam chosen by the accountant. The deficiencies observed by the NEP staff in connection with the surprise exam requirement included failures to file the Form ADV-E by the deadline and evidence suggesting that the exam was not conducted on a "surprise" basis (including exams that were conducted at the same time each year).

Qualified Custodian Requirements

An investment adviser with custody generally must maintain client funds and securities with a qualified custodian (*e.g.*, a bank or 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. Deficiencies observed by the NEP staff in compliance with the qualified custodian requirements included the following:

- Client assets were held in the adviser's name, but not in an account under the adviser's name as agent or trustee for clients, or were commingled with other assets.
- Securities certificates held by an adviser's fund were held in a safe deposit box controlled by the adviser.
- The investment adviser did not have a reasonable basis, after due inquiry, for believing that a qualified custodian was sending quarterly account statements to clients.
- In instances where an investment adviser opened a custodial account on behalf

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of a client and sent account statements to the client, the statements sent by the adviser failed to include a notification urging clients to compare the account statements from the custodian with those from the adviser.

Audit Issues for Pooled Investment Vehicles

A pooled investment vehicle may distribute audited financial statements to investors at least annually instead of complying with the notice and account statement delivery requirements and the surprise examination requirement. The NEP staff observed the following issues with some advisers that relied on the "audit approach" for compliance:

- 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.
- The investment adviser failed to demonstrate that the audited financial statements were distributed to all fund investors.
- The audited financial statements were not sent to investors within 120 days after the fund's fiscal year end (or 180 days for a fund of funds).
- The auditor was not registered with the Public Company Accounting Oversight Board and subject to inspection by such Board.
- A final audit was not performed on liquidated funds.
- An investment adviser obtained investor approval to waive the annual financial statement audit of a fund, but then did not comply with the surprise examination requirement.

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