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# Regulation of Custodial Practices Under the Investment Advisers Act of 1940

## Rule 206(4)-2

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Regulation of Custodial Practices  
Under the Investment Advisers Act of 1940\*

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\* This outline provides general information on the subject matter discussed, does not necessarily reflect the views of Proskauer Rose LLP or any of its clients, and should not be relied upon for legal advice on any matter. Mr. Plaze was formerly Deputy Director of the Division of Investment Management, U.S. Securities and Exchange Commission. Mr. Plaze would like to thank Laura Grossman, Associate General Counsel of the Investment Adviser Association, for her comments on an earlier draft of this outline, and Mark Audet, an associate at Proskauer, for his assistance.

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## I. Background

### A. Adoption in 1962

The SEC has regulated custodial practices of investment advisers since 1962, when it first adopted rule 206(4)-2 (the “Custody Rule”) under the Investment Advisers Act of 1940 (“Advisers Act”) under newly-acquired authority to adopt rules to prevent fraud by investment advisers. The purpose of the rule was to require advisers that have custody of client funds or securities to implement a set of controls to insulate them from “any unlawful activities or financial reverses, including insolvency, of the adviser.”<sup>1</sup>

The 1962 rule required advisers to adopt the best practices of the day, which included segregating client securities from those of the adviser, “marking” them to indicate the name of the client, and holding them in “some place reasonably free from risk of destruction or other loss.”<sup>2</sup> All cash had to be kept in a bank account. Monthly client statements were required, identifying the “location” and “manner” in which the securities were held. At least once each year, the securities were required to be subject to a surprise “physical examination” by an independent public accountant hired by the adviser for that purpose. The rule reflected the paper-based system of owning and holding securities then in place. The SEC felt no need to define the term custody used in the rule—in 1962 it could mean but one thing.<sup>3</sup>

Between 1962 and 2003, the SEC dealt with the limitations of the Custody Rule in a rapidly evolving securities market in which securities were increasingly held in book-entry form on account at regulated financial intermediaries rather than in locked file cabinets.<sup>4</sup> The SEC staff issued a series of no-action letters that accommodated new ways of holding securities. But these letters themselves begat interpretive issues, leading to more no-action letters—almost 90 of them. They sometimes addressed the question of whether the adviser had custody and other times whether a surprise examination could be avoided. Collectively, the letters and the conditions they imposed created a separate regulatory regime that challenged even the most knowledgeable adviser wishing to comply with the rules.

These staff letters and related interpretations during this period provided in many respects the foundation for today’s rule, establishing, for example, that an adviser could have custody even if it did not have physical possession of securities or funds, that an adviser

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<sup>1</sup> Advisers Act Rel. No. 123 (Feb. 27, 1962). The adopting release was three pages long.

<sup>2</sup> *Id.* The SEC amended the Custody Rule, along with the other anti-fraud rules under the Advisers Act, in 1997 to make them inapplicable to unregistered investment advisers, including advisers registered solely with state securities authorities. *Rules Implementing Amendments to the Investment Advisers Act of 1940*, Advisers Act Rel. No. 1633 (May 15, 1997).

<sup>3</sup> In 1985, the SEC developed a definition of custody and added it to Form ADV. Under that definition, which has been incorporated into rule 206(4)-2, an adviser has custody if it directly or indirectly holds client funds or securities, has any authority to obtain possession of them, or has the ability to appropriate them. See Glossary of Terms, *Form ADV; Uniform Investment Adviser Registration Application Form*, Advisers Act Rel. No. 991 (Oct. 15, 1985).

<sup>4</sup> During this period the SEC also updated custody rules under the Investment Company Act of 1940 (“Investment Company Act”). See *Custody of Investment Company Assets with a Securities Depository*, Investment Company Act Rel. No. 25934 (Feb. 13, 2003).

could have custody indirectly through a related person,<sup>5</sup> that authority to deduct fees from client assets implicates the Custody Rule,<sup>6</sup> and providing an allowance for inadvertent custody.<sup>7</sup>

## B. 2003 Amendments

In 2003, the SEC adopted revisions to rule 206(4)-2 designed to clarify advisers' obligations under the rule and to reflect modern custodial practices ("2003 Amendments").<sup>8</sup> The 2003 Amendments incorporated into the rule a definition of "custody," and swept away all traces of the vintage paper-based assumptions of the 1962 version of the rule. Advisers could avoid the cost of annual surprise examination if they maintained client assets with one or more "qualified custodians," such as a broker-dealer, a bank or a futures commission merchant, and the custodian provided quarterly custodial statements directly to clients. These custodians were themselves regulated under different regulatory regimes, and, as the SEC pointed out, an independent verification of assets accomplished little if the assets were already missing when the accountant later arrived for the annual verification.<sup>9</sup> Direct reporting by custodians would provide clients the ability to identify discrepancies, and the knowledge that custodial statements would be provided directly to clients would deter advisers from misusing client assets.<sup>10</sup>

The 2003 Amendments also for the first time directly addressed the obligations of advisers to pooled investment vehicles under the rule, codifying the long-standing staff position that advisers also serving as general partners to a fund have custody of fund assets, while acknowledging that the audited financial statements typically required by investors provided their own form of protections against misuse of client assets. The 2003 Amendments therefore excused advisers to audited pooled investment vehicles from the rule's surprise examination and account statement delivery requirements.

One of the most significant advances of the 2003 Amendments was the elimination of the need for advisers and their counsel to rely on the large body of SEC staff no-action letters to discern whether the adviser had "custody" of client assets. The complexity of the question arose in most cases as a result of the development of a book-entry system of ownership of securities, so that an adviser could have access and control over a client's assets without having physical custody of paper certificates. Constructive custody, in which the adviser has access to or legal title to client securities, presents many of the same custodial risks but without the regulatory certainty that paper certificates provided.

The 2003 Amendments did not provide regulatory certainty as to whether an adviser had custody (and thus was subject to the Custody Rule) so much as they provided a significant

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<sup>5</sup> *Crocker Investment Mgmt. Corp.*, SEC Staff No-Action Letter (Mar. 15, 1978).

<sup>6</sup> *Bennett Mgmt. Co.*, SEC Staff No-Action Letter (Feb. 26, 1990); *Investment Counsel Association of America, Inc.*, SEC Staff No-Action Letter (July 9, 1982).

<sup>7</sup> *Hayes Financial Services, Inc.*, SEC Staff No-Action Letter (Apr. 2, 1991).

<sup>8</sup> *Custody of Funds or Securities of Clients by Investment Advisers*, Advisers Act Rel. No. 2176 (Sep. 25, 2003) (adopting amendments to rule 206(4)-2) ("2003 Adopting Release").

<sup>9</sup> *Custody of Funds or Securities of Clients by Investment Advisers*, Advisers Act Rel. No. 2044 (July 18, 2002) (proposing amendments to rule 206(4)-2) at Section II.C.

<sup>10</sup> See *John B. Kennedy*, SEC Staff No-Action Letter (June 15, 1996) ("We agree . . . that the client rather than the custodian is in the best position to ascertain whether an advisory fee has been properly calculated.")

degree of certainty as to whether an adviser was in compliance with the Custody Rule. As long as client assets were held with a qualified custodian (as they customarily are) that delivers custodial statements directly to clients (which became the norm) there was little practical need to worry about whether the adviser had custody of the assets or, indeed, whether the assets were “securities” or “funds.”<sup>11</sup> Compliance with the rule was met by an adviser operating within standard industry best practice in which the custodial statement provided a check on misuse of client assets by the adviser. The prospect of just one client (or custodian) reviewing the statement and recognizing an inconsistency provided a significant deterrence to advisers and their personnel.

### C. 2009 Amendments

The 2009 Amendments to rule 206(4)-2 represented the SEC’s initial regulatory response to Bernie Madoff’s Ponzi scheme, which went undetected for more than 25 years (“2009 Amendments”).<sup>12</sup> The Madoff scandal involved “equity funded brokerage accounts,” and his firm had only been registered as an adviser for two years as a result of a new interpretation of the Advisers Act that required brokers to treat discretionary brokerage accounts as advisory accounts.<sup>13</sup> Nonetheless, the SEC blamed the Madoff fraud, at least in part, on weaknesses in the regime governing the custodial practices of investment advisers and, in particular, the practice of maintaining client assets with an affiliate (as Madoff purported to do).

The 2009 Amendments were designed to strengthen the controls and safeguards of the rule, but also added a good deal of complexity to the rule that the 2003 rulemaking had jettisoned. These amendments, with some exceptions discussed below, brought back the annual surprise verification requirement (as another “set of eyes” on client assets), expanded the circumstances under which an adviser is deemed to have custody through an affiliate, and required an adviser to obtain an internal control report if the adviser or a related person acts as a qualified custodian for client assets. In addition, the SEC expanded Form ADV disclosure of custodial practices and modernized the rules under which accountants perform the surprise verification.

### D. Current Developments

*Examinations.* Since the Madoff scandal, the SEC’s examination program has made verifying client assets and identifying lapses in custodial practices a priority. During an examination of an adviser that has custody of client assets, the SEC staff will sometimes seek to contact custodians and, in some cases, advisory clients to confirm client

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<sup>11</sup> There has, however, always been the need for an adviser to ascertain whether it has custody of client securities or funds for purposes of responding to an item in Form ADV that requested such information.

<sup>12</sup> *Custody of Funds or Securities of Clients by Investment Advisers*, Advisers Act Rel. No. 2968 (Dec. 30, 2009) (“2009 Adopting Release”).

<sup>13</sup> In *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Advisers Act Rel. No. 2376 (Apr. 12, 2005) the SEC took the position that a discretionary brokerage account was an advisory account subject to the Advisers Act. The entire rulemaking, including this interpretation, was vacated by a federal court in *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007). The SEC formally adopted the interpretation in 2019. *Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser*, Advisers Act Rel. No. 5249 (June 5, 2019).

positions.<sup>14</sup> The SEC’s Office of Compliance Inspections and Examinations (OCIE) issued a “Risk Alert” identifying “significant” deficiencies it had found in a group of 2013 examinations.<sup>15</sup> These examinations have led to numerous settled enforcement actions in which the SEC alleged violations of the Custody Rule.

*Interpretive Issues.* The re-introduction of the surprise examination requirement has complicated the rule significantly. Under the version of the rule in effect between 2003 and 2010, failure of an adviser to recognize whether it had “custody” of client securities and funds was of less consequence given that all client assets were typically maintained with a financial institution under terms that met the requirements of the rule. Not so after the 2009 Amendments. New issues have also arisen as a result of clients investing in non-traditional asset classes, some of which raise difficult issues under the rule. Consider, for instance, the application of the Custody Rule to cryptocurrencies or tokens issued in coin offerings.<sup>16</sup>

*Rulemaking.* In February 2022 the SEC proposed a new rule that would require registered advisers to all private funds to obtain an annual audit of their financial statements from an independent public accountant.<sup>17</sup> If adopted as proposed, the rule would eliminate the “surprise verification” approach to compliance with the Custody Rule with respect to clients that are private funds.<sup>18</sup> Curiously, the SEC did not propose amendments to the Custody Rule to reflect the proposed rule nor to address the many interpretive issues that have arisen over the years, although such amendments have been on the SEC’s Regulatory Flexibility Act Agenda for some time.

This outline summarizes the Custody Rule and the growing body of interpretations.

## II. Summary

Rule 206(4)-2 requires registered investment advisers having custody of client funds or securities to adopt four primary safeguards:

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<sup>14</sup> The SEC staff has developed a standard form which it will provide to such persons. See [http://www.sec.gov/about/offices/ocie/routine\\_account\\_information\\_confirmation.pdf](http://www.sec.gov/about/offices/ocie/routine_account_information_confirmation.pdf).

<sup>15</sup> *Significant Deficiencies Involving Adviser Custody and Safety of Client Assets, National Exam Program Risk Alert*, Volume III, Issue 1 (Mar. 4, 2013).

<sup>16</sup> Failure of an adviser to familiarize itself with the Custody Rule and its application is viewed as an aggravating factor in an enforcement action rather than a defense. See *Ascension Asset Mgmt., LLC*, Initial Decision Rel. No. 1400 (Apr. 3, 2020) (ALJ Decision) (failure to be informed about compliance matters regarding the custody rule, among other things, showed adviser’s conduct was at least reckless).

<sup>17</sup> Under the proposal, the independent public accountant must be registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (“PCAOB”). *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, Advisers Act Rel. No. 5955 (Feb. 9, 2022) (proposing, among other rules, new rule 206(4)-10). Because most large private funds already provide investors with audited financial statements, the primary effect of the new rule would be on smaller private funds and the cost of issuing audited financial statements may be prohibitive. The new rule would also shift the cost of compliance with the custody rule away from the adviser (which usually pays for a surprise verification) the client private fund (which usually bears the cause of the audit of its financial statements).

<sup>18</sup> See VI.A.1 of this outline.

- A. *Maintenance with a Qualified Custodian.* All advisers that have custody of client funds or securities must maintain their assets with a “qualified custodian” in a separate account in the client’s name, or in accounts that contain only the client’s funds and securities under the name of the adviser as agent or trustee. Qualified custodians include broker-dealers, banks, futures commission merchants, and certain foreign custodians.
- B. *Client Notification of Custodian.* Clients must be notified promptly in writing of the identity of the qualified custodian that is holding the client’s assets, but only when the account is opened by the adviser on a client’s behalf and when changes are made to the custodial arrangements.
- C. *Quarterly Account Statements.* The adviser must have a reasonable belief that each qualified custodian sends an account statement at least quarterly to each client for whom it holds funds or securities. These account statements must come directly from the qualified custodian.
- D. *Surprise Annual Verification.* Each adviser with custody, except those having custody solely because they have authority to deduct advisory fees, must undergo an annual surprise verification by an independent public accountant. An adviser to a private fund may satisfy this requirement (with respect to private fund clients) by the delivery of audited financial statements to fund investors.<sup>19</sup>

If the assets are maintained by a qualified custodian that is a “related person,” the adviser must also obtain from the custodian a report of the internal controls relating to custody of client assets prepared by an accountant that is registered with and inspected by the PCAOB.<sup>20</sup> The rule provides special treatment for advisers to pooled investment vehicles (including private funds) that are subject to annual audits.

Rule 206(4)-2 thus requires an adviser to adopt and adhere to a set of controls to protect client assets, but does not itself impose any obligation on an adviser to protect client assets. Such an obligation arises from an adviser’s fiduciary obligations to its clients and, in particular, the duty of care.

### III. Critical Definitions

Rule 206(4)-2 includes two critical definitions: “Custody” and “Qualified Custodian.”

#### A. “Custody”

An adviser is only subject to the rule if it has “custody” of client assets, and it is only subject to the rule with respect to those assets over which it has “custody.” As a consequence, an adviser may be subject to the rule with respect to some clients and not others, and be subject to the rule with respect to some of a single client’s assets it manages and not others.

Identifying whether an adviser has custody of client funds or securities is critical for determining the applicability of the rule. Many of the compliance lapses that have been

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<sup>19</sup> Section VI.A of this outline discusses provisions of the rule that apply with respect to assets of a pooled investment vehicle.

<sup>20</sup> Section VI.B of this outline discusses provisions of the Custody Rule that apply when an adviser itself (which must be a qualified custodian) maintains client assets or maintains client assets with a related person that is a qualified custodian.



identified by the SEC's examination staff<sup>21</sup> and some of the enforcement cases brought by its Enforcement Division<sup>22</sup> have involved advisers that seemingly did not recognize that they had custody of client assets.<sup>23</sup> Moreover, failure to recognize that a firm has custody of client assets may also cause the adviser to fail to report it has custody on Form ADV and to clients in violation of other provisions of the Advisers Act.<sup>24</sup> As discussed below, simply using a third-party custodian to hold client assets does not mean an adviser does not have custody of those assets.

Under paragraph (d)(2) of the rule, an adviser has custody if it holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them. This definition is fleshed out in examples contained in the rule itself, SEC releases, and staff interpretations.<sup>25</sup>

### 1. *Possession of Client Funds or Securities*

An adviser has custody when it (or its related person) has possession of client funds or securities.<sup>26</sup> Thus, an adviser has custody if it physically holds client stock certificates, bonds or cash, even if it only holds them temporarily.<sup>27</sup>

- a. *Inadvertent Receipt.* An adviser that inadvertently receives client funds or securities but returns them to the sender within three business days of receiving them does not have custody.<sup>28</sup> This provision of the rule prevents the staff of an adviser opening the daily mail from discovering that it has custody and is in violation of the rule simply because a client or other person has sent some stock certificates to the adviser.

*Forwarding Funds or Securities.* The inadvertent receipt exception does not permit an adviser to forward client funds or securities to a custodian within the three day

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<sup>21</sup> See *supra* note 15.

