Client Alert

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SEC Targets More Firms for Custody Rule Violations

By Kelley A. Howes

On October 28, 2013, the SEC sanctioned three registered investment advisers for, among other things, violating Rule 206(4)-2 under the Advisers Act (the "Custody Rule"). These settled actions, the subject of a special SEC press release, follow a National Exam Program risk alert last spring that raised concerns about advisers' lack of compliance with the Custody Rule (see our client alert regarding the staff's concerns).

These cases serve as yet another reminder of the SEC staff's focus on the Custody Rule. They also underscore some other themes apparent in recent SEC enforcement actions, which we discuss below.

In the first case, the adviser was the managing member of a fund of private equity funds and, as such, had custody of the fund's assets. The SEC found, among other things, that the adviser failed to arrange annual surprise examinations of the fund's assets, or to provide the fund's members with audited financial statements, as required by the Custody Rule. Most troubling to the SEC was that these deficiencies occurred even though the SEC staff notified the adviser and its CCO in 2005 and again in 2011 that the firm was not in compliance with the Custody Rule. The SEC also found that the adviser failed to adopt procedures reasonably designed to prevent violations of the Custody Rule and filed Form ADVs that included untrue statements of material facts about custody of client assets. Finally, the SEC found that the adviser's CCO had no experience in the compliance industry and failed to ensure that the adviser complied with its books and records obligations.

In the second case, the investment adviser managed assets of high net worth clients and had several client arrangements that gave it access to and the ability to transfer client funds. The SEC said that the adviser did not have proper safeguards in place to protect client assets. For example, the adviser maintained certain pre-signed but otherwise blank letters of authorization to transfer client funds, one of which was used to perpetrate a third-party fraud on a client account. In addition, the firm failed to obtain an examination by an independent public accountant and to identify assets over which it maintained custody in its public disclosure documents.

In the third case, the SEC found that the adviser previously had received a deficiency letter related to its violation of the Custody Rule, but had not remedied those violations. In the course of its most recent examination, the SEC staff discovered that the adviser continued to violate the Custody Rule through its physical possession of certain promissory notes and by acting as general partner to certain funds. The SEC found that the adviser did not form a reasonable belief that a qualified custodian was sending account statements to investors, nor was the adviser subject to surprise examinations for several years. As a result, the adviser's Form ADV disclosures inaccurately stated that it did not have custody of client assets.

In each of these cases, which were settled without the respondents admitting or denying the allegations, the firms were censured and fined. In addition, in two of the cases, individual principals were fined and suspended from the securities industry. In one instance, the suspension was for a period of twelve months. In the other, the adviser's CCO was barred from acting in such capacity for three years.

In its release announcing these cases, the SEC characterizes them largely as violations of the Custody Rule. Advisers should take note, however, that they also underscore several other recent themes emanating from the SEC and its staff. Among these:

- Advisers cannot disregard deficiencies identified in a letter from the staff following an on-site examination. Resolution of such deficiencies will be the staff's first stop on its next examination. The failures to resolve these deficiencies has given rise to the Compliance Program Initiative, as discussed in our recent blog post, and several enforcement actions;
- Advisers should heed the warnings of the SEC staff. In March of this year OCIE issued a risk alert that identified concerns about advisers' failures to recognize when they have custody of client assets and other violations of the Custody Rule. Advisers should carefully consider the implications of such guidance in light of their particular business and should not wait for an examination to uncover compliance issues;
- This is not the first time that the SEC has sanctioned an adviser for its failure to appoint a CCO with the appropriate knowledge and ability to help an adviser assure compliance with the Advisers Act (see our recent blog post). Ensuring that the CCO has the appropriate training and background will go a long way to reassure the staff that an adviser takes its compliance responsibilities seriously; and
- Advisers should ensure that they annually review their compliance programs, as required by Rule 206(4)-7, and should embed in that process a review of their public disclosures and offering documents to ensure that they accurately reflect the adviser's business and policies.

Contact:

Jay G. Baris
(212) 468-8053
jbaris@mofo.com

Kelley A. Howes
(303) 592-2237
khowes@mofo.com

Daniel A. Nathan
(202) 887-1687
dnathan@mofo.com

Isabelle Sajous
(212) 336-4478
isajous@mofo.com

Robert E. Putney, III
(212) 336-4451
rputney@mofo.com

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