Proskauer

Regulation of Custodial Practices Under the Investment Advisers Act of 1940

Rule 206(4)-2

Robert E. Plaze
Partner

October 2019

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

TABLE OF CONTENTS

Page

---

* 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.

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."[1]

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."[2] 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.[3]

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.[4] The SEC staff issued a series of no-action letters that both reflected and 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 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

---

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

2 *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*, Advisers Act Rel. No. 1633 (May 15, 1997).

3 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).

4 During this period the SEC also updated custody rules under the Investment Company Act. *See Custody of Investment Company Assets with a Securities Depository,* Investment Company Act Rel. No. 25266 (Nov. 15, 2001).

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

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").[8] 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 commodity futures merchant, and the custodian provided quarterly custodial reports directly to clients. These custodians were themselves regulated as custodians 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.[9] Direct reporting by custodians would provide clients the ability to identify discrepancies, and the knowledge that custodial reports would be provided directly to clients would deter advisers from misusing client assets.[10]

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.

---

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

6 *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).

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

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

9 *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.

10 *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.")

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 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 has become 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."[11] Compliance with the rule was met by an adviser operating within standard industry best practice in which the custodial report provided a check on misuse of client assets by the adviser. The prospect of just one client (or custodian) reviewing the report and recognizing an inconsistency provided a significant deterrence on advisers.

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").[12] 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.[13] 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

Since the Madoff scandal, the SEC's examination program 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

---

11 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.

12 *Custody of Funds or Securities of Clients by Investment Advisers,* Advisers Act Rel. No. 2968 (Dec. 30, 2009) ("2009 Adopting Release.").

13 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 (Jun 5, 2019).

and, in some cases, advisory clients to confirm client positions.[14] 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.[15] These examinations have led to numerous settled enforcement actions in which the SEC alleged violations of the Custody Rule.

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 not that a surprise examination was also required. 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.[16]

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 and securities to adopt four primary safeguards:

A. *Maintenance with a Qualified Custodian*. All advisers with custody of client assets must maintain those 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, commodity futures 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.

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

---

[14] 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.

[15] *National Exam Program Risk Alert*, Volume II, Issue 1 (Mar. 4, 2013).

[16] Failure of an adviser to familiarize itself with the Custody Rule and its application is viewed by the SEC as an aggravating factor in an enforcement action rather than a defense. *See Ascension Asset Mgmt., LLC*, Advisers Act Rel. No. 33391 (Mar. 7, 2019) (principal of adviser "failed to take steps to educate himself about [the Custody Rule"]).

client assets prepared by an accountant that is registered and inspected by the Public Company Accounting Oversight Board ("PCAOB").[17] The rule provides special treatment for advisers to pooled investment vehicles (including private funds) that are subject to annual audits.[18]

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 identified by the SEC's examination staff[19] and some of the enforcement cases brought by its Enforcement Division[20] have involved advisers that seemingly did not recognize that they had custody of client assets.[21] Moreover, failure to accurately report custody may lead not only to a violation of the Custody Rule, but also cause the adviser to fail to report it has custody to the SEC and its clients in violation of other provisions of the Advisers Act.[22] 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

---

17 Section V.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 who is a qualified custodian.

18 Section V.A of this Outline discusses provisions of the rule that apply with respect to assets of a pooled investment vehicle.

19 *See supra* note 15.

20 *See, e.g.*, *Further Lane Asset Mgmt., et al.*, Advisers Act Rel. No. 3707 (Oct. 28, 2013).

21 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 advised 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).

22 *Bob Brakeman Enterprises, LLC*, Advisers Act Release No. 4620 (Jan. 19, 2017) (adviser and principal misrepresented material facts about its custody of client assets in its Form ADV).

is fleshed out in examples contained in the rule itself, SEC releases, and staff interpretations.[23]

1. Possession of Client Funds or Securities

An adviser has custody when it (or its related person) has possession of client funds or securities.[24] Thus, an adviser has custody if it physically holds client stock certificates, bonds or cash, even if it holds them temporarily.[25]

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.[26] 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 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.[27]

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.[28] 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 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.

---

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

24 Rule 206(4)-2(d)(2)(i).

25 *SEC v. Sentinel Mgmt. Group, Inc.*, 2012 WL 1079961 (N.D. Ill.).

26 *Id.*; Question II.1 of *Staff Responses to Questions About the Custody Rule* ("SEC Staff FAQs").

27 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.

28 *Investment Adviser Association*, SEC Staff No-Action Letter (Sept. 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.

