

Client Alert.

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SEC Adviser Exams Find Widespread Violations of Custody Rule

By Jay G. Baris, Kelley A. Howes and Luke T. Bagley

The SEC's Office of Compliance Inspections and Examinations reports finding widespread compliance deficiencies related to custody of securities. In its March 4, 2013 [National Exam Program Risk Alert](#), OCIE said that approximately one third of its examinations of registered investment advisers revealed significant deficiencies.

As a result of these findings, OCIE referred violations to the SEC's Division of Enforcement where appropriate.

IDENTIFIED COMPLIANCE DEFICIENCIES

OCIE previously identified compliance with Rule 206(4)-2 under the Advisers Act (the "Custody Rule") as a priority area for purposes of its National Exam Program (NEP) (see our recent [client alert regarding 2013 examination priorities](#)). Nonetheless, recent NEP compliance examinations uncovered "widespread and varied" compliance deficiencies, which it grouped into four general categories:

- **Failure to recognize "custody."** Advisers in some cases failed to recognize that they have "custody" of client assets held by a custodian if the adviser has authority over such clients' funds. For example, such authority can result from providing bill-paying services for clients, through the grant to the adviser of check-writing authority over client accounts, or through the grant of a power of attorney to the adviser. These deficiencies also included cases where the advisers simply maintain physical possession over client assets (e.g., physical security certificates).
- **Failure to perform "surprise examinations."** Some advisers failed to timely file Form ADV-E. In other cases, evidence suggested that the examinations were not "surprise" examinations, but rather were scheduled at the same time each year.
- **"Qualified custodian" compliance failures.** Compliance violations with respect to assets held by qualified custodians included holding client assets in the adviser's name, not as agent or trustee for the client, commingling advisory funds with client funds, and holding security certificates in a safe deposit box controlled by the adviser at a local bank. The NEP staff also uncovered cases where advisers did not have a reasonable basis (after due inquiry) to believe the qualified custodian sent quarterly account statements to their clients. In cases where advisers themselves sent account statements to clients, some advisers failed to urge clients to compare those statements with statements received from the custodian.
- **"Audit approach" failures for advisers to pooled investment vehicles.** The NEP staff observed that in some cases the accountant that conducted the audit was not sufficiently "independent," that audited financial statements were not prepared in accordance with GAAP, that audited financial statements were distributed only to investors that requested them (rather than to all investors), and that certain auditors were not registered with and subject to inspection by the PCAOB.

Client Alert.

PROTECTION OF INVESTORS

In a related [investor bulletin](#), the SEC urged investors to not rely on the Custody Rule as a substitute for careful diligence and management of their investments.

The bulletin provides a number of specific recommendations to help investors protect themselves from theft or misuse of their funds and securities. Specifically, the SEC recommends that investors:

- ask advisers about custody arrangements upon establishing an account with an adviser;
- check whose name appears on any custody account;
- ensure that they receive account statements at least quarterly;
- check that account statements from the investment adviser match those received from any custodians; and
- ask advisers about the effect of fees on their investment return, including how those fees compare to other advisers.

Although aimed at educating investors, the SEC's recommendations may also provide useful guidance for advisers on how to communicate with new investors.

THE CUSTODY RULE

Registered investment advisers that have "custody" of client assets must comply with the Custody Rule. An adviser may be deemed to have custody of fund assets in any number of ways. For example, a general partner of a pooled investment vehicle is deemed to have custody of client assets because it has access to those assets by virtue of its position. The Custody Rule requires, among other things, that investment advisers:

- must maintain assets at a "qualified custodian";
- send periodic notices to clients detailing how their assets are being held;
- send periodic account statements to clients detailing their holdings; and
- undergo annual surprise examinations to verify assets.

OCIE found widespread deficiencies in each of these general areas.

CONCLUSION

The risk alert and the investor bulletin underscore the SEC's views regarding the importance of safeguarding client assets. They also serve as a clear reminder of OCIE's previously stated intent to carefully review custody practices of registered investment advisers during compliance examinations. Registered advisers are well advised to review their custody procedures to ensure compliance with the Custody Rule.

Client Alert.

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