

ALERTS

SEC Custody Rule Update: Takeaways from Recent Enforcement

September 19, 2022

On Sept. 9, 2022, the U.S. Securities and Exchange Commission (“SEC”) settled enforcement actions against nine private fund advisers for their failure to: (1) timely disseminate audited financial statements to private fund investors in violation of SEC Rule 206(4)-2 (the “Custody Rule”)[1], and/or (2) timely update their Form ADV disclosures to reflect their receipt of audited financial statements for private funds they advise.[2] These actions follow a targeted sweep by the SEC’s Division of Examinations and Division of Enforcement.

These settlements, which included combined civil penalties of over \$1 million[3], serve as a strong reminder to private fund managers that the SEC does not view violations of the Custody Rule as mere technical deficiencies.

Key Takeaways

- *Aggressive Enforcement.* The SEC is aggressively enforcing custody rule violations even where there are no allegations of theft or loss of any client assets or any other potential wrongdoing by the adviser. This approach can be expected to continue, with the Director of the Division of Enforcement describing the resolution of these cases arising out of the SEC sweep as a “unique circumstance” and indicating that “counsel should not assume the Division will recommend similar resolutions going forward.”[4]

- *Focus on Late Audits.* The SEC cited late delivery of audited financial statements to investors in eight of the nine settlement orders. Existing Staff guidance provides some comfort where an adviser reasonably believed the audited financial statements would be delivered timely, but they were not due to unforeseeable circumstances.[5] The settlement orders do not indicate specific facts and circumstances with respect to late delivery in these cases. Advisers faced with potential delays in delivering the audited financial statements should promptly assess the specific facts and circumstances and take appropriate action.
- *Strict Timing of ADV Updates.* The SEC faulted six of the advisers for failing to timely update their Form ADVs to reflect the receipt of the audited financial statements.[6] When an adviser checks “Report Not Yet Received” in response to Form ADV, Part 1A, Schedule D, Section 7.B.23.(h), the instructions for that item require the adviser to promptly file an amendment to Form ADV when the audit is received. The advisers in these settlements did not update their Form ADVs for several months or until they filed their next annual amendments.

Custody Rule Violations

Six of the firms charged by the SEC failed to timely deliver annual audited financial statements to the investors in their private fund clients in accordance with the Audit Exception. As a reminder, the Custody Rule requires all advisers with custody of client assets to, among other things: (1) ensure that a qualified custodian maintains the client’s assets; (2) notify the client in writing of accounts opened by the adviser at a qualified custodian on the client’s behalf; (3) have a reasonable basis for believing that the qualified custodian sends account statements at least quarterly to clients (or in the case of private funds, a fund’s limited partners); and (4) ensure that client funds and securities are verified by a surprise examination conducted by an independent public accountant at least once every calendar year.[7]

The Custody Rule provides private fund advisers with an exception from complying with the Rule’s notification, account statements delivery and surprise examination requirements so long as the private fund advisers: (1) ensure annual audited financial statements for any private fund client are prepared in accordance with U.S. GAAP by an independent public accountant that is registered with, and subject to inspection by, the PCAOB; and (2) distribute the audited financial statements to each fund’s

investors within 120 days of the fund's fiscal year end (180 days for funds of funds) (the "Audit Exception").[8]

Because the advisers failed to timely deliver audited financial statements to the fund investors, they could not rely on the Audit Exception. Those firms therefore were obligated to comply with the Custody Rule's notification, delivery and surprise examination requirements, which they failed to do.

Form ADV Violations

Six of the firms had checked "Report Not Yet Received" on their annual Form ADV amendments and subsequently received audit opinions for their private fund clients, but failed to file amended Form ADVs for several months or in certain instances until they filed their next annual updating amendments in violation of Section 204(a) and Rule 204-1(a).

As a reminder, Advisers Act Section 204(a)[9] and Rule 204-1(a)[10] thereunder require an adviser to amend its Form ADV at least annually, and more frequently as required by the Form ADV instructions. Form ADV, Part 1A, Schedule D, Section 7.B.23.(h) requires an adviser to report whether all of the audit reports prepared by the auditing firm for the relevant private fund since the adviser's last annual amendment, contain unqualified opinions, with the option to check "Yes," "No," or "Report Not Yet Received." When an adviser files its annual Form ADV amendment and has checked "Report Not Yet Received," the instructions for that item state that the adviser must promptly file an amendment to Form ADV to update this response once the auditor's report is available.

Next Steps

Private fund managers relying on the Audit Exception should consider confirming that their policies and procedures:

- Are reasonably designed to ensure that audited financial statements are prepared and delivered in a timely manner and otherwise consistent with the Custody Rule's requirements; and
- Effectively address the requirement to promptly and accurately amend Form ADV filings when required, including with respect to Form ADV, Part 1A, Schedule D, Section 7.B.23.(h).

Authored by Allison Scher Bernbach, Marc E. Elovitz, Kelly Koscuizska, Tinika M. Brown, Meghan J. Carey, Christopher S. Avellaneda and Tarik M. Shah.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

[1] 17 C.F.R. § 275.206(4)-2.

[2] Specifically, the SEC settled enforcement actions with two firms for alleged Custody Rule violations, one firm for its alleged failure to timely amend its Form ADV disclosures, and six firms for alleged violations of both the Custody Rule and alleged failure to timely update their Form ADV disclosures. *See SEC Charges Two Advisory Firms for Custody Rule Violations, One Firm for Form ADV violations, and Six Firms for Both*, <https://www.sec.gov/news/press-release/2022-156> (Sept. 9, 2022) (“SEC Press Release”).

[3] Penalties ranged from \$50,000 for failure to timely deliver audited financial statements to certain fund investors or failure to timely amend Form ADV to \$330,000 for failure to have independent audits performed, failure to timely deliver audited financial statements and failure on several occasions to timely amend Form ADV to reflect an adviser’s receipt of audited financial statements.

[4] SEC Press Release, *supra* n. 2.

[5] *See* SEC Staff Custody Rule FAQ VI.9 (modified Apr. 27, 2020), https://www.sec.gov/divisions/investment/custody_faq_030510 (stating that the staff would not recommend enforcement action for a violation of the Custody Rule against an adviser relying on the Audit Exception where the adviser reasonably believed that a private fund’s audited financial statements would be distributed within the 120 or 180 day time periods but failed to have them distributed due to unforeseeable circumstances).

[6] A seventh firm failed to amend its Form ADV to reflect its that its private funds were no longer subject to annual audit.

[7] 17 C.F.R. § 275.206(4)-2(a)(1)-(5).

[8] *Id.*, at § 275.206(4)-2(b)(4).

[9] 15 U.S.C. § 80b-4(a).

This communication is issued by Schulte Roth & Zabel LLP for informational purposes only and does not constitute legal advice or establish an attorney-client relationship. In some jurisdictions, this publication may be considered attorney advertising. ©2022 Schulte Roth & Zabel LLP.

All rights reserved. SCHULTE ROTH & ZABEL is the registered trademark of Schulte Roth & Zabel LLP.

Related People



**Allison
Scher Bernbach**

Partner
New York



**Marc
Elovitz**

Partner
New York



**Kelly
Koscuiskza**

Partner
New York



**Tinika
Brown**

Special Counsel
New York



**Christopher
Avellaneda**

Partner
New York



**Tarik
Shah**

Special Counsel
New York

Practices

INVESTMENT MANAGEMENT

REGULATORY AND COMPLIANCE

Attachments

[!\[\]\(d0262bbe9d2356661a2e89321dfcc781_img.jpg\) Download Alert](#)