Note the difference between the three business days an adviser has to return mis-delivered 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.[29] 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.[30] The SEC 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.[31]

Custody of Checks

Drawn on Client's Account Payable to Third Party, *e.g.*, 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 payment for its services would not constitute custody as a result of the adviser's possession of the fees because the funds would no longer be the client's.[32] 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 a third party.[33]

---

29 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(c)(1)(i).

30 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 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.

31 Advisers Act Release No. 2044, *supra* note 9.

32 *Id.*

33 2003 Adopting Release, *supra* note 8 at n. 8.

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.[34] 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.[35] 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 attorney over client assets will likely have custody, as will an adviser providing bill-paying services.[36]

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.[37]

Delivery vs. Payment. "Delivery versus payment" ("DVP") is a settlement procedure in which the buyer's cash payment for securities must be made before or simultaneously with the delivery of the seller's securities. The system eliminates "settlement risk" from a transaction, reducing 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."[38] In 2017 guidance, the SEC staff suggested that an adviser's authority to trade assets may be limited to securities that settle DVP,[39] 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

---

34 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 (Sept. 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. . .").

35 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).

36 *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.,* Advisers Act Rel. No. 2430 (Sept. 15, 2005) (settled enforcement action alleging adviser had custody because it had "unrestricted access to, and control of, clients' assets for investing and payment of firm expenses").

37 2003 Adopting Release, *supra* note 8 at n. 10 and accompanying text.

38 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."

39 *Inadvertent Custody,* 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'" . . .).

advisers with such authority should develop compliance policies and procedures to reduce such risks.[40]

Derivatives. An adviser's client portfolios may include futures contracts or other derivative instruments on which daily margin payments must be made and received. These instruments themselves may not be "securities" and not subject to the Custody Rule. 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 nor have authority to initiate such transfers and thus would not be 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.[41]

Changed Address. An adviser may change a client's address of record with the qualified client, 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.[42] 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.[43] A

---

[40] *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 similar risks.

[41] Question II.5 A of SEC Staff FAQs.

[42] Question II.5.B of SEC Staff FAQs.

[43] 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. Question II.6 of SEC Staff FAQs.

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 number or taxpayer identification number. A transfer from two jointly owned accounts 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 IRA account, (ii) a transfer between a client's personal account and his 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 authorization signed by the client to the sending custodian that identifies the name *and* account numbers of the destination account.[44] 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 the custodian. 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 was 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 a 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.[45] 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 a SLOA from a client does not obtain a surprise examination with respect to client accounts subject to an SLOA under the following conditions:

---

44 Question II.4 of SEC Staff FAQs. The FAQ was modified in this respect on February 21, 2017.

45 *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.

- 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;[46] and

- The custodian sends the client a written initial notice confirming the instruction and an annual notice reconfirming the instruction.[47]

Note that an adviser relying on the no-action letter for relief from surprise examinations nevertheless has custody of client accounts subject to a 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 "any 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 a custodian." Inadvertent custody has arisen in two 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.[48] As a result, statements in the advisory contract denying the adviser authority to hold client assets in custody are ineffective if the custodial agreement authorizes the custodian to take directions from the adviser. It is the unwillingness of the custodian to transfer assets out of the account (except

46 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.

47 *Investment Adviser Association, supra note 45.*

48 *Inadvertent Custody: Advisory Contract versus Custodial Contract Authority,* IM Guidance Update (February 2017).

pursuant to *bona fide* trading authority[49]) that provides an element of the protection afforded by the Custody Rule.

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 that 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.[50]

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 custodial authority by its client.[51] 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.

f. *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.[52] 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.[53] 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 fees.[54]

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 clients assets are maintained with a qualified custodian, and (ii) forming a reasonable belief that the custodian is

49 What constitutes "*bona fide* trading authority" is itself an issue and discussed above at Section III.A.2.a.

50 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 custodian having custody is authority to deduct fees.

51 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.

52 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.

53 Rule 206(4)-2(b)(3)(i). *See* Section V.B of this Outline (discussing related person custody).

54 Instruction Item 9.A.(1) of Form ADV.

sending quarterly account statements to clients. The account statements must reflect deductions for payment of advisory fees, permitting clients to monitor fees.[55]

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,[56] and has brought enforcement actions against advisers for deducting fees in excess of those authorized by the advisory contract.[57]

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 a capacity that gives it legal ownership of, or access to, client funds or securities.[58] 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 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.[59] There are several exceptions:

---

55 2003 Adopting Release, *supra* note 8 at n. 12 and accompanying text.

56 2009 Adopting Release, *supra* note 12 at Section II.G.

57 *See, e.g.*, *Equitas Capital Advisors, LLC,* Advisers Act Rel. No. 3704 (Oct. 23, 2013).