<sup>22</sup> See, e.g., *Further Lane Asset Mgmt. et al.*, Advisers Act Rel. No. 3707 (Oct. 28, 2013).

<sup>23</sup> In some cases it may be difficult to identify what are "client funds or securities" that are subject to the rule. An advisory relationship with the client is required, and the assets must be those of the client. An adviser would not have custody of collateral backing a bond a client owned unless the adviser was also engaged to manage the collateral. As discussed below, the collateral is presumably not a client asset unless and until the issuer of the bond defaults. For similar reasons, an adviser whose client owns a limited partnership interest in a pooled investment vehicle may have custody over the limited partnership interests, but not the assets of the fund itself unless it also advises the fund. For an example of complexities that can arise when considering such issues, see *Eden Arc Capital Mgmt., LLC*, Initial Dec. Rel. No. 1161 (Aug. 16, 2017) (ALJ opinion). Whether a particular asset is a security (such that it must be maintained with a qualified custodian) and whether an advisory relationship exists (such that the Custody Rule applies) is beyond the scope of this outline.

<sup>24</sup> *Bob Brakeman Enterprises, LLC*, Advisers Act Rel. No. 4620 (Jan. 19, 2017) (adviser and principal misrepresented material facts about its custody of client assets in its Form ADV).

<sup>25</sup> The definition of "custody" in rule 206(4)-2 has not changed since the 2003 Amendments, although many issues emerged after the 2009 Amendments.

<sup>26</sup> Rule 206(4)-2(d)(2)(i).

<sup>27</sup> *SEC v. Sentinel Mgmt. Group, Inc.*, 2012 WL 1079961 (N.D. Ill.) (Aug. 20, 2007). See also *Comprehensive Capital Mgmt.*, Advisers Act Rel. No. 3636 (July 29, 2013) (cash disbursement account permitted supervised person to steal client funds as they passed through the account).

<sup>28</sup> Rule 206(4)-2(d)(2)(i); Question II.1 of *Staff Responses to Questions About the Custody Rule* ("SEC Staff FAQs").

period; it must return them to whoever sent them to the adviser. This provision is designed to discourage advisers (and their employees) from offering to help a client arrange for custody of their assets, providing an opportunity to misappropriate them.<sup>29</sup>

*Emergency COVID-19 Relief.* During the national emergency caused by the COVID-19 pandemic, and while staff of advisers are working remotely in accordance with their business continuity plans, the SEC staff has stated that it will not consider an adviser to have custody of client assets inadvertently received by an adviser in its office until firm personnel are able to access the mail or deliveries at the office.<sup>30</sup>

*Exceptions for Tax Refunds, etc.* In 2007, the SEC staff issued a no-action letter to the Investment Adviser Association (“IAA”) stating that it would not recommend enforcement action under rule 206(4)-2 if an adviser forwards client assets inadvertently received from third parties to its client or a qualified custodian within five business days of its receipt of such assets, and maintains appropriate records.<sup>31</sup> The letter is limited to inadvertent receipt by an adviser of (i) client tax refunds from tax authorities, (ii) client settlement proceeds from administrators in connection with class action lawsuits, and (iii) stock certificates or dividend checks in the name of their clients or evidence of new debt from issuers in connection with class action lawsuits involving bankruptcy or a business reorganization. In these circumstances, the failure of an adviser to forward funds or securities could result in a loss to clients, which the Custody Rule was designed to prevent.

*Note the difference between the three business days an adviser has to return misdelivered client securities and funds as set forth in the rule, and the five business days that the IAA letter permits an adviser to forward funds or securities to the custodian in the limited circumstances set forth in the letter.*

- b. *Checks.* As discussed above, the adviser’s physical possession of a “third-party” check made payable to the client would generally give it custody of the client funds. However, an adviser’s possession of a check drawn by the client and made payable to a third party would not mean the adviser has custody of client assets.<sup>32</sup> Thus, for example, an adviser may accept a check made payable to the client’s custodian and forward the check to the custodian without reporting to the SEC that it has custody of client assets or complying with the Custody Rule.<sup>33</sup> The SEC

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<sup>29</sup> An adviser that does not promptly return funds or securities would not only have custody, but would also violate the rule requirement that client assets be maintained with a qualified custodian, unless the adviser is itself a qualified custodian.

<sup>30</sup> Question II.1 of SEC Staff FAQs (paragraph 2).

<sup>31</sup> *Investment Adviser Association*, SEC Staff No-Action Letter (Sep. 20, 2007). The IAA letter stated that the staff expected an adviser that inadvertently received client assets from third parties in more than rare or isolated instances would adopt and implement policies and procedures reasonably designed to meet the terms of the letter.

<sup>32</sup> The treatment of checks drawn by clients payable to third parties is set forth in one of the examples in the rule. Rule 206(4)-2(d)(2)(i).

<sup>33</sup> An adviser that accepts a client’s check and forwards it to the custodian would not, solely as a result of forwarding the check, have custody over the client’s assets. Accordingly, an adviser that has custody of some

explained that the client’s relationship with its bank, which must provide periodic statements regarding the clearance of the check, provides similar protections to those of the Custody Rule.<sup>34</sup>

### Custody of Checks

Drawn on Client’s Account Payable to Third Party, <i>e.g.</i> , Custodian/Transfer Agent	No Custody	
Payable to Adviser for Purpose of Making Investment		Custody
“Third-Party” Checks Made Payable to Client		Custody (subject to exception for tax refunds and settlements)
Payable to Adviser for Fees	No Custody	

*Receipt of Fees.* An adviser’s receipt of a check in payment for its services would not constitute custody of client funds as a result of the adviser’s possession of the check because the funds would no longer be the client’s property.<sup>35</sup> In contrast, an adviser would have custody if it accepts payment of a check made payable to the adviser subject to instructions from the client to pass the funds on to the custodian or to pay a third party.<sup>36</sup>

## 2. Authority to Withdraw Funds or Securities from a Client’s Account

An adviser has custody if the adviser (or its personnel) is authorized to sign checks on a client’s behalf, to withdraw funds or securities from a client’s account, or to dispose of client funds or securities.<sup>37</sup> Even if this authority is never used, or is limited to directing assets to a third person, the adviser will be deemed to have custody.<sup>38</sup> That unused authority could be used at some time, and the third party could be a confederate of an employee of the adviser. Thus, an adviser having a broad power of

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clients’ assets and is therefore required to obtain a surprise verification of those assets from an independent public accountant would not need to include this client’s account as within the scope of the surprise verification.

<sup>34</sup> Advisers Act Rel. No. 2044, *supra* note 9.

<sup>35</sup> *Id.* at n.19.

<sup>36</sup> *Id.*

<sup>37</sup> Rule 206(4)-2(d)(2)(ii). See *VERO Capital Mgmt., LLC et al.*, Advisers Act Rel. No. 4138 (July 8, 2015) (adviser that had authority to withdraw funds from client funds’ custodial account had custody); *CMS Fund Advisers, Inc.*, Advisers Act Rel. No. 2430 (Sep. 15, 2005) (adviser had custody of client funds and securities because “the firm and its principals had unrestricted access to, and control of, clients’ assets for investing and payment of firm expenses”).

<sup>38</sup> Question II.6 of SEC Staff FAQs (adviser has custody if it has password access that provides it with the ability to withdraw client assets or transfer them to an account not in the client’s name).

attorney over client assets will likely have custody, as will an adviser providing bill-paying services.<sup>39</sup>

- a. *Trading Authority.* The authority of an adviser to trade client securities and, in connection therewith, instruct a client's custodian to transfer securities or cash out of an account does not result in the adviser having custody. This exception is not found in rule 206(4)-2, but in the text of the 2003 Adopting Release.<sup>40</sup>

*Delivery vs. Payment.* "Delivery versus payment" ("DVP") is a form of settling trades of securities in which the buyer's cash payment for securities must be made before or simultaneously with the delivery of the seller's securities. DVP settlement avoids the risk that delivery or payment will not be made in times of financial stress. A footnote to the 2003 Adopting Release describes the trading authority "generally" granted to advisers as authority "to transfer funds (or securities) out of a client's account only upon corresponding transfer of securities (or funds) into the account."<sup>41</sup> In 2017 guidance, the SEC staff suggested that an adviser's authority to trade assets may be limited to securities that settle DVP,<sup>42</sup> which would exclude derivatives, bank loans, some foreign securities, interests in private funds, digital assets, and other types of instruments.

The SEC staff issued a letter on March 12, 2019 that moved off the position that the trading authority exception was limited to securities traded DVP, but promised the matter would be reconsidered in connection with future rulemaking. It observed that trading other than DVP involves greater risk of misappropriation and that advisers with such authority should develop compliance policies and procedures to reduce such risks.<sup>43</sup>

*Derivatives.* An adviser's client portfolios may include futures contracts or other derivative instruments on which daily margin payments are made and received. These instruments themselves may not be "securities," but their terms typically require payment of margin payments to the counterparty (a transfer of client *funds* out of the custodial account), which does implicate the Custody Rule. If a client custodial agreement directs the custodian to make such payments, the adviser would not need or have authority to initiate such transfers and thus would not be

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<sup>39</sup> *GW & Wade, LLC*, Advisers Act Rel. No. 3706 (Oct. 28, 2013) (settled enforcement action involving an adviser that maintained blank pre-signed letters from clients authorizing transfers of assets); *CMS Fund Advisers, Inc.*, *supra* note 37.

<sup>40</sup> 2003 Adopting Release, *supra* note 8 at n. 10 and accompanying text.

<sup>41</sup> The footnote further observes that "This 'delivery versus payment' arrangement minimizes the risk that an adviser could withdraw or misappropriate the funds or securities in its client's custodial account."

<sup>42</sup> *Inadvertent Custody; Advisory Contract Versus Custodial Contract Authority*, IM Guidance Update 2017-01 (Feb. 2017) ("One way for an adviser to avoid . . . custody would be to . . . limit [ ] the adviser's authority to 'delivery versus payment'") ("Inadvertent Custody Guidance").

<sup>43</sup> *Engaging in Non-DVP Custodial Practices and Digital Assets*, *Investment Adviser Association*, SEC Staff Letter (Mar. 12, 2019). One could view the trading authority question as involving settlement risk rather than custody risk and thus not addressed by rule 206(4)-2. Custodial agreements involving non-traditional securities sometimes include provisions pursuant to which the custodian will require its customer to acknowledge that industry practice is to deliver physical securities against later payment, agreeing to use best efforts to effect same-day settlement, but disclaiming settlement risk. Acceptance by a custodian of an uncertified check involves the same risk.

considered to have custody of client funds. But what if the custody agreement is silent? Although neither the SEC nor its staff has provided guidance on this question, the better interpretation of the rule is that attendant to the purchase of such investments is an implicit instruction to the adviser's custodian to make margin payments in accordance with its terms.

- b. *Client Remittals.* An adviser's authority to instruct the qualified custodian to remit funds or securities from an account owned by the same client (or clients) at his or her address of record does not constitute custody if (i) the client has granted such authority in writing and provided a copy to the qualified custodian, and (ii) the adviser has neither the authority to open an account on behalf of the client nor the authority to designate or change the client's address of record.<sup>44</sup>

*Changed Address.* An adviser may change a client's address of record with the qualified custodian and still be able to direct the custodian to remit client assets to the client if the adviser has a reasonable belief that the qualified custodian will, upon receiving the adviser's instruction, send a notice of such change to the client's old address.<sup>45</sup> An adviser that cannot meet the requirements of these FAQs should instruct its client to contact the custodian to request that funds or securities be remitted to it.

- c. *First-Party Transfers.* An adviser's limited authority to transfer securities or cash between accounts owned by the same client or clients (maintained at either the same or different qualified custodians) does not constitute custody, if (i) the client has authorized the adviser in writing to make such transfers to a specified account and (ii) a copy of such authorization is provided to the qualified custodians.<sup>46</sup> A new signed authorization is required for each additional destination account, but not for subsequent transfers to the same account.

*Owned by the Same Client.* Although there is no guidance on the question, advisers (and custodians) commonly consider a first-party transfer to occur when both accounts have the same social security or taxpayer identification number. A transfer between two accounts that are both jointly owned by the same owners should be considered a first-party transfer, but perhaps not a transfer from a jointly owned account to a personal account of one of the owners.

Examples of first-party transfers should include (i) a transfer of client assets from a client's personal account to his or her IRA account, (ii) a transfer between a client's personal account and his or her revocable living trust, and (iii) a transfer between a husband/wife's joint account and the same husband/wife's community property account.

*Specified Account.* If the client assets are being transferred from one qualified custodian to another, the staff has stated that the client must have provided

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<sup>44</sup> Question II.5.A of SEC Staff FAQs.

<sup>45</sup> Question II.5.B of SEC Staff FAQs.

<sup>46</sup> Question II.4 of SEC Staff FAQs. Despite the use of the plural "custodians," it is understood that the authorization only has to be provided to the sending custodian (which may be transmitted through the adviser); not to the receiving custodian. Accordingly, authority to rebalance assets among multiple accounts of the same client would not give the adviser custody. See Question II.6 of SEC Staff FAQs.

authorization signed by the client to the sending custodian that identifies the name *and* account numbers of the destination account.<sup>47</sup> Authorizations to transfer assets between accounts at the same custodian (to make so-called “first-party journal entries”) would not require such specificity.

d. *Third-Party Transfers*

*Single Transfers.* An adviser that has authority to transfer client assets from a client account with a qualified custodian to a third person has custody of the client assets held in that account – even if the requested transfer is made at the behest of the adviser’s client. Advisers avoid this result by directing clients to make requests to transfer assets to their custodians. Nothing in the rule would, however, prevent an adviser from passing on a transfer request received from a client to the client’s custodian. Such a referral would not itself give the adviser custody of its client’s assets (even if that referral had been transmitted to the custodian electronically) unless the adviser had authority to effect the transfer, *i.e.*, without the involvement and approval of the custodian.

*Standing Letters of Authorization (“SLOAs”).* SLOAs are customary arrangements under which a client grants an adviser authority to direct the client’s custodian to periodically disburse client funds to third parties designated by the client. The SEC staff views an SLOA as providing the adviser authority to withdraw client funds maintained with a qualified custodian (and thus custody) if the adviser has discretion in determining the amount, payee, or timing of transfers.<sup>48</sup> In a 2017 SEC staff no-action letter, the staff stated that it will not recommend enforcement action for violating the Custody Rule if an adviser with an SLOA from a client does not obtain a surprise examination with respect to client accounts subject to an SLOA under the following conditions:

- The client provides a signed written instruction to the custodian identifying the “third-party” and specific account to which the transfers will be made;
- The client provides a written SLOA to the adviser, which authorizes “third party” transfers either on a specified schedule or from time to time;
- The custodian verifies the SLOA, and provides a transfer of funds notice to the client promptly after each transfer;
- The client has the ability to terminate or change the instruction to the custodian;
- The adviser does not have the ability to change the client’s instructions;
- The adviser maintains records showing that the third party is not a related party of the investment adviser or is located at the same address as the adviser;<sup>49</sup> and

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<sup>47</sup> Question II.4 of SEC Staff FAQs. The FAQ was modified in this respect on February 21, 2017.

<sup>48</sup> *Investment Adviser Association*, SEC Staff No-Action Letter (Feb. 21, 2017). Under the no-action letter, the adviser may have discretion as to the amount or timing of transfers, but the client must designate the payee.

<sup>49</sup> The letter is unclear regarding what records are required to be maintained. The SEC staff has informally stated that an adviser may rely on its practices to identify affiliates necessary to respond to Item 7 of Form ADV.

- The custodian sends the client a written initial notice confirming the instruction and an annual notice reconfirming the instruction.<sup>50</sup>

Note that an adviser relying on the no-action letter for relief from surprise examinations nevertheless has custody of client accounts subject to an SLOA, must comply with other requirements of the Custody Rule with respect to those accounts, and otherwise must report custody of the funds and securities held in the accounts on Form ADV.

