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Custody

Recently Published SEC Risk Alert Reveals Significant Deficiencies in Custody Practices of Hedge Fund Managers and Other Investment Advisers

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On March 4, 2013, the SEC staff published a risk alert (Risk Alert) addressing custody-related compliance gaps that the Office of Compliance Inspections and Examinations (OCIE) uncovered in numerous recent examinations of registered investment advisers, including hedge fund managers. The SEC identified custody-related compliance issues in approximately one-third (approximately 140) of recently-conducted examinations of registered advisers, and some cases were referred to the Division of Enforcement for further action. Among other deficiencies, the SEC identified gaps where advisers: (1) failed to recognize situations in which they had "custody" of client assets, as defined in Rule 206(4)-2 (Custody Rule) under the Investment Advisers Act of 1940; (2) failed to appropriately custody client assets in accordance with the Custody Rule's requirements; and (3) failed to comply with the Custody Rule's surprise examination requirement, including the failure to satisfy the conditions for relief from that requirement. Hedge fund managers should pay close attention to the deficiencies highlighted in the Risk Alert as many directly impact on their businesses, operations and compliance practices. This article highlights those deficiencies that are particularly relevant for hedge fund managers. See also "How Does the SEC Approach Custody Issues in the Course of Examinations of Hedge Fund Managers?, Hedge Fund Law Report, Vol. 5, No. 18 (May 3, 2012).

Background

The Custody Rule generally applies to registered investment advisers that are deemed to have "custody" of client assets, which include situations where an adviser: (1) maintains physical custody of client funds or securities; (2) has the authority to obtain client funds or securities (e.g., by deducting advisory fees from a client's account or otherwise withdrawing funds from a client's account); (3) acts in a capacity that gives it legal ownership of or access to client funds or securities (e.g., where it acts as general partner of a limited partnership); or (4) utilizes a "related person" to hold client funds or securities directly or indirectly. See "How Should Hedge Fund Managers Revise Their Compliance Policies and Procedures in Light of Amendments to the Custody Rule?," Hedge Fund Law Report, Vol. 3, No. 3 (Jan. 20, 2010).

The Custody Rule generally requires a registered adviser deemed to have custody of client assets to maintain client funds and securities with a "qualified custodian" (e.g., a bank or broker-dealer) in accounts containing only client funds. In addition, the registered adviser must notify the client in writing of the qualified custodian's name and address and the manner in which the funds and securities are held promptly any time that an account is opened with a qualified custodian and any time that such information changes (Notice Requirement). In addition, the adviser must have a reasonable belief after due inquiry that a qualified custodian that maintains custody of client assets sends quarterly account statements directly to clients (rather than the adviser itself sending such account statements directly to its clients) (Account Statement Delivery Requirement). An adviser maintaining client assets with a qualified custodian may also send its own account statement to its clients in addition to the statement distributed by the qualified custodian. However, if it does so, the adviser's account statement must include a legend urging the client to compare the adviser's account statement with that provided by the qualified custodian.

Privately-offered securities are exempt from the requirements of the previous paragraph if they: are uncertificated and their ownership is recorded only on the books of the issuer or its transfer agent; have been acquired from the issuer in a transaction or chain of transactions not involving any public offering; and may only be transferable only with the prior consent of the issuer or holders of the issuer's outstanding securities (Privately Offered Securities Exception).

Unless an exemption is otherwise available, the Custody Rule also requires a registered investment adviser with custody of client assets to undergo an annual surprise examination of its client assets to verify that they exist and to check the consistency between the books and records of the adviser and the custodian (Surprise Examination Requirement). The annual surprise examination must be conducted at irregular times each year by an independent public accountant registered with and subject to regular inspection by the Public Company Accounting Oversight Board (PCAOB). The accountant must report to the SEC any material discrepancies or missing assets found during the surprise examination.

Additionally, if the adviser maintains physical custody of client assets or uses a related person as a qualified custodian, the adviser must obtain an annual report, prepared by an independent, PCAOB-registered accountant, on the internal controls of the adviser or related custodian. See "Application to Hedge Fund Managers of the Internal Control Report Requirement of the Amended Custody Rule," Hedge Fund Law Report, Vol. 3, No. 6 (Feb. 11, 2010).

Importantly for hedge fund managers, advisers are excepted from the Notice Requirement and the Account Delivery Requirement and are deemed to have satisfied the Surprise Examination Requirement with respect to an investment vehicle that has an audit that is conducted (1) at least annually and distributes its audited financial statements prepared in accordance with generally accepted accounting principles (GAAP) to all limited partners (or members or other beneficial owners) within 120 days of the end of its fiscal year; (2) by an independent public accountant that is registered with and subject to regular inspection by the PCAOB; and (3) upon liquidation and distributes its audited financial statements prepared in accordance with GAAP to all limited partners (or members or other beneficial owners) promptly after the completion of such audit (Audited Pool Exception).

