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Adviser Custody Revisited

The SEC's National Exam Program (NEP) recently issued a Risk Alert[1] to highlight deficiencies observed with the Adviser Custody Rule, Rule 206(4)-2 under the Investment Advisers Act of 1940. This affords the perfect opportunity to revisit adviser custody issues, focusing in particular on the areas where deficiencies were observed.

Deficiencies Identified

According to the Risk Alert, approximately one-third of over 140 recent adviser examinations with significant deficiencies were found to include custody-related issues, falling generally into the four categories discussed below.

(1) Failure to Recognize "Custody"

Some advisers fail to recognize they have custody of client assets because the definition of "custody" under the rule goes far beyond what anyone would normally think of as "custody." In plain language, "custody" means actually holding or taking physical possession of assets. However, advisers have custody of assets under the rule not only if they *have* possession, but also if they have the mere *authority to obtain possession*. As a result, a significant percentage of advisers have custody for purposes of the rule.[2]

The breadth of the custody definition can lead to some surprising results. For example, if an adviser with authority to trade in a client's online account is given a password to access the account, the adviser will have custody of the account if, using that password, the adviser could withdraw assets from the account. This scenario was cited in the Risk Alert as an example where advisers have failed to recognize they have custody. Other examples include:

- advisers having check-writing authority over a client's account;
- advisers providing bill-paying services to clients; and
- advisers acting as general partners of limited partnership clients, since general partners by law have the authority to access and control the partnership's assets.

Another reason advisers fail to recognize they have custody is that a related person's custody of advised client assets is imputed to the adviser.[3] For example, if an adviser's related bank acts as the custodian of a client's advised assets, both the adviser and the bank will be deemed to have "custody" of those assets under the rule.

Imputing related person custody to an adviser can lead to even more surprising results if the related person is not expecting to have custody the way a custodial bank would. For example, if one of the adviser's executive officers (a "related person") is granted a general power of attorney by an advised client, the officer will have custody of the client's assets by virtue of the authority to control the assets conveyed under the power of attorney.[4] Once the officer has custody, the adviser itself also has custody of the client's assets, because the related person's custody is imputed to the adviser. Advisers should take this into consideration when determining whether they have "custody" under the rule and when responding to the custody items on Form ADV.

(2) Failure to Comply with the "Surprise Exam" Requirement

With certain exceptions, advisers with custody of client assets under the rule must have those assets verified at least once a year by an independent public accountant, on a date chosen by the accountant without prior notice to the adviser that must vary from year to year.[5] This is known as the "surprise exam" requirement. A surprise exam should be followed within 120 days after the date chosen by the accountant by a Form ADV-E filed with the SEC reporting on the exam.[6]

According to the Risk Alert, deficiencies have been observed where the Form ADV-E was not filed by the 120-day deadline. Note, however, that Form ADV-E is filed by the *accountant*, not the adviser. Moreover, technically speaking, neither the adviser nor the accountant violates the rule if the Form ADV-E is not filed by the deadline.[7] Nonetheless, the ADV-E filing is an integral part of the rule and NEP obviously considers late filings as deficiencies. Accordingly, wise advisers will take appropriate steps to ensure that the filing is timely made.

The Risk Alert also indicates that, in some cases, exams are not being conducted on a surprise basis, but rather at the same time each year. While conducting the exam on a date that varies from year to year would seem to avoid this problem, a considerable waste of time and resources can result if the accountant shows up on a random date only to find that the personnel needed to access the necessary records and answer the appropriate questions are on vacation or otherwise not available. Advisers can prevent this, however, by making sure the exam could be conducted even in the absence of regular personnel, for example, by cross-training other personnel in the relevant areas or ensuring remote access to critical players.

(3) Failure to Comply with the "Qualified Custodian" Requirements

Assets as to which an adviser has custody under the rule must be maintained at a "qualified custodian" (QC), such as a bank or broker-dealer.[8] Advisers must also have a reasonable basis, after due inquiry, for believing that the QC sends an account statement at least quarterly to each of the adviser's clients for which the QC maintains assets.[9]

The Risk Alert cites various deficiencies observed in meeting the QC requirements, such as:

- commingling client and proprietary assets in one account;
- holding client securities certificates in the adviser's own safe deposit box at a bank; and
- failing when required to include a statement on the adviser's own client account statements urging clients to compare the account statements from the custodian with those from the adviser.

In some cases, advisers were also observed as not having a reasonable basis for believing that quarterly account statements were being sent directly to clients by the custodian as required by the rule. This raises the question of what will suffice as "due inquiry" to form a reasonable basis. Although circumstances may vary, advisers might inquire directly with the custodian to verify that it will send the necessary statements directly to clients. This could be done before the client opens an account with the custodian, or before the client becomes an advisory client if a new client wants to use its own custodian for advised assets. The adviser could also make periodic checks to verify that the statements are in fact being sent, for example, by inquiring directly with the client or the custodian, by putting reminders in various client communications to let the adviser know if they are not receiving the custodian's statements quarterly, or by asking the custodian to send the adviser a duplicate copy of all statements sent to the client.