- e. *Inadvertent Custody.* An adviser may have custody if it has authority to withdraw securities or funds from a client account without knowing it or accepting it. This consequence results from the passive construction of the rule text, which defines custody to include “[a]ny arrangement (including a general power of attorney) under which [the adviser is] authorized or permitted to withdraw client funds or securities maintained with a custodian upon [the adviser’s] instruction to the custodian.” Inadvertent custody has arisen in the following circumstances addressed by the SEC staff:

*Terms of Custodial Agreement.* In 2017, the SEC staff issued guidance that explained that terms of a custodial agreement between a client and custodian may grant the adviser custody and that authority cannot effectively be proscribed by the advisory agreement.<sup>51</sup> As a result, statements in the advisory contract denying the adviser authority to take custody of client assets are ineffective if the adviser holds client assets or if the custodial agreement gives the adviser access to client assets by authorizing the custodian to take directions from the adviser.<sup>52</sup> It is the unwillingness of the custodian to transfer assets out of the account except pursuant to *bona fide* trading authority that provides an element of the protection afforded by the Custody Rule.<sup>53</sup>

The SEC staff subsequently stated, in a 2018 revision to its FAQs, that it would not recommend enforcement action against an adviser that obtained inadvertent custody as a result of provisions in a custodial agreement if the adviser (i) does not have a copy of the custody agreement; (ii) does not know, or have reason to know whether the custody agreement gave it custody; (iii) did not recommend, request or require use of the custodian; and (iv) the provisions of the custody agreement were the only basis for the adviser having custody of the client funds or securities.<sup>54</sup>

- f. *Password Access.* An adviser that has (or whose employee has) password access to a client’s account will have custody if that access gives the adviser (or the employee) the ability to withdraw or transfer assets to an account that is not in the client’s name with a qualified custodian, even if the adviser has not been granted

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<sup>50</sup> *Investment Adviser Association, supra* note 48.

<sup>51</sup> *Inadvertent Custody Guidance, supra* note 42.

<sup>52</sup> *Id.* It remains a best practice for those advisers that do intend to have custody of client assets to include provisions in their advisory contracts and/or power of attorney.

<sup>53</sup> What constitutes “*bona fide* trading authority” is itself an issue, discussed above at Section III.A.2.a.

<sup>54</sup> Question II.11 of SEC Staff FAQs (posted June 5, 2018). Question II.12 extends the position taken in Question II.11 to circumstances where another basis for the adviser having custody is authority to deduct fees.

custodial authority by its client.<sup>55</sup> Accordingly, advisers should avoid obtaining client login credentials to access a website of a custodian without investigating whether those credentials would cause the adviser to have custody of client assets. To avoid obtaining custody of client assets, advisers need to be certain that the password access is appropriately limited.

- g. *Deduction of Fees.* An adviser authorized to deduct advisory fees or other expenses directly from a client's account has custody of the client funds and securities in that account.<sup>56</sup> An adviser with custody solely as a result of authority to deduct its advisory fees (but not other expenses) is not required to obtain a surprise examination of client assets unless those assets are maintained with a related person that is not "operationally independent" of the adviser.<sup>57</sup> Form ADV does not require an adviser to report that it has custody if the sole reason that it has custody under rule 206(4)-2 is that it has authority to deduct advisory fees directly from clients' accounts.<sup>58</sup>

As a result, in the case of a separately managed account in which the client has made his or her own custodial arrangements and the adviser has authority to deduct only advisory fees from client assets, the adviser's obligations under the Custody Rule are limited to (i) making sure that client assets are maintained with a qualified custodian, and (ii) forming a reasonable belief that the custodian is sending quarterly account statements to clients. The account statements must reflect deductions for payment of advisory fees, permitting clients to monitor fees.<sup>59</sup>

- h. *Incorrect Fee Deductions.* Failure to correctly calculate the fees may involve misappropriation of client assets and violations of the compliance rule and other provisions of the Advisers Act. The SEC has suggested a number of policies and procedures that an adviser with authority to deduct fees should have in place to address the risk that fees are deducted from client accounts to which the adviser is not entitled,<sup>60</sup> and has brought enforcement actions against advisers for deducting fees in excess of those authorized by the advisory contract.<sup>61</sup>

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<sup>55</sup> Question II.6 of SEC Staff FAQs. See *Bradway Financial, LLC*, Advisers Act Rel. No. 4733 (July 25, 2017) (adviser had password access to client account with cash transfer authority). In addition to exposure to an SEC enforcement action, the authority exposes clients and the adviser to the risk that an employee might discover the extent of the authority granted and misappropriate the client assets.

<sup>56</sup> However, if the adviser neither calculates the fee nor sends the fee bill and the qualified custodian makes all calculations for the fees to be deducted from the client's account based on the advisory contract, the adviser does not have custody. See Question III.1 of SEC Staff FAQs.

<sup>57</sup> Rule 206(4)-2(b)(3)(i). See Section VI.B of this outline (discussing related person custody).

<sup>58</sup> Instruction Item 9.A.(1) of Form ADV. See discussion *infra* at Section VII.A.6 of this outline.

<sup>59</sup> 2003 Adopting Release, *supra* note 8 at n.12 and accompanying text.

<sup>60</sup> 2009 Adopting Release, *supra* note 12 at Section II.G.

<sup>61</sup> See, e.g., *Equitas Capital Advisors, LLC*, Advisers Act Rel. No. 3704 (Oct. 23, 2013).



3. *Capacity that Gives the Adviser Legal Ownership of, or Access to, Client Funds or Securities*

An adviser will have custody if it serves in any capacity that gives it legal ownership of, or access to, client funds or securities.<sup>62</sup> Advisers commonly acquire legal ownership of client assets in one of two ways:

- a. *Acting as General Partner.* An adviser that acts as general partner to a limited partnership (or as manager of a limited liability company) generally has legal authority over and access to funds and securities in the limited partnership's (or limited liability company's) account, and thus has custody of the fund's (its client) assets. The adviser will have custody even though the fund's securities are held by a prime broker and all the funds are held in bank accounts.

Hedge funds and other private funds offered to taxable investors are typically organized as limited partnerships, while those offered to "tax-exempt" investors are more likely to be corporations, often organized in the Cayman Islands or some other non-U.S. jurisdiction for tax reasons. While advisers to the former will likely have custody as a result of the form of organization, funds organized as corporations may also result in the adviser having custody because a related person of the adviser controls the corporation or serves on its board of directors. Under Cayman Islands law, directors are given executive authority and thus access to fund assets. In contrast, a sub-adviser to a private fund (however organized) may be able to avoid having custody of fund assets if it (or a related person) does not serve as a general partner or is not otherwise granted authority to access fund assets.

- b. *Acting as Trustee or Executor.* If the adviser is the trustee of a client trust or an executor of an estate for which the adviser provides advisory services, the adviser will generally have custody of the trust's or estate's assets.<sup>63</sup> There are several exceptions:

*Employees.* If the adviser's supervised person is the trustee of a client trust, custody will be imputed to the adviser.<sup>64</sup> But if trusteeship results from a family or personal relationship rather than from employment with the adviser, the SEC will not impute custody to the adviser.<sup>65</sup> The Custody Rule thus permits an adviser that has a policy of not accepting custody of client assets to, nonetheless, manage the assets of a family trust or estate of an employee without complying with the

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<sup>62</sup> Rule 206(4)-2(d)(2)(iii).

<sup>63</sup> See *Fortius Financial Advisors, LLC*, Advisers Act Rel. No. 4483 (Aug. 15, 2016) ("As a named trustee and signatory with ability to effectuate transactions in all of the accounts. . . Fortius had custody over those accounts as defined by the Custody Rule.").

<sup>64</sup> Question II.2 of SEC Staff FAQs. See *Train, Babcock Advisors LLC*, Advisers Act Rel. No. 4835 (Dec. 22, 2017) ("Because certain [supervised persons] served as trustees and signatories with the ability to effectuate transactions in certain client accounts, [the adviser] had custody over those accounts as defined by the Custody Rule."); *Gofen and Glossberg*, Advisers Act Rel. No. 1400 (Jan. 11, 1994) (adviser deemed to have constructive or indirect custody of assets of trusts for which employees acted as trustee).

<sup>65</sup> 2009 Adopting Release, *supra* note 12 at n. 139. See also 2003 Adopting Release, *supra* note 8 at n. 15. The same treatment should be afforded executorships.

requirements of the rule or reporting on its Form ADV that the adviser has custody of client assets.

*Co-Trustees.* The SEC will not treat an adviser as having custody because it is a trustee if it cannot withdraw assets without the prior written consent of all of its co-trustees if the trust has a co-trustee that (i) is a bank or a trust company that itself is a qualified custodian; (ii) is not a related person of the adviser; and (iii) delivers account statements directly to each co-trustee that has custody.<sup>66</sup>

*Successor Trustees.* A person named as a successor to a trustee in a trust document will not have custody of trust assets until it succeeds, *i.e.*, actually has legal ownership and access to trust assets.

*Revocable Trusts.* Revocable grantor trusts are trusts that are established for estate planning and other purposes, control of which, for all intents and purposes, remains with the grantor (typically, the client) because the adviser cannot act without the permission of its client. The SEC staff has stated that it will not treat an adviser as having custody of a revocable grantor trust if (i) the adviser is prohibited from withdrawing assets from the trust without prior written consent of all of its co-trustees; (ii) each grantor who has contributed assets to the trust acts as a co-trustee; and (iii) the qualified custodian delivers account statements directly to each co-trustee.<sup>67</sup>

#### 4. Through Related Persons

- a. *Employees.* Custody of client assets by an adviser's supervised person is imputed to the adviser.<sup>68</sup> Thus, an employee who serves as a general partner to a partnership advised by the adviser will cause the adviser to be subject to the Custody Rule with respect to the partnership's assets. An employee who possesses client funds will cause the adviser to have custody of those funds.<sup>69</sup>

However, SEC staff has expressed the view that an adviser that provides advisory services to an account of its own employee (or other related person) does not have custody simply because the employee has the ability to withdraw his or her own assets.<sup>70</sup> Similarly, the SEC has said that custody will not be imputed to the advisory firm when an employee becomes an executor of an estate or a trustee and engages the advisory firm to manage the assets.<sup>71</sup>

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<sup>66</sup> Question XII.2 of SEC Staff FAQs.

<sup>67</sup> Question XII.3 of SEC Staff FAQs.

<sup>68</sup> Question II.2 of SEC Staff FAQs. See *Reid S. Johnson*, Advisers Act Rel. No. 4368 (Apr. 14, 2016) (settled enforcement action alleging that president of adviser in capacity as trustee for client had authority to obtain possession of securities held in brokerage account and thus had custody).

<sup>69</sup> See *Financial Fiduciaries, LLC*, Advisers Act Rel. No. 4863 (Mar. 5, 2018) (settled SEC enforcement action alleging that an adviser had custody of client assets because one of its employees was simultaneously employed by the qualified custodian and in that capacity had access to the client's funds and securities).

<sup>70</sup> Question II.7 of SEC Staff FAQs (available only to natural persons owning accounts to which the adviser provides advisory services).

<sup>71</sup> See discussion above in Section III.A.3.b of this outline.

- b. *Affiliates.* Rule 206(4)-2 deems an adviser to have custody of client assets directly or indirectly held by a “related person.”<sup>72</sup> Thus an adviser may be deemed to have custody if its related person directly or indirectly holds client funds or securities and has authority to obtain them, but only if that custody arises out of the advisory services provided by the adviser.<sup>73</sup>

*Related Persons.* A “related person” is defined in rule 206(4)-2 as any person, directly or indirectly, controlling the adviser, controlled by the adviser or under common control with the adviser, and includes parent companies and wholly-owned subsidiaries.<sup>74</sup> Custody of client assets by an employee of a related person is imputed to the related person in the same manner as would custody by an employee of the adviser.

*In Connection with Advisory Service.* Custody by a related person will be attributed to the adviser only if and to the extent that the assets held by the related person are held “in connection with advisory services provided by the adviser.” An adviser will thus have custody of securities held in a brokerage account of an affiliated broker-dealer only if the adviser provides the client owning the account advice about the assets held in the account (regardless of whether the adviser has discretionary authority). The same adviser would not have custody over client assets held in a separate trading account with the same broker-dealer.

An adviser that is part of a larger financial services company needs to pay particularly close attention to acquiring custody of client assets as a result of a remote corporate transaction. This might happen when an adviser’s corporate affiliate acquires a company that provides custodial services for some of the adviser’s clients.<sup>75</sup>

*Surprise Verification.* Unless the adviser can demonstrate that the related person is “operationally independent” of the adviser (and maintains records supporting such demonstration), the adviser deemed to have custody as a result of an affiliate’s custody of client assets must obtain an annual surprise verification of

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<sup>72</sup> Rule 206(4)-2(d)(2) (custody includes holding client funds or securities “indirectly”). The approach of the rule (which was preceded by years of SEC staff interpretations) is generally consistent with Section 208(d) of the Advisers Act, which prohibits an adviser from doing anything indirectly through another person that would be unlawful to do by the adviser directly.

<sup>73</sup> Rule 206(4)-2(b)(6)(i). See, e.g., *Reid S. Johnson*, *supra* note 68 (adviser deemed to have custody where securities held in pooled investment vehicles whose managing members were controlled by the adviser and which operated as a single integrated business with the adviser); *Mark M. Wayne*, Advisers Act Rel. No. 3737 (Dec. 12, 2013) (settled administrative action deeming adviser to have had custody because its affiliated recordkeeper had custody as a result of its authority to obtain possession of the adviser’s clients’ securities); *Larry C. Grossman and Gregory J. Adams*, Initial Decision Rel. (Dec. 23, 2014) (finding by administrative law judge that adviser had custody when it pooled client funds in an account of a bank it controlled).

<sup>74</sup> Rule 206(4)-2(d)(7). A related person can be a corporation, partnership, or trust, as well as an individual. The term “control” is defined in rule 206(4)-2(d)(1) to mean “the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise.” Each of the adviser’s officers, partners, or directors exercising executive responsibility is presumed to control the adviser. A person is presumed to control a corporation if it has authority to vote 25% or more of a class of voting securities or has similar rights with respect to a limited liability company or partnership. A person is presumed to control a trust if the person is a trustee or managing agent of the trust. Rule 206(4)-2(d)(1).

<sup>75</sup> *Barclays Capital, Inc.*, Advisers Act Rel. No. 3929 (Sep. 23, 2014) (after acquisition adviser failed to identify client accounts maintained with related persons).

client assets. The surprise examination will be required to encompass securities held by the related person.<sup>76</sup>

Note that a related person that has custody of client assets may cause the adviser to have custody even though client assets are maintained with a third person. For example, a subsidiary of an adviser may serve as a general partner of a hedge fund, which would cause the adviser to have custody (and thus be subject to the rule) even though the hedge fund's assets are all maintained with a qualified custodian (e.g., a prime broker). Provisions of the rule that address the implications of a related person serving as a qualified custodian are discussed below in Section VI.B of this outline.

## B. "Qualified Custodian"

The Custody Rule requires that advisers with custody maintain client funds and securities with only the four types of "qualified custodians" identified in rule 206(4)-2(d)(6).

Under the rule, qualified custodians are limited to:

1. U.S. banks and insured savings associations;
2. Broker-dealers registered with and regulated by the SEC;
3. Futures commission merchants registered with the CFTC, but only with respect to clients' funds and security futures, or other securities incidental to futures and options transactions;<sup>77</sup> and
4. Non-U.S. financial institutions that customarily hold financial assets for their customers provided they hold them in segregated accounts.<sup>78</sup>

While transfer agents are not a type of qualified custodian, the rule contains a limited exemption that permits them to serve as a qualified custodian for some shares of open-end investment companies ("mutual funds").<sup>79</sup>

## IV. Scope of Rule

### A. Registered Advisers

*General.* The Custody Rule applies only to an adviser registered with the SEC under the Advisers Act that has custody of client funds or securities.<sup>80</sup> Thus the rule does not apply to exempt reporting advisers (ERAs) or state registered advisers.

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<sup>76</sup> *Reid S. Johnson, supra* note 68 (adviser failed to have surprise examination of securities held by affiliated adviser with which it operated as a single integrated adviser).

<sup>77</sup> The term "security future" is defined in Section 202(a)(27) of the Advisers Act by reference to Section 3(a)(55) of the Securities Exchange Act of 1934.

<sup>78</sup> Rule 206(4)-2(d)(6)(iv).

<sup>79</sup> Rule 206(4)-2(b)(1). The exception is discussed below at Section V.A.3.b.

<sup>80</sup> The rule also applies to advisers that are not registered under circumstances where they should have been registered. *Redwood Wealth Mgmt., LLC*, Advisers Act Rel. No. 5880 (Sep. 30, 2021).

*Advisers not Subject to the Custody Rule.* Advisers not subject to the Custody Rule are fiduciaries that owe a duty of care to their clients, which extends to advice about or selection of custodians for clients. Thus, an adviser not subject to the rule (or that has custody of assets that are not funds or securities) but recommends clients employ a particular custodian must take care that such assets are subject to safekeeping similar to that provided by a qualified custodian or to disclose to its clients the risks of using the custodian.<sup>81</sup>

## B. Advisory Clients

1. *Securities Advice.* The Custody Rule does not apply with respect to a “client” for which the adviser does not provide advice about “securities.”