58 Rule 206(4)-2(d)(2)(iii).

59 *See Ascension Asset Mgmt., LLC, supra* note 16 ([i]n serving as sole trustee over the Trust, [principal of adviser] held the authority to obtain possession of and to withdraw client funds or securities. . .]; *Fortius Financial*

Employees. If the adviser's supervised person is the trustee of a client trust, custody will be imputed to the adviser.[60] 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.[61] The Custody Rule thus permits an adviser that, as a matter of policy, will not accept custody of client assets to manage the assets of a family trust or estate of an employee without complying with the 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 a co-trustee (i) that is a bank or a trust company that itself is a qualified custodian; (ii) that is not a related person of the adviser; and (iii) the co-trustee delivers account statements directly to each co-trustee that has custody.[62]

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. In recognition of this, 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.[63]

4. Through Related Persons

   a. *Employees*. Custody of client assets by an adviser's supervised person is imputed to the adviser.[64] 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

---

Advisors, Inc., Advisers Act Rel. No. 32212 (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.").

60 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, TBA 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).

61 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.

62 Question XII.2 of SEC Staff FAQs.

63 Question XII.3 of SEC Staff FAQs.

64 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).

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.[65]

However, SEC staff has expressed the view that an adviser that provides advisory services to an account owned by 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.[66] 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.[67]

b. *Affiliates*. Rule 206(4)-2 deems an adviser to have custody of client assets directly or indirectly held by a "related person."[68] 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.[69]

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.[70] 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

---

65 *See Financial Fiduciaries, LLC*, Advisers Act Rel. No. 4863 (Mar. 5, 2018) (settled SEC enforcement action alleging that an adviser had custody of client asset 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).

66 Question II.7 of SEC Staff FAQs (available only to natural persons owning accounts to which the adviser provides advisory services).

67 *See* discussion above in Section III.A.3.b of this Outline.

68 Rule 206(4)-2(d)(2) (custody includes holding client funds and 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.

69 Rule 206(4)-2(b)(6)(i). *See, e.g., Reid S. Johnson, supra* note 64 (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 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).

70 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 to exercise a controlling influence over the management or policies of the adviser, 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% of a class of voting securities, or has similar rights with respect to a limited liability company or partnership. Rule 206(4)-2(d)(1).

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.[71]

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 client assets. The surprise examination will be required to encompass securities held by the related person.[72]

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 V.B of this Outline.

5. Multiple Lines of Business

An adviser may have custody if it has access to a client's funds through another line of business. For example, an adviser may also offer a separate bill-paying service that gives its employees signatory power over a customer's checking account. If the customer is not also an advisory client of the adviser, the adviser will not be deemed to have custody for purposes of the rule. If, however, the customer is also an advisory client, the adviser has access to the client's assets, and therefore has custody, even if access arises through a separate line of business.[73]

Note that an adviser will be deemed to have custody of client funds or securities held by the adviser even if the custody arises from another line of business that has nothing to do with the advisory services. In contrast, custody of client assets held by an adviser's related person will be imputed to the adviser only if that custody arises "in connection with" the advisory services provided by the adviser.

[71] *Barclays Capital, Inc.*, Advisers Act Rel. No. 3929 (Sept. 23, 2014) (after acquisition adviser failed to identify client accounts maintained with related persons).

[72] *Reid S. Johnson, supra* note 64 (adviser failed to have surprise examination of securities held by affiliated adviser with which it operated as a single integrated adviser).

[73] 2003 Adopting Release, *supra* note 8 at n.4.

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;[74] and

4. Non-U.S. financial institutions that customarily hold financial assets for their customers provided they hold them in segregated accounts.[75]

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").[76]

IV. 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.[77] 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.[78]

Digital Assets. The SEC has stated that digital offerings, including "initial coin offerings," may be securities,[79] 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. Both of these types of offerings raise difficult questions regarding how a qualified custodian would hold custody of assets that exist

---

74 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.

75 Rule 2064-2(c)(6).

76 Rule 206(4)-2(b)(2)(ii). The exception is discussed below at Section IV.A.3.b.

77 Question II.3 of SEC Staff FAQs. Rule 206(4)-2 does not impose an independent legal obligation on qualified clients to protect client assets. *Lamm IRA v. State Street Bank and Trust*, 749 F.3d 983 (11th Cir. 2014).

78 Section 2(a)(18) of the Advisers Act.

79 *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).

on the blockchain.[80] The SEC staff has requested comment on such issues but has provided no guidance.[81]

One way advisers may provide their clients with exposure to investments in digital assets without addressing difficult Custody Rule issues is to purchase interests in trusts established to hold a pool of digital assets, Bitcoin for example. In such circumstances, the Custody Rule would require interests in the trust to be maintained with a qualified custodian rather than the underlying digital assets.[82]

Collateral. Collateral securing an obligation owned by a client is not an asset of the client that must be maintained with a qualified custodian, unless (or until) the adviser has custody of the actual collateral, *e.g.*, upon default of the obligation.[83] 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.[84] The former type of collateral continues to be owned by the obligor, while the latter is owned by the client and only held by the counterparty.

