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SEC clamps down on Custody Rule

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Under rule 206(4)-2 of the Advisers Act, otherwise known as the Custody Rule, it is a fraudulent practice for a registered investment adviser to have custody of client funds or securities, unless the adviser takes certain required steps to protect the assets. Over the past year the SEC's Enforcement division has been relatively active investigating and enforcing the rule – which, at most, requires a showing of negligence – with a number of complicated provisions that can trip up the uninformed.

Recently, the SEC brought enforcement actions that highlight two key areas under the Custody Rule that can result in liability. First, in addition to maintaining client funds and securities with a "qualified custodian," advisers with custody of the funds and securities must obtain either (i) a "surprise examination" of those assets annually from an independent public accountant or (ii) an annual audit of its financial statements by an independent public accounting firm that is registered with (and is subject to regular inspection by) the PCAOB and distribute the financial statements prepared in accordance with GAAP to each investor in the fund within 120 days of the fund's fiscal year end (180 days for fund of funds). Most registered private fund advisers rely on the annual audit approach.

Sometimes the 120-day deadline can be difficult to meet for a variety of reasons, including when the auditor is unable to provide an unqualified opinion required to accompany the statements. The SEC staff has stated that it would not recommend enforcement action if the adviser relying on the audit approach "reasonably believed" that the 120-day deadline would be met but the deadline is missed due to "unforeseeable circumstances". But the Commission's flexibility is limited, as illustrated in a recent enforcement action. In September, the SEC charged hedge fund advisory firm ED Capital Management and its principal with violations of the Custody Rule (among other violations). In that case, the adviser was unable to timely obtain unqualified opinions from the audit firm it engaged, and failed to deliver GAAP-compliant fund financial statements to fund investors, over four consecutive years. Compounding the error, the adviser incorrectly stated in its Form ADV that it had distributed audited financial statements prepared in accordance with GAAP, leading to the SEC alleging willful violations of Section 207 of the Advisers Act, which prohibits advisers from making false statements in reports the SEC.

Second, the Custody Rule requires the accounting firm performing either a surprise examination or financial statement audit to meet the auditor independence standards set forth in Regulation S-X.   Provision of non-audit services by the auditor to either the adviser or one of its affiliates can jeopardize the auditor's independence and cause the adviser to fail to meet the requirements of the audited financials alternative or the surprise exam.

As but one example, the SEC recently settled an order with RSM US LLP for, among other things, violating the auditor independence rules and thereby causing Custody Rule violations by eight registered advisers, although it did not charge the advisers for the Custody Rule violations. The SEC alleged that RSM repeatedly misrepresented that it was "independent" in its clients' audit reports while providing non-audit services to affiliates of RSM's audit clients. The non-audit services included corporate secretarial services, payment facilitation, payroll outsourcing, loaned staff, financial information system design or implementation, bookkeeping, internal audit outsourcing, and investment adviser services. The auditor ultimately agreed to violations of the auditor independence rules and improper professional conduct.

Registered advisers with custody of client assets should be careful when maintaining such assets with qualified custodians and engaging auditors in order to avoid inadvertently violating the Custody Rule. Although an adviser may view the auditor's independence as the auditor's responsibility, the SEC views the adviser as responsible for compliance with the Custody Rule, and it has brought enforcement actions against advisers as a result of the auditor's breach of its independence requirements. *See Katz, Sapper & Miller, LLP* and *Total Wealth Mgmt., Inc*. Thus it is risky for advisers to ignore the need for the auditor to maintain its independence, and many advisers require auditors to provide periodic representations that the auditors meet audit independence requirements with respect to the adviser and its affiliates. The SEC is most likely to bring an action against the adviser when it believes that the adviser had reason to know of the auditor firm's lack of independence. It's best to be careful.

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