*Seed Money.* An adviser should not be subject to the Custody Rule with respect to a private fund that does not yet have any third-party investors (*i.e.*, holds only seed money provided by the adviser or its related persons) even with respect to the cash held by the fund (because the fund is not yet an advisory client), *i.e.*, it is giving advice to itself.<sup>82</sup> In contrast, if the adviser gives advice with respect some securities in an account or there is a third-party investor in the fund, the Custody Rule would apply to all the securities and funds held in the account.

*Advice about Non-securities.* If an adviser gives advice only with respect to real estate assets (or other assets that are not securities), the Custody Rule would not apply to the *entire* account, including the cash held in the account, because the adviser is not providing securities advice to the account.<sup>83</sup>

2. *Pooled Investment Vehicles.* Because each pooled investment vehicle an adviser advises is treated as a separate client, the Custody Rule may apply to some or all of them depending on the nature of the assets on which the adviser provides advice.
3. *Non-U.S. Advisers.* In the case of a registered adviser with a principal office and place of business outside the U.S., the Custody Rule only applies to clients who are U.S. persons.<sup>84</sup> The Custody Rule would thus not apply to an offshore fund (its client) even if it has U.S. investors.<sup>85</sup>

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<sup>81</sup> See, e.g., 2003 Adopting Release, *supra* note 8 at n. 22 (fiduciary duties of advisers recommending foreign custodians).

<sup>82</sup> The cash in such a private fund would normally be held with a qualified custodian. A question arises occasionally whether a fund that has accepted investor commitments before the end of its fiscal year, typically December 31st, must obtain an audit for that year when it does not accept investor funds until after the beginning of the new fiscal year. Although the SEC staff has provided no guidance on this question, the adviser should not be obligated to obtain an audit of any financial statements issued by the fund for the earlier fiscal year. This is because the fund did not have any “third-party” investors in the earlier fiscal year. Moreover, if the fund had not yet begun investing (because it had not drawn on the commitments) it would not hold any securities, and thus would not be a securities client.

<sup>83</sup> See *infra* Section IV.D discussion on advisers to real estate partnerships.

<sup>84</sup> See Section VI.E of this outline.

<sup>85</sup> *Id.*

## V. Operation of the Rule

### A. Maintenance of Client Funds and Securities with Qualified Custodians

#### 1. Client Funds and Securities

An adviser that advises clients with respect to assets (including financial assets) that are *not* securities is not required to maintain such assets with a qualified custodian, although clients may require assets to be so maintained.<sup>86</sup> Note, however, that the definition of “security” under the Advisers Act is interpreted by the SEC more broadly than similar definitions under the Securities Act of 1933 and the Securities Exchange Act of 1934, and includes all types of swap contracts.<sup>87</sup>

*Digital Assets.* The SEC has stated that digital offerings, including “initial coin offerings,” may be securities,<sup>88</sup> and thus subject to the Custody Rule. Virtual currencies, such as Bitcoin and Ether, would presumably be considered client “funds,” also subject to the Custody Rule.<sup>89</sup> Both of these types of offerings raise difficult questions regarding how a qualified custodian would hold custody of assets that exist on the blockchain.<sup>90</sup> The SEC staff has requested comment on such issues but has provided no guidance.<sup>91</sup>

An adviser may provide clients with exposure to investments in digital assets without addressing difficult Custody Rule issues by purchasing interests in trusts established to hold a pool of digital assets or hedge funds that invest in digital assets, both of which are offered only to clients who are accredited investors or qualified purchasers. In

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<sup>86</sup> Question II.3 of SEC Staff FAQs. Rule 206(4)-2 does not impose an independent legal obligation on qualified custodians to protect client assets. *Lamm IRA v. State Street Bank and Trust*, 749 F.3d 938 (11<sup>th</sup> Cir. 2014).

<sup>87</sup> Section 202(a)(18) of the Advisers Act (defining the term “security” for purposes of the Advisers Act).

<sup>88</sup> *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, Exchange Act Rel. No. 81207 (July 25, 2017).

<sup>89</sup> The SEC staff has requested public input on the challenges advisers face in complying with the Custody Rule, and asked “to what extent are investment advisers construing digital assets as ‘funds’, ‘securities’, or neither, for purposes of the Custody Rule?”. *Engaging on Non-DVP Custodial Practices and Digital Assets* (Mar. 12, 2019).

<sup>90</sup> An issue of some significance to advisers considering investing client assets in cryptocurrencies or other digital assets will be finding a qualified custodian willing and able to maintain such assets. The SEC and FINRA have been (so far) unwilling to approve broker-dealers’ provision of custody services. See SEC/FINRA Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities (July 8, 2019). In 2020, the Comptroller of the Currency (“OCC”) issued an interpretive letter confirming the authority of national banks and federal savings associations to provide cryptocurrency custody services to their customers. OCC Interpretive Letter 1170 (July 22, 2020). However, the OCC subsequently issued an interpretive letter requiring national banks and federal savings institutions to obtain a supervisory office non-objection before beginning to custody cryptocurrency. OCC Letter 1179 (Nov. 18, 2021). The SEC has requested comment on whether special purpose broker-dealers should be able to maintain custody of digital assets. See *Custody of Digital Asset Securities by Special Purpose Broker-Dealers*, Exchange Act Rel. No. 90788 (Dec. 23, 2020). A number of digital custodians are organized as state-chartered trust companies; some states have enacted statutes that specifically anticipate their state-chartered trust companies acting as digital custodians. It is not clear, however, whether all state-chartered trust companies are “qualified custodians.” See Staff Statement on WY Division of Banking’s “NAL on Custody of Digital Assets and Qualified Custodian Status,” available at <https://www.sec.gov/news/public-statement/statement-im-finhub-wyoming-nal-custody-digital-assets>. These issues are anticipated to be addressed in future SEC rulemaking.

<sup>91</sup> *Letter from Dalia Blass, Director, Division of Investment Management to Investment Adviser Association* (Mar. 12, 2019).

such circumstances, the Custody Rule would require interests in the trust (or the fund) to be maintained with a qualified custodian rather than the underlying digital assets.<sup>92</sup> The interests in the trust or the fund could be maintained with a broker-dealer or as a privately offered security. Another way for a client to obtain exposure to digital assets would be to purchase futures contracts, which could be custodied with a futures commission merchant, a qualified custodian.

*Collateral.* Collateral securing an obligation of a client is not an asset of the client that must be maintained with a qualified custodian, unless (or until) the adviser takes custody of the actual collateral, e.g., upon default of the obligation.<sup>93</sup> However, client funds or securities posted as margin in connection with a swap agreement, futures contract or similar financial contracts must be maintained with a qualified custodian, at least where the collateral continues to be the property of the client.<sup>94</sup>

## 2. On Account with a Qualified Custodian

An adviser with custody of client funds and securities must maintain<sup>95</sup> those assets in accounts with qualified custodians, either:

- a. In a separate account in the name of each client; or
- b. In an account that contains only client funds and securities in the name of the adviser as agent or trustee for clients (*i.e.*, an omnibus account).<sup>96</sup>

These two requirements operate to impose three safekeeping requirements:

- a. *Physical Possession of Assets.* A registered adviser that is not itself a qualified custodian may not have physical possession of client funds or securities. This is because an adviser taking possession of a client's stock certificate would immediately have custody of a security that would not be maintained by a qualified custodian.<sup>97</sup>

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<sup>92</sup> Section 208(d) of the Act may, however, prevent an adviser from establishing such a trust or fund merely to avoid application of the Custody Rule. Investment in otherwise available trusts or funds should avoid application of Section 208(d).

<sup>93</sup> See *Merrill Lynch Prime Fund, Inc.*, SEC Staff No-Action Letter (Nov. 4, 1992) (syndicated loan collateral not held by a custodian meeting the requirements of Section 17(f) of the Investment Company Act). See also *Delta Govt. Options Corp.*, SEC Staff No-Action Letter (July 21, 1989) (registered fund's margin is an asset of the fund and must be maintained in a manner that complies with Section 17(f) of the Investment Company Act).

<sup>94</sup> Question II.10 of SEC Staff FAQs. The FAQ is unclear whether it is limited to collateral that continues to be the property of the client. If it is not so limited, the effect of the position is to limit swap counterparties to qualified custodians.

<sup>95</sup> Rule 206(4)-2 was originally drafted to require that advisers with custody of client funds "deposit" them in a separate bank account, which was interpreted by the SEC as requiring advisers to "maintain" the assets in separate accounts. *SEC v. Slocum, Gordon & Co.*, 334 F.Supp. 2d 144, 178 (D.R.I. 2004). The SEC addressed the ambiguity in 2003 when it revised the rule to use the word "maintain."

<sup>96</sup> Rule 206(4)-2(a)(1). See *Donald F. Lathen, Jr.*, Advisers Act Rel. No. 4485 (Aug. 15, 2016) (settled enforcement action against a fund adviser that failed to hold fund assets in the name of the fund or the adviser on behalf of the fund).

<sup>97</sup> *Reid S. Johnson, supra* note 68 (stock certificates held at principal's home and storage facility); *Clean Energy Capital, LLC*, Advisers Act Rel. No. 3955 (Oct. 17, 2014) (adviser to private funds held stock certificates owned

- b. *Commingling Assets Prohibited.* A registered adviser may not commingle client assets with proprietary or other non-client assets.<sup>98</sup> In contrast, commingling of assets of multiple clients in one or more “omnibus” accounts is explicitly permitted.

*Pooled Investment Vehicles.* An adviser that invests proprietary assets in a fund it advises would not thereby commingle its assets with those of its clients also invested in the same fund.<sup>99</sup>

*Loan Syndicates.* The SEC staff issued a no-action letter providing relief from this provision for an adviser that acts as administrative agent for a loan syndicate that is comprised, at least in part, of its advisory clients. Subject to numerous conditions, the letter permits the adviser/loan agent to establish a single bank account on behalf of the loan syndicate to facilitate movement of funds among syndicate participants and borrowers notwithstanding that funds of clients and non-clients’ participating syndicate assets would be held in the same bank account.<sup>100</sup>

- c. *Maintaining Assets*

(1) *Traditionally Held Securities.* Client securities are commonly maintained on account with a qualified custodian (e.g., a broker-dealer) in book-entry (uncertificated) form, the ownership of which is governed by Article 8 of the Uniform Commercial Code. Rule 206(4)-2’s requirement that client securities be “maintained” with a qualified custodian is designed to accommodate this system of ownership but is not so limited.

- (2) *Non-Traditional Securities*

*Physical Custody.* Some forms of non-traditional investments (such as shares of other pooled investment vehicles or syndicated loans) may not be held on account with a broker or bank. In some cases, these securities will qualify as “privately offered securities,” which are not required to be maintained with a qualified custodian.<sup>101</sup> If the exception is not available, such securities may be reduced to paper and maintained in the vault of a qualified custodian, provided that the custodian provides required reports to clients with respect to those securities.<sup>102</sup>

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by private funds at its office); *Further Lane Asset Mgmt.*, Advisers Act Rel. No. 3707 (Oct. 28, 2013) (adviser had physical possession of promissory notes).

<sup>98</sup> See *SEC v. Sentinel Mgmt. Group, Inc. et al.*, 2012 WL1079961, N.D. Ill. (Mar. 30, 2012) (adviser commingled its clients’ assets with proprietary assets held in a clearing account). See also *SEC v. Steadman*, 967 F.2d 636, 646 (D.C. Cir. 1992); *SEC v. Slocum, Gordon & Co.*, 334 F.Supp. 2d 144, 178 (D.R.I. 2004); *Finser Int’l. Corp.*, Advisers Act Rel. No. 5593 (Sep. 24, 2020); *SEC v. Nutmeg Grp.*, 162 F.Supp.3d (N.D. Ill. 2016).

<sup>99</sup> Moreover, the interests in shares of the pooled investment vehicle would typically qualify as “privately issued securities,” not required to be maintained with a qualified custodian.

<sup>100</sup> *Madison Capital Funding LLC*, SEC Staff No-Action Letter (Dec. 20, 2018). The letter is subject to 11 conditions. The letter specifically states that third parties may rely on the letter to the extent their circumstances are similar.

<sup>101</sup> See Section V.A.3.a of this outline.

<sup>102</sup> Implicit in the rule’s requirements is the ability of the qualified custodian to report to clients on assets held on account with the custodian. Accordingly, the SEC takes the position that keeping stock certificates in the adviser’s bank safe deposit box would not satisfy the requirement of the rule because they would not be



*Legal Custody.* Non-traditional assets may also be maintained with a qualified custodian that takes nominal ownership of the securities and holds them “for the benefit of” the client, in which case such securities need not be reduced to paper.<sup>103</sup>

### 3. *Exceptions*

Rule 206(4)-2 contains two important but narrow exceptions to the qualified custodian requirement for privately offered securities and shares of mutual funds.

a. *Privately Offered Securities.* Some privately offered securities, such as shares of private funds, are recorded only on the books of the issuer and cannot easily be held in an account with a qualified custodian. Therefore, rule 206(4)-2 includes an exception from the requirement that client assets be maintained with a qualified custodian, which is available only for securities that are:

- (1) Acquired from the issuer in a transaction not involving any public offering;
- (2) Uncertificated and ownership is recorded only on the books of the issuer or its transfer agent in the name of the client; and
- (3) Transferrable only with prior consent of the issuer or shareholders.<sup>104</sup>

*Private Funds.* The privately offered securities exception is only available with respect to assets of pooled investment vehicles that are audited annually pursuant to paragraph (b)(4) of the Custody Rule.<sup>105</sup> This limitation presents challenges to advisers to pooled investment vehicles whose financial statements are not audited or have failed to distribute the results of the audit in a timely manner—obtaining a surprise examination in lieu of an audit may not be a viable alternative.

*Non-transferrable Certificated Securities.* The SEC staff has effectively expanded the privately offered securities exception by issuing guidance stating that it would not object if an adviser does not maintain stock certificates with a qualified custodian, provided that (i) the client is a pooled investment vehicle that is subject to a financial statement audit; (ii) the stock certificate can only be used to effect a transfer of the security with the prior consent of the issuer or shareholders of the issuer; (iii) ownership of the security is recorded on the books of the issuer or its transfer agent in the name of the client; (iv) the stock certificate contains a legend restricting transfer; and (v) the stock certificate is appropriately safeguarded by the adviser and can be replaced upon loss or destruction.<sup>106</sup> The guidance was issued

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maintained in “accounts” with the qualified custodian, and thus could not be reported on the quarterly statements. 2003 Adopting Release, *supra* note 8 at n. 18.

<sup>103</sup> By taking nominal ownership of the securities, the custodian will be in a position to “establish the [client’s] interest in each Loan and to enforce the [client’s] ownership rights in a court of law.” *Merrill Lynch Prime Fund, Inc.*, *supra* note 92 (SEC staff no-action letter regarding Section 17(f) of the Investment Company Act).

<sup>104</sup> Rule 206(4)-2(b)(2)(i).

<sup>105</sup> Rule 206(4)-2(b)(2)(ii). The application of the rule to pooled investment vehicles is discussed in more detail in Section VI.A of this outline.

<sup>106</sup> *Privately Offered Securities under the Investment Advisers Act Custody Rule*, IM Guidance Update 2013-04 (Aug. 2013).

in response to arguments that maintaining custody of non-transferrable securities (including those that issue certificates) does not provide any meaningful client protections to investors in private funds.

*Partnership, Subscription, LLC, and Swap Agreements.* For purposes of the Custody Rule, the SEC staff considers partnership agreements, LLC agreements, subscription agreements and securities evidenced by ISDA master agreements that cannot be transferred without consent of the counterparty to be privately offered securities.<sup>107</sup> Consequently, they do not have to be maintained with a qualified custodian.

- b. *Mutual Fund Transfer Agents.* Shares of an open-end management investment company (mutual fund) held with the fund's transfer agent need not be maintained with a qualified custodian.<sup>108</sup> Shares not held with the fund's own transfer agent, however, must be held with a qualified custodian.<sup>109</sup>

*Insurance Companies.* In a 2005 no-action letter the SEC staff expanded the mutual fund transfer agent exception to include insurance companies with respect to variable insurance contracts the owners of which grant authority to their advisers to withdraw cash value to pay their advisory fees and thus have "custody" of the client assets held in the separate account.<sup>110</sup>

Both exceptions relieve an adviser only from the requirement that the securities be maintained with a qualified custodian – privately offered securities and shares of mutual funds still must be subject to surprise verification and reported on quarterly client statements unless another exception is available.