2. On Account with a Qualified Custodian

An adviser with custody of client funds and securities must maintain[85] 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).[86]

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

---

80 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. *See* SEC/FINRA Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities (July 18, 2019).

81 *Letter from Dalia Blass, Director, Division of Investment Management to Investment Adviser Association* (Mar. 12, 2019).

82 Section 208(d) of the Act may, however, prevent an adviser from establishing such a trust merely to avoid application of the Custody Rule. Investment in commercially available trusts should avoid application of Section 208(d).

83 *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).

84 Question II.10 of SEC Staff FAQs.

85 Rule 206(4) 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."

86 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).

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.[87]

b. *Comingling Assets Prohibited*. A registered adviser may not comingle proprietary assets with client assets.[88] In contrast, comingling of assets of multiple clients in a single "omnibus" account is explicitly permitted.

Pooled Investment Vehicles. An adviser that invests proprietary assets in a fund it advises would not thereby comingle its assets with those of its clients also invested in the same fund.[89]

c. *Maintaining Assets*

(1) *Traditionally Held Securities*. Client securities are commonly maintained on account with a qualified custodian 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.[90] 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.[91]

Legal Custody. Non-traditional assets may also be maintained with a qualified custodian that takes nominal ownership of the securities and holds them "for

---

87 *Reid S. Johnson, supra* note 64 (stock certificates held at principal's home and storage facility); *Clean Energy Capital*, Advisers Act Rel. No. 3955 (Oct. 14, 2014) (adviser to private funds held stock certificates owned 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).

88 *See SEC v. Sentinel Mgmt. Group, Inc., et al.,* 2012 WL1079961, N.D. Ill. (Mar. 30, 2012) (adviser comingled 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).

89 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.

90 *See* Section IV.A.3.a of this outline.

91 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 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.

the benefit of" the client, in which case such securities need not be reduced to paper.[92]

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 shareholder.[93]

Private Funds. The privately offered security exception is not available with respect to assets of pooled investment vehicles that are not audited annually pursuant to paragraph (b)(4) of the Custody Rule.[94] 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 security exemption by issuing guidance stating that it would not object if an adviser to an audited private fund did not maintain non-transferrable stock certificates or certificated LLC interests with a qualified custodian if all of the other provisions of the rule are met and "the private stock certificate is appropriately safeguarded by the adviser and can be replaced upon loss or destruction." The guidance was issued in response to arguments that maintaining custody of non-transferrable securities does not provide any meaningful client protections to investors in private funds.[95]

The interpretation is only available to advisers to private funds that are audited and otherwise comply with paragraph (b)(4) of the rule and does not alter the requirement that the securities be non-transferrable except by consent of the

---

92 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 83 (SEC staff no-action letter regarding Section 17(f) of the Investment Company Act).

93 Rule 206(4)-2(b)(2)(i).

94 Rule 206(4)-2(b)(2)(ii). The application of the rule to pooled investment vehicles is discussed in more detail in Section V.A of this Outline.

95 *Privately Offered Securities under the Investment Advisers Act Custody Rule*, IM Guidance Update *2013-04* (Aug. 2013).

issuer or shareholder. Such certificates must continue to be maintained with a qualified custodian.

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.[96] Consequently, they do not have to be maintained with a qualified custodian.

b. *Shares of Mutual Funds*. 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.[97] Shares not held with the fund's own transfer agent, however, must be held with a qualified custodian.

Affiliated Transfer Agents. If the transfer agent is a "related person" of the adviser, the adviser must receive a control report from the transfer agent.[98]

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.[99]

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:

- 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

---

96 *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.

97 Rule 206(4)-2(b)(1).

98 Question XV.1 of SEC Staff FAQs. *See also* discussion, *infra* Section V.B of this Outline regarding related person custody.

99 2003 Adopting Release, *supra* note 8 at n. 17.

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."[100]

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.[101]

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.[102]

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 in the account at the end of the period and (ii) each transaction during the period.[103] This

[100] *Id.* at n. 19.

[101] Rule 206(4)-2(a)(2).

[102] Question V.1 of SEC Staff FAQs.

[103] 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*, Securities Act Rel. No. 7288 (May 9, 1996). *See also* Question IV.1 of SEC Staff FAQs.

