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Compliance Clinic

How CCOs Can Prepare a Custody Rule Review

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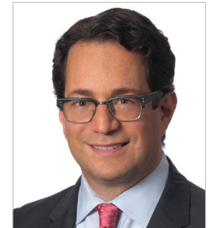

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Under the **Securities and Exchange Commission**'s custody rule (Investment Advisers Act Rule 206(4)-2(d)(2)), a registered investment adviser is deemed to have custody of client assets if the adviser or a so-called "related person" of the adviser—including parties under common control with the IA—directly or indirectly holds, or has any authority to obtain possession of, client funds or securities.

Many managers of private funds, such as most hedge or private equity funds, are deemed to have custody because their investment management agreements grant them the authority to withdraw funds or securities from a client account or because the manager or a related person serves as a general partner or managing member of a fund vehicle.

Custody Rule Obligations

Chief compliance officers at private fund managers are generally aware of the custody rule and its key safeguarding requirements. These are:

- To maintain client funds and securities with a qualified custodian in separate client accounts
- To ensure either that pooled investment vehicle investors timely receive financial statements prepared in accordance with U.S. Generally Accepted Accounting Principles, or that the manager satisfies certain "surprise audit" and account statement content and delivery obligations

However, many CCOs have less experience with evaluating a manager's compliance with the custody rule, particularly in the context of the annual compliance review.

Self-Assessment Obligations

All registered IAs have an obligation under Rule 206(4)-7 to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder. They also have an obligation under that rule to perform an at-least-annual review of the adequacy of these policies and procedures.

In March 2013, the SEC's National Examination Program issued a Risk Alert in which it stated that the custody rule is "one of the most critical rules" under the Advisers Act and that the staff of the Office of Compliance Inspections and Examinations had found "widespread and varied non-compliance with elements of the [rule]" in a large sample of recent examinations. Given that warning, CCOs to private fund managers should ensure that a robust custody rule assessment is part of their annual compliance reviews.

Structuring a Custody Rule Review

CCOs have a great amount of latitude in structuring their annual compliance reviews, but OCIE's Risk Alert presents a convenient and comprehensive four-question framework that should be used—and modified, if necessary.

1. Ask if you have custody

OCIE cited a variety of situations, ranging from technical deficiencies to blatant failures, where advisers failed to recognize that they had custody. In response, CCOs should review the definition of "custody" and carefully review the grants of authority in the manager's investment management agreements. Remember that a manager can have custody—even without holding client funds or securities—if it has *any authority to obtain possession* of those assets.

Where a manager's client agreements do not appear to establish or impute custody, a CCO should also review the manager's operational procedures and all client account agreements to ensure the manager does not have actual custody. In addition, CCOs should consider whether a related person of the adviser has custody of funds or securities of the adviser's clients.

2. Ask if client assets are properly maintained with a qualified custodian

The OCIE Risk Alert reported numerous issues with the "qualified custodian" requirement. Accordingly, for managers with custody over client assets, CCOs should confirm that all accounts and custodial relationships (including physical custody) are held with qualified custodians, are titled in the correct client's name and are properly segregated from manager assets. Particular attention should be paid to non-U.S. custodians, as there is a prong of the qualified custodian definition that specifically addresses foreign financial institutions.

There is an exception to the qualified custodian requirement with

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respect to certain privately offered securities. Such securities are:

- Acquired from the issuer in a transaction or chain of transactions not involving any public offering
- Uncertificated, with ownership recorded on the books of the issuer or transfer agent in the client's name
- Transferable only with prior consent of the issuer or other security holders

Traditionally, this narrow exception has only applied to uncertificated privately placed securities and certificated privately offered securities needed to be held with a qualified custodian. There was much frustration with this requirement, particularly where ownership of a security is recorded on the books of the issuer and the related certificate or document is non-transferable.

In an August 2013 Guidance Update*,* the SEC's Division of Investment Management indicated that it would "not object" if an adviser does not maintain certificates evidencing privately offered securities with a qualified custodian, provided:

- The client is a pooled investment vehicle that complies with the audit exception
- The private stock certificate can only be used to effect a transfer or otherwise to facilitate a change in beneficial ownership of the security with the prior consent of the issuer or holders of the outstanding securities of the issuer
- Ownership of the security is recorded on the books of the issuer or its transfer agent in the name of the client
- The private stock certificate contains a legend restricting transfer
- The private stock certificate is appropriately safeguarded by the adviser and can be replaced in the event of loss or destruction

The Division also noted that: (i) partnership agreements, subscription agreements and limited liability company agreements are not "certificates" for the purposes of this exception; and (ii) securities evidenced by **International Swaps and Derivatives Association** master agreements "that cannot be assigned or transferred without the consent of the counterparty" are "privately offered securities" under that exception.

CCOs, however, should note that for pooled investment vehicles the privately offered securities exception is only applicable if the pooled investment vehicle is subject to an annual financial statement audit and the audited financial statements are delivered on a timely basis.

3. Ask if you can rely on the audit exception

In its Risk Alert, OCIE reported that it found violations of virtually every prong of the audit exception. CCOs using the audit exception should focus their self-assessment on the four key areas of concern identified by the staff:

- *Independence*. CCOs should confirm that each auditor is independent and obtain confirmation of **Public Company Accounting Oversight Board** registration and inspection status. This may sound like a needless technicality, but it is well worth the time, given the stakes involved
- *GAAP compliance*. Subject to certain exceptions, the audited financial statements need to be prepared in accordance with U.S. GAAP for each year of operation (including so-called "stub years"). All CCOs, particularly those at firms launching new funds that amortize organizational costs and/or managing funds with illiquid assets, should regularly discuss with their auditors issues that could result in a qualified audit opinion. CCOs overseeing investment vehicles that are eligible to use accounting standards other than U.S. GAAP should have the auditors confirm that their financial statements and audit processes satisfy this element of the custody rule
- *Delivery*. CCOs should confirm that financial statements are delivered, and not merely made "available upon request," within the time frames prescribed by the rule. For managers and administrators that distribute financial statements electronically, CCOs should benchmark their practices against the SEC's 2000 guidance on electronic delivery
- *Liquidation audit*. Advisers winding up a pooled investment vehicle must ensure they obtain a final audit upon liquidation of that vehicle

4. If you cannot rely on the audit exception, ask if you are complying with the notice, account statement delivery and surprise exam requirements

While the overwhelming majority of private fund advisers rely on the audit exception to address custody issues, IAs have the option to comply with the notice, account statement and surprise exam requirements of the custody rule. CCOs should note that OCIE reported numerous weaknesses with the surprise exam, and should focus on these areas in any assessment of surprise exam procedures. OCIE found that in many cases the "surprise" exam was scheduled in advance, and not much of a surprise, and that the Form ADV-E was often not filed on a timely basis. It is due within 120 days of the exam.

In addition to the surprise exam, CCOs to private fund managers not relying on the audit exception should also confirm that: (i) their account opening notices have been sent to clients; (ii) these notices included the proper legends—urging the client recipient to compare account statements received from the custodian with those sent by the adviser; and (iii) the qualified custodians are sending quarterly account statements to clients and investors. Ideally, the CCO will have ensured the private fund manager receives and preserves duplicates of all statements sent by the qualified custodians.

Performing, Documenting the Review

Each CCO will need to adapt the custody rule review to the individual adviser's annual compliance review and may want to consult with outside counsel at various points in the process. The format of the final deliverable will also vary from adviser to adviser, but CCOs are well advised to retain some kind of evidence that the review addressed the most commonly noted deficiencies.

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