#### 4. *Multiple Custodians*

An adviser may use one qualified custodian for some clients and a different qualified custodian for other clients. Multiple qualified custodians can serve a single client, some of whose assets are maintained with each.<sup>111</sup>

#### 5. *Foreign Custodians*

Rule 206(4)-2 permits advisers to maintain client securities and cash with foreign financial institutions subject to two requirements. The foreign custodian must:

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<sup>107</sup> *Id.* at n. 2. Although the relief for privately offered securities provided by the IM Guidance Update is described as being available only to advisers with respect to a pooled investment vehicle, it is understood that the interpretation set forth in footnote 1 of the Update was not intended to be so limited.

<sup>108</sup> Rule 206(4)-2(b)(1).

<sup>109</sup> If the transfer agent is a "related person" of the adviser, the adviser must receive an internal control report from the transfer agent. Question XV.1 of SEC Staff FAQs. See also discussion, *infra* Section VI.B of this outline regarding related person custody.

<sup>110</sup> *American Skandia Life Assurance Corp.*, SEC Staff No-Action Letter (May 16, 2005). The insurance companies act just like transfer agents on behalf of their separate accounts, but are excluded from the definition of "transfer agent" in the Securities Exchange Act of 1934.

<sup>111</sup> 2003 Adopting Release, *supra* note 8 at n. 17.

- Be used customarily to hold financial assets for its customers; and
- Hold the client assets in an account segregated from its proprietary accounts.

The rule does not limit assets that can be held with a foreign custodian to those that are traded in the market that the custodian serves. Nor does it establish minimum regulatory, capital, or other types of requirements for the custodian. The SEC has stated that where an adviser has selected a foreign custodian, its fiduciary duties require it to have “a reasonable basis for believing that the foreign institution will provide a level of safety for client assets similar to that which would be provided by a ‘qualified custodian’ in the United States or to fully disclose to clients any material risks attendant to maintaining the assets with the foreign custodian.”<sup>112</sup>

As long as the adviser (or a related person) does not have custody of client assets, there are no limitations on the types of foreign institutions that can hold client assets and no regulatory requirement that the institution segregate client assets. However, if the adviser recommends securities or custodial arrangements that present custodial risks materially greater than those to which the client would be exposed if the assets were held in the United States, consideration should be given to disclosing the risks to the client.

## B. Notice to Clients

An adviser that opens an account with a qualified custodian on a client’s behalf (either in the client’s name, or in the name of the adviser, as agent) must notify the client in writing, and provide the following information:

### 1. *Upon Opening Account*

- Name and address of the qualified custodian; and
- The manner in which the client funds or securities are being held.<sup>113</sup>

If multiple custodians will be used, an adviser can satisfy the rule by providing a one-time notice of all custodians and does not need to provide a new notice each time assets move among custodians.<sup>114</sup>

### 2. *Upon Any Change*

If any of this information changes, the adviser must promptly inform the client. Notices need not be provided when the client engages the custodian.

## C. Delivery of Account Statements

Each adviser that has custody of client assets must have a reasonable belief, after due inquiry, that the qualified custodians deliver to the adviser’s clients account statements, no less frequently than quarterly, identifying (i) the amount of funds and each security held

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<sup>112</sup> *Id.* at n.22.

<sup>113</sup> Rule 206(4)-2(a)(2).

<sup>114</sup> Question V.1 of SEC Staff FAQs.

in the account at the end of the period and (ii) each transaction during the period.<sup>115</sup> This provision precludes the adviser from being the sole provider of account statements to clients and is designed as a check on the adviser's use of assets.<sup>116</sup>

#### 1. *Directly to Client from Custodian*

The Custody Rule requires that an adviser establish a reasonable basis for believing that the qualified custodian is delivering account statements to each of the adviser's clients, but does not require an adviser to confirm with each of its clients that they, in fact, received an account statement.

*Methods.* The rule requires an adviser have a reasonable belief formed after "due inquiry." Advisers employ many methods, including:

- The custodian sends the adviser duplicate statements when it sends statements directly to the client,<sup>117</sup> or it periodically sends bulk statements it has sent to clients (e.g., on a CD or other media) to the adviser;
- The custodian signs an attestation, letter or other form of representation (typically annually) that it has delivered the account statements to the clients and provides the representation to the adviser;
- Adviser surveys all or a sample of clients to confirm they received the account statements;
- The custodian's SSAE 18 report includes an attestation or other statement indicating that the custodian has sent account statements to the adviser's clients.

As noted above, advisers whose clients receive electronic statements from the qualified custodian may satisfy this requirement by being copied on the email notifications of account statement postings sent by the qualified custodian to clients in addition to having access to client statements on the custodian's website.<sup>118</sup> Merely having access to view statements online is insufficient.<sup>119</sup>

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<sup>115</sup> Rule 206(4)-2(a)(3). Account statements may be delivered electronically, following the guidelines on electronic delivery set out in the SEC's electronic delivery interpretive releases. See *Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information*, Advisers Act Rel. No. 1562 (May 9, 1996). See also Question IV.1 of SEC Staff FAQs.

<sup>116</sup> *Walter V. Gerasimowicz et al.*, Advisers Act Rel. No. 3601 (May 3, 2013) (order making findings that, among other things, fund investors did not receive account statements from the fund's qualified custodian, but instead from the adviser). See also *Envision Capital Mgmt., Ltd.*, Advisers Act Rel. No. 3160 (Feb. 16, 2011); *SFX Financial Advisory Mgmt. Enterprises, Inc.*, Advisers Act Rel. No. 4116 (June 15, 2015).

<sup>117</sup> This was the one method specifically approved by the SEC in the 2009 Adopting Release, *supra* note 12 at n.21 and accompanying text.

<sup>118</sup> Question IV.1 of SEC Staff FAQs.

<sup>119</sup> 2009 Adopting Release, *supra* note 12 at n. 21.

## 2. *Independent Representative*

A qualified custodian may deliver the account statement (and the notice discussed above) to an independent representative of the client instead of the client.<sup>120</sup> The representative:

- a. Acts as agent for the advisory client and must be obligated by law or contract to act in the advisory client's best interest;
- b. Must be independent of the adviser – it must not control, be controlled by, or be under common control with the adviser; and cannot have (or have had within the past two years) a material business relationship with the adviser.<sup>121</sup>

## 3. *Sub-custodians*

The account statement may consolidate information from sub-custodians (that are also qualified custodians), in which case the sub-custodians need not send separate account statements.<sup>122</sup>

## 4. *Adviser Account Statements*

Rule 206(4)-2 does not require an adviser with custody to send account statements to clients separate and apart from those the qualified custodian sends. If, however, the adviser does send clients its own account statements, the adviser must include a legend urging the client to compare the account statements from the adviser with those from the qualified custodian (i) in the notice that the qualified custodian sends upon opening an account for a client, and (ii) in its own subsequent account statements.<sup>123</sup>

## D. Annual Surprise Exams

Advisers that have custody of client funds or securities must undergo an annual surprise examination by an independent public accountant that verifies the client funds and securities over which the adviser has custody.<sup>124</sup> The rule also imposes a set of requirements on accountants conducting the surprise examination that, among other things, obligates them to alert the SEC of any discrepancies.

The SEC has brought many enforcement cases against advisers that have had custody of client assets and failed to obtain an annual surprise examination.<sup>125</sup> The SEC can identify failures by comparing a list of advisers that report having custody of client assets on their Form ADVs and that report that they comply with the Custody Rule by obtaining a surprise verification with those advisers whose accountants have filed Form ADV-E,

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<sup>120</sup> Rule 206(4)-2(a)(7).

<sup>121</sup> Rule 206(4)-2(d)(4). See Section VIII of SEC Staff FAQs for more discussion about independent representatives.

<sup>122</sup> Question IX.1 of SEC Staff FAQs.

<sup>123</sup> Rule 206(4)-2(a)(2); Question IV.2 of SEC Staff FAQs.

<sup>124</sup> Rule 206(4)-2(a)(4).

<sup>125</sup> See, e.g., *CMS Fund Advisers*, *supra* note 37.

reporting the results of their examination. Both lists can be generated by the IARD system on which advisers file Form ADV and accountants file Form ADV-E.

## 1. *Exceptions*

- a. *Fee Deductions.* Advisers that have custody solely because they have authority to deduct advisory fees from client accounts (discussed above).<sup>126</sup>
- b. *Pooled Investment Vehicles Subject to Audit.* Advisers with respect to their pooled investment vehicles that are annually audited (discussed below in Section VI.A.1).<sup>127</sup>
- c. *Operationally Independent Related Persons.* Advisers that are deemed to have custody only because a related person has custody of their clients' assets are not required to obtain a surprise examination if the adviser establishes and documents that the related person is "operationally independent."<sup>128</sup> See discussion below in Section VI.B.3.
- d. *Related Sub-Advisers.* An adviser that acts as a sub-adviser in an investment advisory program for which a related person is the qualified custodian or primary adviser (or an affiliate of the primary adviser), may avoid a surprise examination, regardless of whether it is operationally independent of the primary adviser (or its affiliate), if: (i) the sole reason that the sub-adviser is deemed to have custody is that it is a related person of the qualified custodian and the primary adviser; (ii) the principal adviser is responsible for complying with the Custody Rule, including obtaining a surprise examination of the client's assets; and (iii) the sub-adviser would still be required to obtain from the primary adviser or qualified custodian the written internal control report discussed below in Section VI.B.2 of this outline. This exception, set forth in an SEC staff letter, addresses a quirk in the Custody Rule that otherwise would require both the adviser and an affiliated sub-adviser to obtain a surprise examination of the same assets.<sup>129</sup>
- e. *SLOAs.* An adviser that has authority to transfer client assets pursuant to a SLOA and relies on 2017 no-action letter regarding SLOAs discussed above may avoid a surprise examination with respect to such client assets.<sup>130</sup>

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<sup>126</sup> Rule 206(4)-2(b)(3)(i).

<sup>127</sup> Rule 206(4)-2(b)(4). The exception is not available with respect to assets of a client that is not a pooled investment vehicle. Question X.1 of SEC Staff FAQs.

<sup>128</sup> Rule 206(4)-2(b)(6). See also Question XIII.1 of SEC Staff FAQs (an adviser which has custody imputed to it as a result of an affiliate's custody of its client's assets is not required to obtain an internal control report).

<sup>129</sup> *Investment Adviser Association*, SEC Staff Letter (Apr. 25, 2016).

<sup>130</sup> SLOAs are discussed in Section III.2.d. above. Notwithstanding the use of the word "solely" in the paragraph (b)(3) of the rule (the fee deductions exception), it is understood that an adviser that has custody for any combination of the fee deductions, operationally independent related persons, and/or SLOAs exceptions is relieved from the annual surprise verification requirement.

## 2. *Once During Each Calendar Year*

- a. *Calendar Year.* Client funds and securities over which the adviser has custody must be verified by examination at least once during each calendar year.<sup>131</sup> That an examination has not occurred yet in a calendar year does not mean that the rule has been violated. An adviser is in breach of the rule if a calendar year (rather than a 12 month period) occurs during which an examination has not occurred (which may be more or less than a 12 month period). This approach means that the verification may occur at the beginning of one calendar year and the end of the following year.
- b. *First Year.* The rule presumes (but does not require) that the adviser will enter into a contract for a surprise examination with an independent public accountant, and requires that the contract provide that the first examination occur within six months of when the adviser becomes subject to the surprise examination requirement.<sup>132</sup> This could occur when the adviser (i) registers as an adviser, (ii) first obtains custody of client assets or (iii) switches from the audit method of complying with the Custody Rule.<sup>133</sup>

## 3. *By an Independent Public Accountant*

The examination must be conducted by an independent public accountant, which the rule defines as a public accountant that meets the standards of independence of rule 2-01(b) and (c) of Regulation S-X.<sup>134</sup> The failure of an accountant to maintain its independence from the adviser will result in the adviser's violation of its obligations under rule 206(4)-2, for which the accountant may be held secondarily responsible.<sup>135</sup>

- a. The SEC will not recognize an accountant as independent if the accountant or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. The SEC's auditing standards require the auditor to be independent of its audit clients both "in fact and appearance."<sup>136</sup>

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<sup>131</sup> Rule 206(4)-2(a)(4).

<sup>132</sup> *Id.*

<sup>133</sup> There is no guidance on how to determine when an adviser has "switched" from one method to another so as to trigger the beginning of the 6 month period but the signing of the engagement letter with the independent public accountant for the surprise verification should satisfy the rule.

<sup>134</sup> Rule 206(4)-2(d)(3).

<sup>135</sup> *Total Wealth Mgmt., Inc.*, Initial Decision No. 860 (Aug. 17, 2015) (ALJ opinion) (auditor lacked independence because it provided accounting services to a related party); *Katz, Sapper & Miller, LLP*, Advisers Act Rel. No. 5100 (Jan. 9, 2019) (auditor prepared financial statements and then audited them). In some cases, the SEC has brought enforcement cases in these circumstances against only the auditor. See *Stockman Kast Ryan & Co. LLP*, Advisers Act Rel. No. 5989 (Mar. 31, 2022) (partner of auditor served as trustee of trusts that invested in private funds; auditor provided bookkeeping services to fund); *RSM US LLP*, Advisers Act Rel. No. 5331 (Aug. 27, 2019) (auditor provided prohibited non-audit services to 8 registered advisers causing violation of rule 206(4)-2). The *RSM* case appears to have been brought to the SEC's attention by the PCAOB.

<sup>136</sup> See Rule 2-01 of Regulation S-X.

- b. The accountant's independence must be maintained not only with respect to the adviser but also to its affiliates and entities that control the adviser, that are controlled by the adviser or that are under common control with the adviser, *i.e.*, its related persons.
- c. Independence must be maintained throughout the term of the engagement.<sup>137</sup>
- d. Independence of an accountant may be affected by its (or members of its engagement team's) (i) financial interests in the adviser, (ii) employment relationships, (iii) business relationships, and (iv) the provision of non-audit services.
- e. In determining whether an accountant is independent with respect to a private fund, the SEC considers all relevant circumstances.<sup>138</sup> The SEC staff has expressed the view that an accountant that audits the financial statements of a pooled investment vehicle sponsored by the adviser would be independent if it met the requirements of rules 2-01(b) and (c) Regulation S-X.<sup>139</sup>

Because of the significant consequences to the adviser if the public accountant fails to maintain its independence, many advisers require accountants to certify their independence in their engagement letter and to periodically confirm their independence thereafter.<sup>140</sup>

*When Independent Accountant is Required to be Registered with PCAOB.* Under rule 206(4)-2, an accountant performing services for an adviser under the rule must be registered with *and* subject to regular inspection by the PCAOB in three circumstances:

- a. It performs an annual audit of a pooled investment vehicle that is taking advantage of the "audit exception" discussed below in Section VI.A.1 of this outline;
- b. It performs an annual surprise examination of an adviser that maintains client assets with a qualified custodian that is the adviser (*i.e.*, self-custody) or a related person, discussed below in Section VI.B of this outline; or
- c. It prepares an internal control report with respect to a related person that serves as a qualified custodian.<sup>141</sup>

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<sup>137</sup> In the case of an accountant performing a surprise examination, the engagement period begins the earliest of (i) the date the accountant signs the initial agreement to perform the surprise examination, (ii) the date the accountant begins attestation procedures, or (iii) the beginning of the period subject to the surprise examination. Question XVI.2 of SEC Staff FAQs. See *also* Questions XVI.1 and 3 regarding the engagement period.

<sup>138</sup> Office of the SEC Chief Accountant: Application of the Commission's Rules on Auditor Independence, Frequently Asked Questions (updated as of Dec. 13, 2011) (Broker Dealer and Investment Advisers Question 2).

<sup>139</sup> Question XVI.4 of SEC Staff FAQs. Note that the SEC has amended the auditor independence rules as they apply to private funds. *Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships*, Advisers Act Rel. No. 5255 (June 18, 2019).

<sup>140</sup> PCAOB Rule 3526 requires accounting firms registered with it to annually provide audit clients with a written statement regarding its independence.

<sup>141</sup> Question II.8 of SEC Staff FAQs.