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.[104]

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." One method specifically approved by the SEC is for the adviser to receive duplicate statements whenever the custodian sends statements directly to the client.[105] Other methods that advisers use include client surveys asking whether they received the account statements; receipt of attestation or other statement from the custodian that it has delivered account statements on a quarterly basis; and receipt from custodians of a CD or other media with the account statements sent to clients.

   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.[106] Merely having access to view statements online is insufficient.[107]

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.[108] 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.[109]

---

104 *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 custodians, 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).

105 2009 Adopting Release, *supra* note 12 at n. 21 and accompanying text.

106 Question IV.1 of SEC Staff FAQs.

107 2009 Adopting Release, *supra* note 12 at n. 21.

108 Rule 206(4)-2(a)(7).

109 Rule 206(4)-2(d)(4). *See* Section VIII of SEC Staff FAQs for more discussion about independent representatives.

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.[110]

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 statement urging the client to compare the account statements from the qualified custodian with those from the adviser (i) in the notice that the qualified custodian sends upon opening an account for a client, and (ii) in its own subsequent account statements.[111]

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.[112] The rule also imposes a set of requirements on accountants conducting the surprise examination that, among other things, obligates them to alert the SEC to 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.[113] To identify compliance failures, the SEC can simply compare a list of advisers that report having custody of client assets on their Form ADVs with advisers with respect to which accountants have filed Form ADV-E, reporting the results of their examination.

1. Exceptions

a. *Fee Deductions*. Advisers that have custody solely because they have authority to deduct advisory fees from client accounts (discussed above).[114]

b. *Pooled Investment Vehicles Subject to Audit*. Advisers with respect to their pooled investment vehicles that are annually audited (discussed below in Section V.A.1).[115]

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

---

110 Question IX.1 of SEC Staff FAQs.

111 Rule 206(4)-2(a)(2); Question IV.2 of SEC Staff FAQs.

112 Rule 206(4)-2(a)(4).

113 *See, e.g., CMS Fund Advisers*, Advisers Act Rel. No. 2430 (Sept. 15, 2005).

114 Rule 206(4)-2(b)(3)(i).

115 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.

that the related person is "operationally independent."[116] *See* discussion below in Section V.B.3.

d. *Related Sub-Advisers*. An adviser that acts as a sub-adviser in an investment advisory program for which a related person qualified custodian is the primary adviser (or an affiliate of the primary adviser), may avoid a surprise examination, regardless of whether they are 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 V.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.[117]

2. 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.[118] The failure of an accountant to maintain its independence from the adviser will result in the adviser's violation of its obligations under rule 204-2, for which the accountant may be held secondarily responsible.[119]

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."[120]

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 of the adviser, *i.e.*, its related persons.

c. Independence must be maintained throughout the term of the engagement.[121]

---

116 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).

117 *Investment Adviser Association,* SEC Staff Letter (Apr. 25, 2016).

118 Rule 206(4)-2(d)(3).

119 *Total Wealth Mgmt., Inc.*, Advisers Act Rel. No. 3818 (Apr. 15, 2004) (adviser violated Custody Rule because, among other things, the accounting firm auditing the pooled investment vehicle did not meet SEC independence requirements); *Katz, Sapper & Miller, LLP*, Advisers Act Rel. No. 5100 (Jan. 9, 2019) (auditor prepared financial statements and then audited them).

120 See Rule 2-01(c) of Regulation S-X.

121 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

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, including all prior relationships between the accountant and the fund, and not only those that exist during the filing of the reports with the SEC.[122] 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.[123]

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

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 V.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 V.B of this Outline;[124] or

c. It prepares an internal control report with respect to a related person that serves as a qualified custodian.

3. 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.[125]

---

accountant begins attest 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.

122 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 Adviser Question 2).

123 Question XVI.4 of SEC Staff FAQs. Note that the SEC recently 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).

124 Question II.8 of SEC Staff FAQs.

125 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). 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 69 (settled administrative action in which the SEC observed that the adviser "violated the Custody

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.[126] 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.[127] 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.[128]

c. *Promptly report material discrepancies*. Upon finding any material discrepancies during the course of an exam, the accountant must notify the SEC within one business day of the finding.[129] A material discrepancy includes material non-compliance with rule 206(4)-2 or 204-2 under the Advisers Act.

   Material discrepancies. 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 Advisers Act. A shortfall would,

---

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). 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 64.

[126] *See Reid S. Johnson, supra* note 64 (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).

[127] 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.6A and IV.6B of SEC Staff FAQs and http://www.iard.com/pdf/formADV-E.pdf.

[128] *Illustrative Report of Independent Accountant on Examinations of Securities Pursuant to rule 206(4)-1* (Feb. 12, 2012, *available at* http://www.aicpa.org/InterestAreas/FRC/IndustryInsights/DownloadableDocuments/Surprise_Exam_Report.pdf.