Another deficiency cited in this category was client assets held in an account in the adviser's name, but not as agent or trustee for clients.[10] A seemingly easy fix would be to make sure the appropriate "as agent" or "as trustee" designation is included on the account. However, this scenario points out a hidden glitch in the rule. The plain language of the rule permits client assets to be maintained in an account in the adviser's name so long as the account is under the adviser's name as agent or trustee.[11] Yet if accounts are set up in the adviser's name, the qualified custodian will not have in its records the client-level names and addresses necessary to send quarterly account statements directly to clients as required under the rule. Omnibus accounts opened in the adviser's name raise the same issue, particularly if the adviser handles the client-level sub-accounting. In that case, the custodian will also not have the client-by-client transaction and holdings information necessary to send statements. Thus, client accounts in the adviser's name—although seemingly permitted by one provision of the rule—might not be able to comply with the quarterly account statement requirement specified in a different provision of the rule. Advisers should consider this before setting up any client account in their name.[12]

(4) Failure to Comply with the "Audit Approach" for Pooled Investment Vehicles

Advisers following the so-called "audit approach" avoid the notice and account statement delivery obligations that would otherwise apply to the pooled vehicle accounts for which they have custody, and are deemed to have satisfied the surprise examination requirement.[13] Among other things, the "audit approach" requires a pooled vehicle's audited financial statements to be distributed to all pool investors at least annually.[14]

According to the Risk Alert, various deficiencies have been observed with advisers using the "audit approach," such as:

- failing to use an accountant that was "independent" or that was registered with, and inspected by, the Public Company Accounting Oversight Board as required;
- failing to follow generally accepted accounting principles in preparing the financial statements;
- failing to distribute the financial statements to *all* investors;
- failing to distribute the financial statements within 120 days of the pool's fiscal year end (or 180 days for funds-of-funds);
- failing to perform a final audit on a liquidated pool; and
- having investors waive the annual audit requirement without obtaining a surprise exam so the adviser failed to comply with either the "audit approach" or undergo a surprise exam.

The variety of these deficiencies suggests that at least some private fund advisers are finding the custody rule a challenge. This may be because they are new to the rule or because in some cases their ability to comply depends on other parties that pose an obstacle, such as when an adviser trying to meet the financial statement delivery deadline under the rule does not receive timely financial statements from the funds in which its fund is invested. Indeed, these issues have already prompted informal relief from some of the custody rule requirements for private fund advisers in certain circumstances.[15]

Key Takeaway

The Risk Alert provides its own key takeaway, telling advisers to review their practices in light of the custody deficiencies observed. This would give all advisers the chance to avoid somebody else's mistakes, including advisers that do not think they have custody, in case they are among those failing to recognize they have custody under the broad definition in the rule.

Notes

1. Risk Alerts can be found on the NEP webpage at *http://www.sec.gov/about/offices/ocie.shtml*.

2. The percentage of SEC-registered advisers reporting they have custody is 30.4 percent (42.4 percent if related person imputed custody is added in). *See* "2012

Evolution Revolution—A Profile of the Investment Adviser Profession," issued by the Investment Adviser Association and National Regulatory Services, at 12.

3. Rule 206(4)-2(d)(2).

4. *See* Rule 206(4)-2(d)(2)(ii).

5. Rule 206(4)-2(a)(4). Exceptions from this requirement include if (i) the adviser has custody solely because it has authority to withdraw advisory fees from client accounts (*see* Rule 206(4)-2(b)(3)), and/or (ii) the adviser has custody solely because a related person is the qualified custodian and the qualified custodian is "operationally independent" of the adviser under the rule (*see* Rule 206(4)-2(b)(6)).

6. Rule 206(4)-2(a)(4)(i).

7. The adviser complies with this aspect of the rule so long as it has a written agreement with the accountant that requires the accountant to make the filing. Rule 206(4)-2(a)(4)(i). The accountant, on the other hand, is not covered by the rule at all and therefore would not violate the rule if it made the filing late, even if doing so would breach the accountant's written agreement with the adviser.

8. Rule 206(4)-2(a)(1). Rule 206(4)-2(b)(2) excepts privately offered securities from this requirement under certain conditions.

9. Rule 206(4)-2(a)(3).

10. *See* Rule 206(4)-2(a)(1)(ii).

11. *Id.*

12. Certain account arrangements might offer the qualified custodian access to the client-level information necessary to send the account statements required by the rule. *See*, *e.g.*, the various types of account structures and servicing arrangements available for holding mutual funds shares described in "Navigating Intermediary Relationships," an ICI/IDC whitepaper (Sept. 2009). However, arrangements of this type would have to be verified as compliant with the rule before the account is set up.

13. Rule 206(4)-2(b)(4).

14. *Id.*

15. *See*, *e.g.*, Staff Responses to Questions About the Custody Rule, Questions VI.7 through VI.9, available at *http://www.sec.gov/divisions/investment/custody_faq_030510.htm*.