#### 4. *Mechanics of the Surprise Examination*

An adviser subject to the surprise examination requirement is required to enter into a written agreement with an independent public accountant.<sup>142</sup>

The written agreement must specify the following:

- a. *Annual examination.* The accountant must verify the client's funds and securities at least once each calendar year. The exam should be a "surprise" to the adviser. Accountants must schedule exams so that their timing is irregular from year to year, so that the adviser cannot anticipate when it will take place.<sup>143</sup> The scope and methodology used by the accountant are governed by professional attestation standards and guidance provided by the SEC (discussed below). After the examination, the accountant will provide the adviser with an opinion of the adviser's compliance with the requirements of rule 206(4)-2 and rule 204-2(b) (recordkeeping) during the period since the date of the previous examination.
- b. *File a certificate on Form ADV-E.* The accountant must file a certificate with the SEC within 120 days of the time chosen for the surprise examination by the accountant, stating that he or she has examined the funds and securities and describing the nature and extent of the examination.<sup>144</sup> Accountants, following guidance supplied by the American Institute of Certified Public Accountants ("AICPA"), will append to Form ADV-E (i) a copy of their opinion, and (ii) a statement from the adviser's management about its responsibility for compliance with rule 206(4)-2, establishing and maintaining relevant compliance controls during the examination period, and asserting that the adviser was in compliance during the period.<sup>145</sup>

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<sup>142</sup> Rule 206(4)-2(a)(4). The written agreement is a required record of the adviser, which it must maintain for at least five years. Rule 204-2(a)(10). The SEC has observed that the failure of an adviser's engagement letter with a public accountant to include the language required by the rule is itself a violation of the rule. *Reid S. Johnson, supra* note 68. Although the rule is written in such a manner as to suggest that an adviser's obligations with respect to the surprise examination are satisfied merely by entering into a contract with an independent public accountant, the SEC does not apply the rule in such a narrow manner. See *Mark M. Wayne, supra* note 73 (settled administrative action in which the SEC observed that the adviser "violated the Custody Rule because it took no action to determine whether the independent public accountants it retained to conduct annual surprise exams to verify the assets over which it had custody performed those exams"), and *James T. Budden and Alexander W. Budden, Advisers Act Rel. No. 4225* (Oct. 13, 2015) (among other things, adviser failed to cooperate with accountants and determine whether they had submitted Form ADV-E).

<sup>143</sup> See *Reid S. Johnson, supra* note 68 (engagement letter "improperly" stated the dates that the accountant would begin the surprise examination); *Kaufman, Bernstein, Oberman, Tivoli & Miller, LLC and Howard M. Bernstein, Advisers Act Rel. No. 2194* (Nov. 20, 2003) (adviser that had independent auditor begin examination the same date each year).

<sup>144</sup> The filing must be made electronically through the Investment Adviser Registration Depository ("IARD") system. The IARD provides accountants with the ability to upload their reports to the IARD system. See Questions IV.6.A and IV.6.B of SEC Staff FAQs and <http://www.iard.com/pdf/formADV-E.pdf>.

<sup>145</sup> *Illustrative Report of Independent Accountant on Examinations of Securities Pursuant to Rule 206(4)-2* (Oct. 26 2017) available at <https://us.aicpa.org/content/dam/aicpa/interestareas/frc/industryinsights/downloadabledocuments/surprise-exam-report.pdf>.

- c. *Promptly report material discrepancies.* Within one business day of finding any “material discrepancies,” the accountant must notify the SEC.<sup>146</sup>

*Material discrepancies.* A material discrepancy includes material non-compliance with rule 206(4)-2 or rule 204-2 under the Advisers Act. A shortfall in funds or securities might not implicate rule 206(4)-2. No provision in the rule prohibits an adviser (or one of its supervised persons) from misappropriating client assets, although misappropriation would be a fraud under Sections 206(1) and (2) of the Act. A shortfall would, however, create inconsistencies in the adviser’s records implicating rule 204-2, and create a discrepancy the accountant must report if material.

- d. *Noisy withdrawal.* Upon termination of its engagement, the accountant must file within four business days a Form ADV-E accompanied by a statement that includes the date of and reasons for its termination, resignation, removal, or dismissal.<sup>147</sup>

## 5. *Guidance for Accountants*

When it adopted the 2009 Amendments, the SEC issued a companion interpretive release to update its guidance for accountants.<sup>148</sup>

- a. *Verify Assets on Sampling Basis.* Under the old guidance, which harkened back to the era of paper certificates, the accountant performing the surprise examination was required to verify all client assets.<sup>149</sup> To reflect modern auditing methods, the guidance for accountants permits the accountant to verify client assets on a sampling basis.<sup>150</sup>

The sampling guidance makes it important that an adviser with a large number of accounts correctly identify for its accountant those accounts subject to a surprise examination. In one settled enforcement action, the SEC alleged that the failure to do so caused the accountant to verify funds and securities from an inadequate sample of advisory accounts.<sup>151</sup>

- b. *Guidance for Internal Control Report.* The release provides guidance on the scope, standards, and procedures, as well as a list of control objectives, for the

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<sup>146</sup> Rule 206(4)-2(a)(4)(ii). The SEC has provided guidance on how accountants may submit notifications to the SEC. See <https://www.sec.gov/about/offices/ocie/awc-instructions.htm>.

<sup>147</sup> Rule 206(4)-2(a)(4)(iii).

<sup>148</sup> *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*, Advisers Act Rel. No. 2969 (Dec. 30, 2009) (“Guidance for Accountants”). This guidance replaced previous guidance given to accountants in 1966 in Accounting Series Rel. No. 103, *Nature of Examination Required To Be Made of Funds and Securities Held in Custody of Investment Advisers and Related Accountant’s Certificate*, Advisers Act Rel. No. 201 (May 26, 1966).

<sup>149</sup> Issues regarding custody of paper certificates, however, still occasionally show up in SEC enforcement actions. See *Reid S. Johnson*, *supra* note 68 (stock certificates kept in locked office cabinet and personal residence).

<sup>150</sup> Guidance for Accountants, *supra* note 148 at Section II.

<sup>151</sup> *Morgan Stanley Smith Barney, LLC*, Advisers Act Rel. No. 4607 (Jan. 13, 2017).

annual internal control report required of certain advisers under the Custody Rule.<sup>152</sup>

- c. *Planning and Execution of the Surprise Examination.* In addition, the release provides guidance on how the accountant would consider the internal control report in the planning and execution of the surprise examination.
- d. *Potential Liability of Accountants.* Although accountants performing a surprise examination pursuant to rule 206(4)-2 are not regulated under the Advisers Act, the SEC has instituted settled enforcement proceedings under the Advisers Act against accountants that failed to complete a surprise examination and file form ADV-E for “aiding and abetting” the adviser’s violation of the Custody Rule. The SEC will also assert improper professional conduct under the SEC’s rules of practice.<sup>153</sup>

The AICPA has developed illustrated reports for use when an accountant is asked to verify the assets of an adviser pursuant to rule 206(4)-2.<sup>154</sup>

## 6. *Newly Registered Advisers*

- a. *Surprise Examination Method.* The rule requires an adviser to have entered into a written agreement for a surprise examination at the later of the time (i) it becomes registered with the SEC, or (ii) it obtains custody of the assets of an advisory client. The written agreement must provide for the first examination to occur within six months of that time.<sup>155</sup>
- b. *Audit Method.* There is no SEC guidance for a new adviser intending to rely on the audit method, but presumably (i) entering into an audit agreement with the audit firm at the time the private fund first accepts money from a third-party investor, or (ii) the distribution of an offering document representing that the pooled investment vehicle will distribute audited financial statements will satisfy the rule even if the audit has yet to occur. Arguably, an adviser to a private fund employing the audit method would not violate the delivery requirement of the rule until the fiscal year

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<sup>152</sup> *Guidance for Accountants*, *supra* note 148. at Section III.

<sup>153</sup> See *RSM US LLP*, Advisers Act Rel. No. 5331 (Aug. 27, 2019) (non-audit services provided to advisers); *Rodney A. Smith, Michael Santicchia, CPA, and Stephen D. Cheaney, CPA*, Advisers Act Rel. No. 3738 (Dec. 12, 2013) (failure to complete surprise examinations). See also *Holthouse Carlin & Van Trigt LLP*, Advisers Act Rel. No. 5008 (Sep. 13, 2018) (failure to comply with auditor independence rules); *Santos, Postal & Company*, Advisers Act Rel. No. 4380 (Apr. 29, 2016) (failure to follow AICPA professional standards when conducting custody examination of adviser); *Wesley N. Stark, CPA*, Advisers Act Rel. No. 4162 (Aug. 6, 2015) (multiple examination failures by unqualified accountants); *Michael S. Wilson, CPA*, Advisers Act Rel. No. 4130 (June 25, 2015) (accountant failed to complete examination or withdraw therefrom); *Altschuler, Melvoin and Glasser LLP*, Advisers Act Rel. No. 3096 (Oct. 4, 2010) (accountants negligently failed to exercise standards of “due professional care” in failing to identify improper commingling of adviser and client assets).

<sup>154</sup> *Illustrative Report of Independent Accountant on Examinations of Securities Pursuant to Rule 206(4)-2* (Report on Management’s Assertion) and Management’s Assertion, *supra* note 145.

<sup>155</sup> Rule 206(4)-2(a)(4). If the adviser maintains client assets itself (self-custody) or with a related person so that the adviser must obtain an internal control report, the first examination must occur no later than six months after receiving the internal control report.

has ended and financial statements have not been delivered to investors in a timely manner.

## VI. Special Circumstances

Rule 206(4)-2 presents different issues for (i) advisers to pooled investment vehicles, (ii) advisers whose clients maintain assets with a related person, (iii) advisers to registered investment companies, (iv) advisers to real estate partnerships and (v) non-U.S. advisers.

### A. Advisers to Pooled Investment Vehicles

An adviser to a hedge fund, private equity fund or other pooled investment vehicle that invests in securities will generally have custody of its client's assets. Custody typically arises because of the authority of the adviser (or an affiliate) as general partner (or some similar position) of the pooled investment vehicle, or as a result of the management agreement that gives the adviser authority to withdraw assets to, for example, pay its fees. Advisers to pooled investment vehicles can comply with the rule in one of two different ways:

#### 1. *Audit Approach*

An adviser to a pooled investment vehicle that (i) is “subject to” an audit at least annually by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB and (ii) distributes its audited financial statements to each investor in the pool (or his or her independent representative) within 120 days of the limited partnership's fiscal year end, is:

- a. Deemed to have complied with the surprise examination requirement;
- b. Exempt from the requirement to send notice to a client upon opening accounts on behalf of the client;
- c. Exempt from the account statements delivery requirement; and
- d. Permitted to self-custody certain privately offered securities.<sup>156</sup>

*Subject to Annual Audit.* The rule does not address how a fund becomes “subject to” an annual audit. The SEC will consider a fund subject to an annual audit if (i) the limited partnership agreement (or other governing document) requires an annual audit, (ii) the fund has entered into an ongoing engagement letter with an independent public accountant, or (iii) the fund has disclosed to its investors that an audit will be performed annually.<sup>157</sup>

*Limited Exemption.* The obligations under the Custody Rule for an adviser taking advantage of the “audit approach” are limited to maintaining assets with a qualified custodian. This approach reflects the SEC's understanding that the annual audit of

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<sup>156</sup> Rule 206(4)-2(b)(4); Rule 206(4)-2(b)(2)(ii). Failure to distribute financial statements that meet the requirements of the rule will result in the loss of these exemptions and a violation of the underlying requirements. See, e.g., *Spruce Investment Advisors, LLC*, Advisers Act Rel. No. 5987 (Mar. 30, 2022) (self-custody of privately offered securities).

<sup>157</sup> 2003 Adopting Release, *supra* note 8 at n.47. This interpretation addresses how an adviser sponsoring a new private fund will comply with the Custody Rule before its first audit.

the fund's financial statements provides "meaningful" protections for investors.<sup>158</sup> Most advisers to private funds use the audit approach because the funds' governing documents typically require the fund to be annually audited, and few wish to send account statements that reflect portfolio transactions to investors in pooled investment vehicles, as required by the "surprise examination approach," discussed below.

*Available to Pooled Investment Vehicles.* The audit approach is available only with respect to clients that are pooled investment vehicles.<sup>159</sup> These include limited partnerships, limited liability companies, trusts, and other types of pooled investment vehicles.<sup>160</sup> An adviser that advises both pooled investment vehicles and other accounts may use this approach only for the pooled investment vehicles, *i.e.*, it will have to arrange for a surprise examination by an independent public accountant for its other client assets. An adviser can choose to rely on the audit approach with respect to all or some of the pooled investment vehicles.

*Conditions.* Care must be taken that each of the conditions for use of the audit approach is met:

- a. *PCAOB Registered and Inspected.* To prevent the type of auditor implicated in the Madoff fraud from certifying financial statements of funds under the audit approach, the rule requires that the annual audit be conducted by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB.<sup>161</sup>

*Broker-Dealer Auditors.* When the SEC adopted this requirement in 2009, only accountants to publicly-traded companies were both registered and inspected by the PCAOB, which excluded many smaller accounting firms that audited broker-dealers and advisers, including well known boutique accounting firms that specialize in auditing private funds. In 2010, the Dodd-Frank Act addressed this, in part, by extending PCAOB authority to include auditors of broker-dealers.<sup>162</sup> The SEC staff has issued a letter permitting advisers whose funds are audited by these

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<sup>158</sup> 2003 Adopting Release, *supra* note 8.

<sup>159</sup> Question X.I of SEC Staff FAQs. The term "pooled investment vehicle" is not defined in rule 206(4)-2. In one enforcement action, the SEC asserted that a fund of private equity funds was a pooled investment vehicle because it held itself out as investing in securities and was not registered under the Investment Company Act in reliance on Section 3(c)(1) of that Act. *Knelman Asset Mgmt. Group, LLC*, Advisers Act Rel. No. 3705 (Oct. 28, 2013). The audit approach is likely to be available to a broader range of pooled investment vehicles than private funds relying on Section 3(c)(1) or 3(c)(7). See, e.g., Investment Company Institute, SEC Staff No-Action Letter (Sep. 5, 2012) (treating 529 plan trust as a pooled investment vehicle and providing no-action relief if audited financial statements of plan provided to state agency sponsoring plan).

<sup>160</sup> The SEC staff has clarified that the audit exception is available regardless of the number of investors (even a single one) or amount of assets in the pool. Question VI.11 of SEC Staff FAQs.

<sup>161</sup> Rule 206(4)-2(b)(4)(ii). See *Diastole Wealth Mgmt., Inc.*, Advisers Act Rel. No. 5855 (Sep. 10, 2021) (accountant auditing financial statements of hedge fund was not registered with PCAOB); *Parallax Investments, LLC*, Advisers Act Rel. No. 3726 (Nov. 26, 2013) (same); *Columbia River Advisors, LLC*, Advisers Act Rel. No. 4734 (July 28, 2017) (accounting firm registered with PCAOB but not subject to PCAOB inspection); *Southwind Associates of NJ Inc.*, Advisers Act Rel. No. 4834 (Dec. 22, 2017) (same).

<sup>162</sup> Section 982 of the Dodd-Frank Act.

firms to continue to use the audit approach until the PCAOB adopts rules establishing a permanent inspection program for auditors of broker-dealers.<sup>163</sup>

- b. *Financial Statement Preparation.* The audited financial statements must be prepared in accordance with U.S. Generally Accepted Accounting Principles (“U.S. GAAP”) and audited in accordance with U.S. Generally Accepted Auditing Standards (“U.S. GAAS”).<sup>164</sup> Financial statements do not meet these requirements if the auditor cannot give an unqualified opinion.<sup>165</sup> Thus, problems with the pool’s financial statements will create a serious problem under the Custody Rule for advisers.<sup>166</sup> In some cases, misconduct such as mis-valuation of fund assets that has nothing to do with the safekeeping of fund assets will result in a violation of the Custody Rule if the misconduct affects the financial statements.<sup>167</sup>

*Non-U.S. Pooled Investment Vehicles.* An adviser to a non-U.S. pooled investment vehicle that is subject to the Custody Rule may have financial statements prepared in accordance with a different comprehensive system of accounting (e.g., IFRS) so long as the financial statements (i) contain information substantially similar to financial statements prepared in accordance with U.S. GAAP, and (ii) are reconciled to U.S. GAAP.<sup>168</sup> The SEC staff has issued a no-action letter permitting advisers to forgo reconciliation with U.S. GAAP where the financial statements are not delivered to U.S. persons.<sup>169</sup>

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<sup>163</sup> *Seward & Kissel LLP*, SEC Staff No-Action Letter (Dec. 11, 2019). The PCAOB is currently operating on a temporary program for the inspection of accountants that audit the financial statements of broker-dealers. See PCAOB Adopts Interim Inspection Program for Broker-Dealer Audits and Broker and Dealer Funding Rules (June 14, 2011), available at [https://pcaobus.org/News/Releases/Pages/06142011\\_OpenBoardMeeting.aspx](https://pcaobus.org/News/Releases/Pages/06142011_OpenBoardMeeting.aspx).

<sup>164</sup> Rule 206(4)-2(b)(4); Question VI.6 of SEC Staff FAQs.