[129] 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.

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, or dismissal.[130]

4. Guidance for Accountants

In connection with the 2009 Amendments, the SEC adopted a companion interpretive release to update its guidance for accountants.[131]

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.[132] To reflect modern auditing methods, the new guidance for accountants permits the accountant to verify client assets on a sampling basis.[133]

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.[134]

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 annual internal control report required of certain advisers under the amended Custody Rule.[135]

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

---

130 Rule 206(4)-2(a)(4)(iii).

131 *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").

132 *Statement of the Commission Describing the Nature of Examination Required to be Made of All Funds and Securities held by an Investment Adviser and the Contents of Related Accountant's Certificate*, Advisers Act Rel. No. 201 (June 1, 1966). Issues regarding custody of paper certificates, however, still occasionally show up in SEC enforcement actions. *See Reid Johnson, supra* note 65 (stock certificates kept in locked office cabinet and personal residence).

133 Guidance for Accountants, *supra* note 131 at Section II.

134 *Morgan Stanley Smith Barney, LLC*, Advisers Act Rel. No. 4607 (Jan. 13, 2017).

135 *Id.* at Section III.

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.[136]

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.[137]

5. New Advisers

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.[138]

There is no SEC guidance for a new adviser intending to rely on the audit method, but presumably, 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.

V. 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 Hedge Funds, Private Equity Funds, Venture Capital Funds and other Pooled Investment Vehicles

An adviser to a pooled investment vehicle that invests in securities will generally have custody of client 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 vehicles, 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:

---

136 *See RSM UL 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). *See also Holthouse Carlin & Van Trigt LLP,* Advisers Act Rel. No. 5008 (Sept. 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 "professional due care" in failing to identify improper commingling of adviser and client assets).

137 *Illustrative Report of Independent Accountant on Examinations of Securities Pursuant to Rule 206(4)-2* (Feb. 2012).

138 Rule 206(4)-2(a)(4).

1. Audit Approach

An adviser to a pooled investment vehicle that (i) is audited at least annually by an independent public accountant that is registered with, and is 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 of sending 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.[139]

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 the fund's financial statements provides "meaningful" protections for investors.[140] 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.

The audit approach is available <u>only</u> with respect to clients that are pooled investment vehicles.[141] These include limited partnerships, limited liability companies, trusts, and other types of pooled investment vehicles.[142] 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.

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

[139] Rule 206(4)-2(b)(4); Rule 206(4)-2(b)(2)(ii).

[140] 2003 Adopting Release, *supra* note 8.

[141] Question X.I of SEC Staff FAQs. 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).

[142] The term "pooled investment vehicle" is not defined in rule 206(4)-2. 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.

public accountant that is registered with, and subject to regular inspection by, the PCAOB.[143]

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.[144] The SEC staff has issued a series of no-action letters permitting advisers whose funds are audited by these firms to continue to use the audit approach until the PCAOB adopts rules establishing a permanent inspection program for auditors of broker-dealers.[145]

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").[146] Financial statements do not meet these requirements if the auditor cannot give an unqualified opinion.[147] Thus, problems with the pool's financial statements will create a serious problem under the Custody Rule for advisers.[148] 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.[149]

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

---

143 Rule 206(4)-2(b)(4)(ii). *See Parallax Investments, LLC*, Advisers Act Rel. No. 3726 (Nov. 26, 2013) (accountant auditing financial statements of hedge fund was not registered with PCAOB); *Columbia River Advisers LLC*, Advisers Act Rel. No. 4734 (July 28, 2017) (accounting firm registered with PCAOB but not subject to PCOAB inspection); *Southwind Associates of NJ Inc.*, Advisers Act Rel. No. 4834 (Dec. 22, 2017) (same).

144 Section 982 of the Dodd-Frank Act.

145 *Seward & Kissel LLP*, SEC Staff No-Action Letter (Oct. 4, 2016); *Seward & Kissel LLP*, SEC Staff No-Action Letter (Nov. 5, 2013); *Seward & Kissel LLP*, SEC Staff No-Action Letter (July 21, 2011); *Seward & Kissel LLP*, SEC Staff No-Action Letter (Oct. 12, 2010).

146 Rule 206(4)-2(b)(4); Question VI.6 of SEC Staff FAQs.

147 Advisers relying on the audit approach must report the receipt of a qualified opinion on Schedule D to Form ADV *See* Item 9.C.(6). *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).

148 *See Alpha Titans, LLC,* Advisers Act Rel. No. 31586 (Apr. 29, 2015) (settled enforcement action in which the SEC found that an adviser to a hedge fund violated the Custody Rule where the 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 Envisco 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).

149 *Envisco, supra note 148; Capital, LLC,* Advisers Act Rel. No. 4731 (July 19, 2017) (settled enforcement action alleging failure to properly value hedge fund assets).

substantially similar to financial statements prepared in accordance with U.S. GAAP, and (ii) are reconciled to U.S. GAAP.[150] 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.[151]

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.[152]

   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.[153]

   - *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.[154] 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.[155] 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

---

[150] 2003 Adopting Release, *supra* note 8 at n. 41.

[151] *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 V.E. of this Outline.

[152] Rule 206(4)-2(b)(4)(iii).

[153] 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).

[154] An adviser switching to the surprise examination approach would need to amend Section 9.C.(3) of the Schedule D of Form ADV for the affected fund and engage an independent public accountant to conduct the surprise examination – which could be the same accountant that had been auditing the fund.

[155] 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 *SEC v. Goldstein,* 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).

fiscal year end of a fund-of-funds.[156] The failure to deliver timely financial statements to investors will cause the adviser relying on the audit approach to violate the Custody Rule.[157]

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.[158] 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.[159]

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.[160]

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.[161] However, if there are owners other than the adviser, its related persons (*e.g.*, the general partner) or 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

---

[156] 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.

[157] *See New Silk Route Advisors, L.P.,* Advisers Act Release No. 4970 (July 17, 2018) (financial statements delivered from 6 to 245 days late over a period of six years); *Sands Brothers Asset Mgmt., LLC et al.*, Advisers Act Rel. No. 3960 (Nov. 19, 2015) (financial statements distributed 8 months late for some funds); *Columbia River Advisers, LLC*, *supra* note 143 (financial statements distributed 9 months late); *Altheia Research and Mgmt., Inc.*, Advisers Act Rel. No. 3197 (May 9, 2011) (financial statements delivered 1½ to 14 months late).

[158] Question VI.9 of SEC Staff FAQs. *See Sands Brothers Asset Mgmt., LLC, supra* note 157 (circumstances that led to the audits' delay "were predictable and not unforeseeable.").

[159] *New Silk Route Advisors, L.P., supra* note 157 (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. 547 (Sept. 25, 2018) (adviser missed multiple deadlines for distributing financial statements and failed to subsequently revise its processes).

[160] 2009 Adopting Release at Section II.F, explaining the operation of rule 206(4)-2(c).

[161] *Private Funds and the Application of the Custody Rule to Special Purpose Vehicles and Escrows,* IM Guidance Update 2014-07 (June 2014).

if the adviser maintains client funds in such escrow accounts provided, among other things, the client is a pooled investment vehicle that relied on the audit approach and includes the portion of the escrow attributable to the pooled investment vehicle in its financial statements.[162]

2. Surprise Examination Approach

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, an approach that works 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. *Privately Offered Securities*. Maintain all client funds and securities, including privately offered securities, with a qualified custodian.[163] 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.[164] 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 fund to provide complete transparency of its portfolio to investors (and perhaps competitors).[165]

c. *Annual Surprise Examination*. Undergo an annual surprise examination by an independent public accountant.[166]

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.[167]

---

162 *Id.*

163 Rule 206(4)-2(b)(2)(ii); Question VII.1 of SEC Staff FAQs.

164 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.

165 *See* Question VI.2 of SEC Staff FAQs. *See Walter V. Gerasimowicz*, *supra* note 104 (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).

166 Rule 206(4)-2(a)(4).

167 Rule 206(4)-2(a)(6).

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 broker-dealer, 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 unless the related person is "operationally independent" of the adviser. Each of these elements is discussed below:

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.[168] 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.[169]

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 16 report.[170]

   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.[171]

   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).

---

168 Rule 206(4)-2(a)(6)(i).

169 Guidance for Accountants, *supra* note 131.

170 Rule 206(4)-2(a)(6)(ii). "SSAE 16 reports" refer to a report prepared in accordance with the AICPA's Statement on Standards for Attestation Engagements 16, which replaced the Type II 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.

171 Control objectives are listed in the Guidance for Accountants, *supra* note 131.

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 examined by the PCAOB.[172] The SEC has stated that such a report satisfies the internal control report requirements of rule 206(4)-2.[173]

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 infra* Section V.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,[174] and (ii) the related person acting as qualified custodian is "operationally independent" of the adviser.[175] The adviser must, however, still obtain the control report from the related person.[176] 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…"[177]

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

172 Rule 17a-5(g) under the Securities Exchange Act of 1934.

173 *Broker-Dealer Reports*, Exchange Act Rel. No. 70073 (July 20, 2013) at Section II.H.

174 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.