<sup>165</sup> Advisers relying on the audit approach must report the receipt of a qualified opinion on Schedule D to Form ADV. See Section 9.C.(6) of Schedule D of Form ADV. See also *Sands Brothers Asset Mgmt. LLC et al.*, Advisers Act Rel. No. 3099 (Oct. 22, 2010) (auditor “disclaimer” of opinion on financial statements caused the audit not to be prepared in accordance with U.S. GAAS and therefore caused the financial statements not to be prepared in accordance with U.S. GAAP); and *ED Capital Mgmt., LLC*, Advisers Act Rel. No. 5344 (Sep. 13, 2019) (auditing firm was never able to complete an audit and express an opinion on whether the fund’s financial statements were prepared in accordance with GAAP).

<sup>166</sup> See *Corinthian Capital Group, LLC*, Advisers Act Rel. No. 5229 (May 6, 2019) (auditor withdrew unqualified opinion after identifying inappropriate transfers and misclassification of expenses); *Alpha Titans, LLC*, Advisers Act Rel. No. 4073 (Apr. 29, 2015) (hedge fund distributed to investors financial statements that failed to reflect certain related-party relationships and material transactions and thus were not prepared in accordance with GAAP). The SEC also brought an enforcement action against the fund’s auditor for aiding and abetting the adviser’s violation of rule 206(4)-2 and for improper professional conduct. *Simon Lesser, CPA*, Advisers Act Rel. No. 4072 (Apr. 29, 2015). See also *Enviso Capital, LLC*, Advisers Act Rel. No. 4731 (July 19, 2017) (settled enforcement action alleging mis-valuation of private fund assets resulted in failure of the fund’s financial statements to be prepared in accordance with GAAP); *Spruce Investment Advisors, LLC*, *supra* note 156 (settled enforcement action alleging failure of adviser to maintain records supporting reallocation of expenses responsible for delays in completion of audits).

<sup>167</sup> *Enviso Capital, LLC*, *supra* note 166 (settled enforcement action alleging failure to properly value hedge fund assets).

<sup>168</sup> 2003 Adopting Release, *supra* note 8 at n.41.

<sup>169</sup> *Goodwin, Procter & Hoar*, SEC Staff No-Action Letter (Feb. 28, 1997). Offshore advisers registered with the SEC are not subject to the Custody Rule with respect to offshore funds they advise. See discussion, *infra*, Section VI.E of this outline.

- c. *Liquidation Audit.* In addition to an annual audit, the adviser must arrange for a special audit of the financial statements upon liquidation of the pooled investment vehicle (if the liquidation occurs before the end of the vehicle's fiscal year), which must be distributed to investors promptly upon completion of the audit.<sup>170</sup>

The liquidation audit is designed to provide information to investors that they can use to protect their rights, but unless planned for can impose significant expenses on the remaining investors when the fund is winding down.<sup>171</sup>

- *Surprise Examination Approach.* In some cases, following an audit, an adviser may consider switching the fund to the surprise examination approach and avoid ongoing audit expenses, including the expense of a liquidation audit.<sup>172</sup> This may be particularly appealing to an adviser to a fund that is planning to liquidate but continues to hold cash and government securities to pay for expenses or as a reserve against contingent liabilities. While the adviser must then begin providing quarterly reports of fund portfolio transactions to fund investors, disclosure of these types of investments should not adversely affect the fund or its investors.
  - *Proprietary Assets.* Once the limited partners (or other investors) redeem their interests, the remaining assets of the fund should properly be viewed as proprietary assets (rather than client assets) to which the rule would not apply.<sup>173</sup> Accordingly, neither a termination audit nor a surprise examination would be required.
- d. *Delivery of Financial Statements.* The financial statements must be delivered to investors within 120 days of the pool's fiscal year end, and within 180 days of the fiscal year end of a fund-of-funds.<sup>174</sup> The failure to deliver timely financial

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<sup>170</sup> Rule 206(4)-2(b)(4)(iii).

<sup>171</sup> The audit requirements under the rule are not excused when the assets of the pooled investment vehicle diminish. See *Aria Partners GP, LLC*, Advisers Act Rel. No. 4991 (Aug. 22, 2018) (settled enforcement action alleging that audits were not conducted for two years because the funds had wound down and there were almost no assets at year-end).

<sup>172</sup> An adviser switching to the surprise examination approach would need to amend Section 9.C.(5) of Schedule D of Form ADV and engage an independent public accountant to conduct the surprise examination, which could be the same accountant that had been auditing the fund's financial statements.

<sup>173</sup> The SEC staff has provided more limited no-action assurances where interests in the fund continued to be held by principals of the adviser and their families. See *16th Amendment Advisors LLC*, SEC Staff No-Action Letter (Mar. 23, 2015). It seems clear, however, that the Custody Rule should not apply where interests in the fund are held exclusively by the fund's adviser and/or its affiliates notwithstanding the reasoning of the D.C. Circuit in *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006) (suggesting that the Advisers Act must be interpreted to treat the private fund as the "client" for all purposes under the Advisers Act).

<sup>174</sup> 2009 Adopting Release, *supra* note 12 at n.45 (citing *ABA Committee on Private Investment Entities*, SEC Staff No-Action Letter (Aug. 10, 2006)). A fund-of-funds can delay delivery for 260 days after the end of the fiscal year of the fund-of-funds. Question VI.8B of SEC Staff FAQs. For this purpose, the SEC staff defines a fund-of-funds as a pooled investment vehicle that has 10% or more of its assets invested in pooled investment vehicles that are not related persons of the pool.

statements to investors will cause the adviser relying on the audit approach to violate the Custody Rule.<sup>175</sup>

The SEC staff has stated that it would not recommend enforcement action, however, if the adviser relying on the audit approach “reasonably believed” that the 120 day deadline would be met but that deadline is missed due to “unforeseeable circumstances.”<sup>176</sup> Where financial statements are repeatedly distributed late, or the SEC concludes that the adviser bore some responsibility for the lateness, an adviser may not be able to rely on this staff position.<sup>177</sup> Most of the enforcement actions for failure to deliver financial statement involved multiple failures.

- e. *Special Purpose Vehicles.* Advisers to pooled investment vehicles may from time to time use special purpose vehicles (“SPVs”) to facilitate investments in certain securities. The adviser has the choice of (i) treating each SPV as a separate client and distributing the financial statements for each to the investors in the pooled investment vehicle, or (ii) subject to the conditions discussed below, treating the pooled investment vehicle and the SPVs as a single client and distributing the audited consolidated financial statements to the investors.<sup>178</sup>

*Consolidation Issues.* The SEC staff has clarified that if an SPV is owned by one or more pooled investment vehicles controlled by the same investment adviser, then the adviser may (regardless of whether the SPV owns different securities) treat the assets of the SPV as the assets of the pooled investment vehicle for purposes of the Custody Rule.<sup>179</sup> However, if there are owners other than (i) the adviser, (ii) its related persons (e.g., the general partner) or (iii) other funds controlled by the adviser or its related persons, the adviser must treat the SPV as a separate client and deliver separate audited financial statements in order to comply with the audit approach.

*Escrow Accounts.* Advisers to private equity funds sometimes establish escrow accounts to hold a portion of the proceeds of a sale of a security, which typically belong to both the seller and purchaser. The SEC staff has stated it will not object if the adviser maintains client funds in such escrow accounts provided, among other things, the client is a pooled investment vehicle that relies on the audit

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<sup>175</sup> *Spruce Investment Advisors, LLC*, *supra* note 156; *Diastole Wealth Mgmt., Inc.*, *supra* note 161; *SQN Capital Mgmt., LLC*, Advisers Act Rel. No. 5573 (Sep. 4, 2020); *TSP Capital Mgmt. Group, LLC*, Advisers Act Rel. No. 5508 (May 22, 2020); *New Silk Route Advisors, L.P.*, Advisers Act Rel. No. 4970 (July 17, 2018); *Sands Brothers Asset Mgmt., LLC et al.*, Advisers Act Rel. No. 3960 (Oct. 29, 2014); *Columbia River Advisors, LLC*, *supra* note 161; *Aletheia Research and Mgmt., Inc.*, Advisers Act Rel. No. 3197 (May 9, 2011).

<sup>176</sup> Question VI.9 of SEC Staff FAQs. See *Sands Brothers Asset Mgmt., LLC*, *supra* note 175 (circumstances that led to the audits’ delay “were predictable and not unforeseeable”).

<sup>177</sup> *New Silk Route Advisors, L.P.*, *supra* note 175 (late distribution of audit reports due to foreseeable result of failure to change processes related to audits); *Hudson Housing Capital LLC*, Advisers Act Rel. No. 5047 (Sep. 25, 2018) (adviser missed multiple deadlines for distributing financial statements and failed to subsequently revise its processes).

<sup>178</sup> 2009 Adopting Release, *supra* note 12 at Section II.F (explaining the operation of rule 206(4)-2(c)).

<sup>179</sup> *Private Funds and the Application of the Custody Rule to Special Purpose Vehicles and Escrows*, IM Guidance Update 2014-07 (June 2014).



approach and includes the portion of the escrow attributable to the pooled investment vehicle in its financial statements.<sup>180</sup>

*Combined Financial Statements.* Under limited circumstances the SEC staff has indicated that an adviser may meet the requirements of the audit exception by means of delivery of “combined financial statements” of multiple SPVs.<sup>181</sup> The circumstances are much more limited than those under which accounting rules permit combined financial statements.

## 2. *Surprise Examination Approach*

Note: The SEC has proposed to require registered advisers to obtain audits with respect to each private fund they advise, eliminating the surprise examination approach for private funds.<sup>182</sup>

If a pooled investment vehicle cannot (or does not wish to) comply with the audit approach, the adviser must obtain a surprise examination for the pooled investment vehicle.<sup>183</sup> The surprise examination approach may work well for advisers to smaller pooled investment vehicles (that may engage an accountant for a surprise examination of other accounts for which it has custody), but provides challenges for advisers to hedge funds and other larger pooled investment vehicles because the adviser must also:

- a. *Qualified Custodian.* Maintain all client funds and securities, including privately offered securities, with a qualified custodian.<sup>184</sup> Because many prime brokers will not accept custody of some forms of privately offered securities, many advisers have had to make arrangements with other custodians.
- b. *Notice and Account Statements.* Provide notice to clients of the identity of the custodian (typically, in the offering documents), and form a reasonable belief that each qualified custodian is sending account statements directly to investors in the pool or their independent representative.<sup>185</sup> These account statements from the qualified custodian must report account activities of the pooled vehicle and not for a limited partner’s individual capital account, thus effectively requiring the hedge

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<sup>180</sup> *Id.*

<sup>181</sup> *Letter to CFOs from the Office of Chief Accountant of the Division of Investment Management* (Oct. 23, 2020).

<sup>182</sup> *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, *supra* note 17.

<sup>183</sup> Failure to satisfy the requirements of the audit approach is not itself a violation of the rule. Rather, as explained in SEC enforcement releases, a violation will occur if neither the audit approach nor the surprise examination approach is satisfied. *See, e.g., TSP Capital Mgmt. Group, LLC.*, *supra* note 175 (“TSP Capital did not satisfy the requirements of the Audited Financials Alternative in Rule 206(4)-2(b)(4) for the Cameroon Fund for fiscal years 2014 through 2018 and was therefore obligated to comply with Rule 206(4)-2(a)(2), (3) and (4), which it also failed to do.”).

<sup>184</sup> Rule 206(4)-2(a)(i); Question VII.1 of SEC Staff FAQs.

<sup>185</sup> Rule 206(4)-2(a)(5) requires that an adviser that has custody because it is a general partner (in the case of a limited partnership) or a managing member (in the case of a limited liability company) must send account statements required by paragraph (a)(3) of the rule to limited partners or other beneficial owners of the pooled investment vehicle rather than the clients of the adviser, which could be construed to be the pooled investment vehicle itself.

fund to provide complete transparency of its portfolio to investors (and perhaps competitors).<sup>186</sup>

- c. *Annual Surprise Examination.* Undergo an annual surprise examination by an independent public accountant.<sup>187</sup>

## B. Self-Custody or Maintaining Client Assets with a Related Person

Rule 206(4)-2 does not require the use of independent third-party custodians. Rather, the rule imposes additional requirements when client assets are maintained by the adviser itself or by a “related person” instead of an independent qualified custodian.<sup>188</sup>

To maintain assets under the rule the adviser or related person must be a “qualified custodian.” Thus, these provisions typically apply when the adviser is a dually-registered broker-dealer whose clients maintain assets in brokerage accounts, such as wrap fee accounts or fee-based brokerage accounts. They may also apply when client assets are maintained with a related person that is a bank or futures commission merchant.

The rule requires an adviser whose client assets are maintained with a related person to (i) cause the related person to be subject to a surprise examination and (ii) obtain an internal control report from the independent public accountant. As discussed below, a surprise examination may be avoided if the related person is “operationally independent” of the adviser.

### 1. *Surprise Examination*

This is the same examination that any other adviser with custody of client assets must undergo, with two significant differences. First, the examination must be performed by an independent public accountant registered with, and subject to regular inspection by, the PCAOB.<sup>189</sup> Second, the accountant must, in preparing its report, review the most recent report on internal controls obtained by the adviser pursuant to the Custody Rule (discussed below) and consider whether any weaknesses identified in that report would affect its report.<sup>190</sup>

### 2. *Internal Control Report*

The adviser must obtain, or receive from the related person acting as the qualified custodian, an annual report of the internal controls relating to the custody of client assets prepared by an independent public accountant registered with, and subject to regular inspection by, the PCAOB, such as an SSAE 18 report.<sup>191</sup>

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<sup>186</sup> See Question VI.2 of SEC Staff FAQs. See *Walter V. Gerasimowicz*, *supra* note 116 (order making findings that, among other things, adviser not using audit approach distributed account statements to investors that provided no information about the fund’s specific portfolio investments).

<sup>187</sup> Rule 206(4)-2(a)(4).

<sup>188</sup> Rule 206(4)-2(a)(6).

<sup>189</sup> Rule 206(4)-2(a)(6)(i).

<sup>190</sup> Guidance for Accountants, *supra* note 148.

<sup>191</sup> Rule 206(4)-2(a)(6)(ii). “SSAE 18 reports” refer to a report prepared in accordance with the AICPA’s Statement on Standards for Attestation Engagements No. 18, which replaced the SSAE 16 report in 2017 and the Type II

- a. *Opinion of Accountant.* The report must contain an opinion of the accountant as to whether controls that meet the control objectives relating to custodial services, including whether the safeguards of funds and securities held by either the adviser or the related person, are suitably designed, placed in operation, and are operating effectively.<sup>192</sup>
- b. *Verification of Funds and Securities.* The accountant must verify that the funds and securities are reconciled to a custodian other than the adviser or the related person (such as The Depository Trust Company).

*Broker-Dealers.* A broker-dealer that clears transactions or carries customer accounts must obtain a written internal control report prepared by an independent public accountant registered with and inspected by the PCAOB.<sup>193</sup> The SEC has stated that such a report satisfies the internal control report requirements of rule 206(4)-2.<sup>194</sup>

The broker-dealer control report does not satisfy the surprise verification examination requirement for dually-registered advisers or advisers that maintain custody with a related person that is not operationally independent. See *below* Section VI.B.3.

### 3. *Exception for Operationally Independent Related Persons*

The adviser may forgo the surprise examination if (i) the adviser has custody solely because a related person is maintaining those assets,<sup>195</sup> and (ii) the related person acting as qualified custodian is “operationally independent” of the adviser.<sup>196</sup> The adviser must, however, still obtain the internal control report from the related person.<sup>197</sup> The SEC concluded that “firms under common ownership that are operationally independent of each other present substantially lower client custodial risks than those that are not because misuse of client assets would tend to require collusion among employees...”<sup>198</sup>

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SAS 70 report in 2011. The SEC staff has indicated that two additional types of reports issued under AICPA standards would be sufficient to satisfy the Custody Rule, AT 601 and AT 101. Question XIII.3 of SEC Staff FAQs.

Only client assets held by a related person “in connection with advisory services” provided by the adviser would be attributed to the custody of the adviser. Consequently, an adviser will not be deemed to have custody of client assets held with a related person custodian if the adviser does not provide advice with respect to such assets. 2009 Adopting Release, *supra* note 12 at n. 106.

<sup>192</sup> Control objectives are listed in the Guidance for Accountants, *supra* note 148.

<sup>193</sup> Rule 17a-5(g) under the Securities Exchange Act of 1934.

<sup>194</sup> *Broker-Dealer Reports*, Exchange Act Rel. No. 70073 (July 20, 2013) at Section II.H.

<sup>195</sup> Rule 206(4)-2(b)(6)(i). If, for example, the adviser also has custody because it is a trustee of the trust the assets of which are maintained with a related person qualified custodian, it could not take advantage of the exception and would be required to obtain a surprise examination of client assets.

<sup>196</sup> Rule 206(4)-2(b)(6)(ii).

<sup>197</sup> Question XIII.2 of SEC Staff FAQs.

<sup>198</sup> 2009 Adopting Release, *supra* note 12 at n. 110 and accompanying text.

*Operationally Independent.* The rule does not explain when a related person is operationally independent. Instead, it creates a hurdle, presuming a related person is not operationally independent unless each of the following conditions is met:

- a. Client assets in the custody of the related person are not subject to claims of the adviser's creditors;
- b. Advisory personnel do not have any access to or possession of client assets, or power to control dispositions of client assets for the benefit of the adviser or its related person, or otherwise have the opportunity to misappropriate such client assets;
- c. Advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision;
- d. Advisory personnel do not hold any position with the related person or share premises with the related person; and
- e. No other circumstance can reasonably be expected to compromise the operational independence of the related person.<sup>199</sup>

The SEC has stated that it would not consider a related person that shared management persons with the adviser, or that had an owner that is actively engaged in the management of the two firms, to be operationally independent of the adviser.<sup>200</sup>

An adviser relying on this exemption must maintain a file memo describing the basis for its determination that the related person is operationally independent.<sup>201</sup> Such adviser should consider establishing compliance policies designed to preserve operational independence and compliance officials of the adviser should be tasked with testing their operation.

#### 4. *Pooled Investment Vehicles and Related Person Custody*

In many cases a hedge fund or other type of pooled investment vehicle will maintain fund assets with one or more prime brokers. The adviser to the pooled investment vehicle will be deemed to have custody of the fund assets if a related person of the adviser serves as general partner or managing member of the fund. The adviser would not need to receive an internal control report from (i) the general partner if the general partner is not serving as a qualified custodian, and (ii) the prime broker that is serving as qualified custodian but is not a related person of the adviser. The adviser would, however, be required to undergo a surprise examination unless the fund qualified for the audit approach.<sup>202</sup>

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<sup>199</sup> Rule 206(4)-2(d)(5) (defining "operationally independent").

<sup>200</sup> 2009 Adopting Release, *supra* note 12 at n. 111.

<sup>201</sup> 2009 Adopting Release, *supra* note 12 at n.116 and accompanying text (citing Rule 204-2(b)(5)).

<sup>202</sup> Rule 206(4)-2(b)(4); Question XIII.1 of SEC Staff FAQs.

### C. Advisers to Registered Investment Companies

Advisers are exempt from all provisions of the rule with respect to clients that are registered investment companies.<sup>203</sup> These accounts are subject to the requirements of section 17(f) of the Investment Company Act and the Investment Company Act custody rules.<sup>204</sup>

### D. Advisers to Real Estate Partnerships

If an investment adviser is the general partner for a real estate partnership, the Custody Rule does not apply to the real estate partnership's assets, unless the partnership is an advisory client of the investment adviser.<sup>205</sup> This turns on whether the advice being provided is about securities held by the partnership. If the partnership holds only direct interests in real property, the rule would not apply even if the adviser is registered under the Advisers Act. If the partnership holds interests in REITs, limited partnerships or limited liability companies that own real estate, the general partner will likely be giving advice regarding securities, and the rule will apply.<sup>206</sup>

### E. Non-U.S. Advisers

The Custody Rule applies to registered advisers with a principal place of business outside the United States only with respect to their U.S. clients.<sup>207</sup> As a general matter, most of the substantive provisions of the Advisers Act, including the Custody Rule, are not applied to non-U.S. clients of an SEC-registered adviser that has a principal office and place of business outside the U.S. This policy was first set forth in a staff letter from the Division of Investment Management, in which Division staff stated that they would not recommend enforcement against an offshore adviser under such circumstances.<sup>208</sup> For purposes of

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<sup>203</sup> Rule 206(4)-2(b)(5). The staff has extended this exception to unregistered money market funds available exclusively to registered investment companies, provided that the financial statements of the unregistered money market funds are delivered to each registered investment company's chief compliance officer, audit committee members, and independent directors. Question VI.10 of SEC Staff FAQs.

<sup>204</sup> Omitted (perhaps unintentionally) are shares of business development companies (BDCs), which are also subject to Section 17(f). See Section 59 of the Investment Company Act.

<sup>205</sup> 2003 Adopting Release, *supra* note 8 at n.16.

<sup>206</sup> If the rule applies, it will apply to all the client funds under the control of the adviser and not simply those held in connection with the securities activities of the real estate fund. See *Brighton Pacific Realty Asset Mgmt. Co.*, SEC Staff No-Action Letter (Feb. 10, 1992) (bank account established to collect rents and pay expenses associated with real property). If the Custody Rule does not apply, it will not apply to the entire fund, including the cash the fund holds, because the fund will not be an advisory client.

<sup>207</sup> On the other hand, the Custody Rule applies fully with respect to the non-U.S. clients of a U.S.-based adviser over which the adviser has custody. The Custody Rule permits such clients to maintain their assets with a local custodian. Rule 206(4)-2(d)(6)(iv), discussed *supra*, Section V.A.5 of this outline.

<sup>208</sup> See *Uniao de Bancos de Brasileiros S.A.*, SEC Staff No-Action Letter (July 28, 1992). See also *Royal Bank of Canada*, SEC Staff No-Action Letter (June 3, 1998) (staff will not recommend enforcement action against registered offshore advisers if the advisers do not comply with certain substantive rules under the Advisers Act with respect to their advisory services to their foreign clients, provided that their activities do not involve conduct or effects in the United States). The Unibanco interpretation was adopted by the SEC in 2011. *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers*, Advisers Act Rel. No. 3222 (June 22, 2011) at text accompanying n. 515.

this policy, an individual's residence generally determines whether he or she is a U.S. or non-U.S. client.

*Pooled Investment Vehicles.* In the case of a pooled investment vehicle, the partnership, limited liability company, or corporation is the client,<sup>209</sup> and its place of organization determines whether it is a U.S. person.<sup>210</sup> The combined effect of these interpretations is to make the Custody Rule inapplicable to a pooled investment vehicle organized offshore that is advised by an adviser whose principal office and place of business is outside the jurisdiction of the United States—even if many of the investors are U.S. persons.<sup>211</sup>

## VII. Form ADV

Form ADV requires extensive information about an adviser's custodial practices. These requirements are found mostly in Item 9 of Part 1 and Section 9.C. of Schedule D.

### Part 1 of Form ADV

#### A. Item 9 Custody

##### 1. General Information

Items 9.A. and 9.B. of Part 1A require information about (i) whether the adviser or a related person has custody of client funds and securities, and (ii) the dollar amount and number of client accounts for which the adviser and its related persons have custody.<sup>212</sup>

- a. Responses to either item are not required if (i) the sole reason the adviser (or a related person) has custody is because it has authority to deduct the amount of its fee from client accounts; or (ii) the related person is "operationally independent" from the adviser.
- b. Advisers should exclude from responses to Item 9.A. assets held in custody by related persons, which are reported in Item 9.B.
- c. Assets subject to an SLOA (discussed above) must be reported in Item 9 as assets over which the adviser has custody even if the adviser qualifies for SEC no-action relief from the surprise examination requirement.<sup>213</sup> This is because the adviser has discretion as to the amount or timing of transfers under the SLOA and thus the SEC staff considers that adviser to have custody of client assets subject to the SLOA.

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<sup>209</sup> *Goldstein v. SEC*, *supra*, note 173.

<sup>210</sup> See Rule 203(m)-1(d)(8) (defining United States person by reference to Regulation S).

<sup>211</sup> While this outcome is not intuitive, it reflects a policy decision of the SEC to limit the extraterritorial reach of its regulation in circumstances in which an ordinarily sophisticated and/or wealthy investor seeks to invest in an offshore entity managed by an offshore adviser.

<sup>212</sup> The term "custody" is defined in the Glossary of Form ADV identically as it is defined in Rule 206(4)-2(d).

<sup>213</sup> *Investment Adviser Association*, *supra* note 48.

- d. It is unclear whether custody of assets attributable to the adviser as a result of the custody of those assets by an employee (who will be a related person of the adviser) must be reported in response to Item 9.A. or 9.B. The SEC has not provided guidance, but it seems clear that the assets should *not* be reported in response to both, which would result in over-counting of assets.<sup>214</sup>

The SEC staff views advisers with custody as potentially presenting more significant compliance risks and thus generally schedules them for more frequent examinations. They use information from this item to identify such advisers.<sup>215</sup>

## 2. *Method of Compliance*

Item 9.C. requires an adviser that (i) has custody of client assets or (ii) whose related person has custody of the adviser's client assets in connection with the advisory services provided by the adviser to report whether:

- a. A qualified custodian sends quarterly account statements to clients.
- b. An independent public accountant audits pooled investment vehicles.
- c. An independent public conducts an annual surprise verification of client assets.
- d. An independent public accountant prepares an internal control report.

It is possible for an adviser to employ one method of compliance for some clients and another for other clients. Advisers must check each box that applies and, if any of the last three are checked, must identify the accountant in Section 9.C. of Schedule D.

Section 9.C. requires the adviser to provide information about each independent public accountant engaged to either (i) perform a surprise examination, (ii) perform an audit of a private fund or (iii) prepare an internal control report. An adviser to a private fund that has identified the accountant auditing the fund's financial statements in response to Section 7.B.(1) of Schedule D does not need to repeat the information in Section 9.C.

## 3. *Self-Custody*

Item 9.D. asks whether the adviser or a related person acts as a *qualified custodian*. A qualified custodian is the company at which client assets are maintained, and is limited by the rule to broker-dealers, banks, futures commission merchants, and foreign financial institutions. An adviser that merely has custody of client assets would respond negatively.

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<sup>214</sup> The confusion has arisen because under the definition of "custody" in the Form ADV Glossary, "you" (the adviser) are deemed to have custody if your related persons have custody in connection with adviser services you provide.

<sup>215</sup> SEC enforcement actions against advisers that have failed to recognize that they have custody of client assets frequently include an allegation that they failed to properly report that they have custody on Form ADV in response to these items. See, e.g., *Ascension Asset Mgmt., LLC*, *supra* note 16; *Stanley Peter Kerry*, Advisers Act Rel. No. 1550 (Jan. 25, 1996).

Detailed information about related persons that are custodians must be provided in Section 7.A. of Schedule D. Related persons must be identified even if they are “operationally independent” of the adviser and, as a result, the adviser may not be required to obtain a surprise verification of client assets.

#### 4. *Surprise Examination*

Item 9.E. requires an adviser to report the date of any surprise examination of client assets that occurred during its last fiscal year in an annual updating amendment only. The SEC can compare the responses to this item with the adviser’s response to Item 9.C. to determine whether an adviser relying on the surprise examination method of compliance has in fact obtained a surprise examination.

#### 5. *Total Number of Custodians*

Item 9.F. requires an adviser to report the total number of client custodians, including custodians of clients whose assets the adviser has custody of only because it has authority to deduct advisory fees (and are not otherwise required to report on Item 9). If several clients use the same custodian (perhaps because the adviser requires use of a single custodian), the adviser should report only one custodian. If multiple affiliates of the adviser have custody of client assets, each should be counted separately if they are separate legal entities.<sup>216</sup>

#### 6. *Advisers with Custody Solely because they Deduct Fees*

Advisers with custody of client assets solely because they have authority to deduct fees may respond “no” to Item 9.A. (which contains an instruction to this effect), but must respond to the other items (which do not). In a March 2014 email to registered advisers, the SEC staff explained that advisers with authority to deduct fees from client assets will likely respond “no” to Items 9.B. and 9.D., and most likely would not have to report information in response to Items 9.C. or 9.E., but likely would need to indicate that there is at least one person acting as qualified custodian in response to Item 9.F., which requires advisers to report the total number of persons (including the adviser and its related persons) that act as a qualified custodian for the adviser’s clients.

An adviser with custody as a result of authority to directly deduct advisory fees is still subject to the rule’s requirement that client funds or securities be maintained with a qualified custodian. Because most advisers submit invoices to such custodians in order to be paid, advisers will ordinarily have this information.

#### 7. *Updating*

- Items 9.A.(1) and 9.B.(1) must be amended promptly upon obtaining custody of client assets.
- Items 9.A.(2) and 9.B.(2) (the amount of assets custodied and total number of clients) must be updated only in the annual updating amendment.

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<sup>216</sup> The SEC staff has not provided guidance on these last two points, but the application of the item seems clear.



- Item 9.C. (method of compliance) must be updated promptly if any information becomes inaccurate.
- Item 9.D. (qualified custodians) must be updated promptly if any information becomes inaccurate.
- Items 9.E. and 9.F. need be updated only in the annual updating amendment.

The corresponding sections of Schedule D must be updated when the item is required to be updated.<sup>217</sup>

#### B. Item 5 Separate Accounts

*Separate Account Custodians.* Item 5.K.(4) requires advisers to identify and provide certain information about each custodian that holds 10% or more of the adviser's regulatory assets under management attributable to separate accounts in Section 5.K.(3) of Schedule D.<sup>218</sup> A separate Section 5.K.(3) must be completed for each custodian that holds 10% or more of an adviser's separately managed account regulatory assets under management.

#### C. Item 7.A. Related Persons

Item 7.A. requires advisers to report their financial industry affiliations and activities, and requires identification of certain related persons, including broker-dealers, banks and futures commission merchants.<sup>219</sup> A separate Section 7.A. must be completed for each related person that acts as a qualified custodian (but not a mutual fund transfer agent) in connection with advisory services provided by the adviser.

#### D. Item 7.B Private Funds

Item 7.B.(1) requires advisers to complete a separate Section 7.B.(1) of Schedule D for each private fund it advises. Sub-advisers to private funds complete an abbreviated Section 7.B.(2); information about the fund (including its custodians) will have been reported by the principal adviser to the private fund.

Section 7.B.(2) of Schedule D requires advisers to private funds to report information about each private fund, including information about the fund's auditor, prime broker, custodian and financial statements. The information is used by the SEC staff to, among other things, monitor compliance with the Custody Rule.

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<sup>217</sup> General Instruction 4 to Form ADV.

<sup>218</sup> The amount of aggregate separately managed account assets is determined by subtracting from the firm's regulatory assets under management (RAUM) the assets attributable to (i) investment companies, (ii) business development companies, and (iii) pooled investment vehicles such as private funds. See Item 5.D. This item was added in *Form ADV and Investment Advisers Act Rules*, Advisers Act Rel. No. 4509 (Aug. 25, 2016), which expanded the amount of information about separate accounts that must be reported on Form ADV.

<sup>219</sup> There is an exception (set forth in the instructions to Item 7.A.) to the requirement to report related persons available if the adviser has no dealings with the related person, etc. That exception would not be available to exclude a related person that acts as a qualified custodian.

## 1. *Auditors*

Question 23 requires an adviser advising a private fund to report with respect to each private fund:

- The name of the firm that audits its financial statements;
- Whether the auditing firm meets the independence requirements and is registered with and subject to regular inspection by the PCAOB;
- Whether the fund's financial statements for the most recently completed fiscal year have been distributed to investors; and
- Whether all the private fund's financial statements since the adviser's last annual updating amendment contain unqualified opinions.<sup>220</sup>

Many of these questions go to whether the audit has met the requirements of the audit approach to compliance with the Custody Rule and responses are required regardless of whether the adviser is relying on the audit approach.

## 2. *Prime Brokers*

Question 24 requires an adviser to report each prime broker used by the private fund, and asks whether the prime broker has custody for some or all of the fund's assets. This section is designed for advisers to hedge funds.

## 3. *Custodians*

Question 25 requires information about each custodian used by the private fund.

## Part 2 of Form ADV

Part 2A of Form ADV requires a limited amount of information about an adviser's custody practices to be disclosed in the client brochure. All of the information requirements are in Item 15.

- If an adviser has custody of client funds or securities *and* a qualified custodian sends quarterly account statements, the adviser must explain that clients will receive them from the custodian and that clients should carefully review the statements.
- If the adviser itself *also* sends account statements, the brochure must include a statement urging clients to compare the two.<sup>221</sup>

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<sup>220</sup> As noted above, a fund delivering to investors financial statements that have received a qualified opinion would have failed to deliver required audited financial statements under the audit approach. See discussion, *supra* Section VI.A.1.b of this outline.

<sup>221</sup> This disclosure requirement essentially repeats the disclosure required in rule 206(4)-2(a)(2) ("If you send account statements to a client to which you are required to provide this notice, include in the notification provided to that client and in any subsequent account statement you send that client a statement urging the client to compare the account statements from the custodian with those from the adviser."). It would not, however, satisfy the requirements because the Custody Rule requires the statement to be included in every adviser account statement.

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