175 Rule 206(4)-2(b)(6).

176 Question XIII.2 of SEC Staff FAQs.

177 2009 Adopting Release, *supra* note 12 at n. 110 and accompanying text.

e. No other circumstance can reasonably be expected to compromise the operational independence of the related person.[178]

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.[179]

An adviser relying on this exemption must maintain a file memo describing the basis for its determination that the related person is operationally independent.[180] Such adviser should consider establishing compliance policies designed to preserve operational independence and compliance officials of the advisers should be tasked with testing their operation.

4. Pooled Investment Vehicles and Related Person Custody

In many cases a hedge fund or other 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 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.[181]

C. Advisers to Registered Investment Companies

Advisers are exempt from all provisions of the rule with respect to clients that are registered investment companies.[182] These accounts are subject to the requirements of section 17(f) of the Investment Company Act of 1940 ("Investment Company Act") and the Investment Company Act custody rules.

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.[183] 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

[178] Rule 206(4)-2(d)(5) (defining "operationally independent").

[179] 2009 Adopting Release, *supra* note 12 at n. 111.

[180] Rule 204-2(b)(5).

[181] Rule 206(4)-2(b)(4); Question XIII.1 of the SEC Staff FAQs.

[182] 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 investment company are delivered to each registered investment company's chief compliance officer, audit committee members, and independent directors. Question VI.10 of SEC Staff FAQs.

[183] 2003 Adopting Release, *supra* note 8 at n. 16.

liability companies that own real estate, the general partner will likely be giving advice regarding securities, and the rule will apply.[184]

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. 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.[185] For purposes of this policy, an individual's residence 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,[186] and its place of organization determines whether it is a U.S. person.[187] 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 some of the investors are U.S. persons.

VI. Form ADV

Form ADV requires extensive information about an adviser's custodial practices.

A. Information About Whether the Adviser has Custody of Client Assets

Items 9A. and B. of Part 1.A. require information about whether the adviser or a related person has custody of client assets. Responses (either as to whether the adviser has custody or the amount of assets under custody) are not required if (i) the sole reason the adviser has custody is because it has authority to deduct the amount of its fee from client accounts; or (ii) the adviser is operationally independent from the related person.[188]

---

184 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 Asset Mgmt. Co.*, SEC Staff No-Action Letter (Feb. 10, 1992) (bank account established to collect rents and pay expenses associated with real property).

185 *See Uniao de Bancos de Brasileiros S.A.,* SEC Staff No-Action Letter (July 13, 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).

186 *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

187 *See* Rule 203(m)-1(b)(8) (defining United States person by reference to Regulation S).

188 Item 9.A. must be amended promptly upon obtaining custody of client assets. However, the amount of assets custodied must be updated only annually in the annual updating amendment. General Instruction 4 to Form ADV.

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.[189]

B. Information About Custodians

Affiliated Custodians. When the adviser or a related person acts as the qualified custodian of client funds or securities, Items 9.C. and 9.D require the adviser to:

1. *Compliance Approach.* Report the adviser's approach in complying with the Custody Rule (*e.g.*, does it take advantage of the audited approach for pooled investment vehicles); and

2. *Qualified Custodian.* Identify on Schedule D any related persons that act as a qualified custodian of client funds or securities. The identification must be made regardless of whether the related person is determined to be operationally independent.

Certain Separate Account Custodians. Form ADV also requires advisers to identify and provide certain information about each custodian that holds 10% or more of the adviser's "aggregate separately managed account regulatory assets under management."[190]

C. Information About Accountants

Form ADV also requires advisers that were subject to the surprise examination requirement during the previous fiscal year or had a pooled investment vehicle audited for the previous fiscal year to identify the independent public accountant that performed the surprise examination or audited the pool.[191]

D. 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 an email to registered advisers, the SEC staff has explained that such advisers 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.[192]

---

[189] 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 (or their predecessors). *See, e.g., Ascension Asset Mgmt., LLC, supra* note 16; *Stanley Peter Kerry,* Advisers Act Rel. No. 1550 (Jan. 25, 1996).

[190] Section 5.K.(3) of Schedule D. This item was added in *Form ADV and Investment Adviser Rules*, Advisers Act Rel. No. 4509 (Aug. 25, 2016).

[191] Form ADV Item 9(E); 2009 Adopting Release, *supra* note 12 at Section II.H.

[192] This item was added to Form ADV in 2011. *See Rules Implementing Amendments to the Investment Advisers Act of 1940*, Advisers Act Rel. No. 3221 (June 22, 2011) at Section II.C.5.

An adviser with custody as a result of authority to withdraw 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. If several clients use the same custodian, the adviser should report only one custodian.

Proskauer