Hedge Fund Manager-Specific Compliance Issues Identified in the Risk Alert

The deficiencies identified in the Risk Alert that are most pertinent to hedge fund managers include: (1) the failure to comply with the requirements of the Audited Pool Exception; and (2) the failure of advisers to satisfy the “qualified custodian” requirements contained in the Custody Rule.

Audited Pool Exception

Most importantly for hedge fund managers, the SEC highlighted a number of deficiencies that would prevent noncompliant hedge fund managers from relying on the Audited Pool Exception, which would therefore subject such managers to the Surprise Examination Requirement.

First, the SEC highlighted deficiencies related to the qualification of accountants preparing fund audited financial statements. Among other things, the SEC pointed to a deficiency where the accountant is not deemed to be “independent” pursuant to Regulation S-X, as mandated by the Custody Rule. The SEC also cited a deficiency where an accountant is not registered with and subject to regular inspection by the PCAOB. As a result, hedge fund managers should demand that their auditors make representations concerning these qualifications prior to their retention.

Second, the SEC turned to deficiencies related to the preparation of audited financial statements. One of the conditions of the Audited Pool Exception is that a fund’s audited financial statements must be prepared in accordance with GAAP, which requires the delivery of an unqualified audit opinion. As a result, hedge funds that amortize their organizational expenses over a period (e.g., over five years) as opposed to expensing them as incurred would receive a qualified opinion, which would make them ineligible for the Audited Pool Exception. Next, in situations where the adviser cannot substantiate fair valuation for assets, the accountant cannot deliver an unqualified opinion, which would cause the audited financial statements to be non-compliant with GAAP. Also, audited financial statements that are prepared on a federal income tax basis are not GAAP-compliant.

In addition, the SEC highlighted deficiencies with respect to the failure to prepare a final audit in anticipation of the liquidation of a fund. These final audits can be costly in proportion to the remaining assets in the fund, and many investors may not even want such audits to be performed. Nonetheless, even if an adviser obtains consent from investors to waive the final audit, the SEC still expects the adviser to arrange for the performance of the final audit for the fund or arrange for a surprise examination. Otherwise, the adviser would violate the Custody Rule. As a result, the hedge fund manager will be faced with one of these two options, both of which can be costly.

In addition, although not a specific deficiency noted in recent examinations, the SEC commented on the fact that certain audited financial statements being relied on by many private funds to satisfy the Audited Pool Exception may not be satisfactory because either the audit was not conducted in accordance with generally accepted auditing standards or because audited financial statements that are prepared in accordance with International Financial Reporting Standards did not contain information substantially similar to financials prepared in accordance with GAAP, including the fact that schedules of investments and/or financial highlights were either omitted entirely or included but labeled as unaudited. Therefore, hedge fund managers must ensure that, if they use other accounting standards for the preparation of their funds’ audited financial statements, they must ensure that they provide information equivalent to that required by GAAP.

Third, the SEC pointed to deficiencies in the delivery of audited financial statements to fund investors. Among other things, the SEC stressed that it is not sufficient for advisers to simply make audited financial statements available to fund investors upon request. Rather, the adviser must be able to demonstrate that the audited financial statements were actually delivered to investors, and that they were delivered within 120 days of the end of the fund's fiscal year (180 days for fund of funds). There is no indication that the SEC has provided any exception from this delivery deadline. As a result, hedge fund managers must work diligently to ensure that audited financial statements are prepared and delivered as quickly as possible after the end of a fund's fiscal year.

Qualified Custodian Requirements

The SEC identified several specific deficiencies in this area, beginning with deficiencies where advisers had not properly custodied client assets with a qualified custodian. For instance, the SEC pointed to a situation where client assets were held in an account in the adviser's name, but not in an account that was under the adviser's name as agent or trustee for the client where only client funds and securities were maintained in that account. The Custody Rule permits an adviser to maintain client assets with a qualified custodian either: (1) in a separate account for each client under the client's name; or (2) in the name of the adviser, as agent or trustee for its clients, but only if the account contains only client funds and securities. As a result, a hedge fund manager that wishes to maintain its clients' assets in accounts with qualified custodians in its own name must ensure that such accounts do not include any assets of the manager or any of its principals or employees and that the custodial relationship properly reflects the manager's agency capacity. For an enforcement action highlighting this particular violation, see "SEC Charges Hedge Fund Manager with Impermissible Cross Trades, Inflating Valuation and Misleading Investors," Hedge Fund Law Report, Vol. 5, No. 45 (Nov. 29, 2012).

Next, the SEC cited a compliance gap where client assets were commingled with an adviser's proprietary assets and/or those of its employees in a single account. The Custody Rule prohibits such commingling. As a result, hedge fund managers must be particularly careful when they purchase assets on an aggregated basis on behalf of both their funds and their firms/employees and ensure that such purchased assets are not deposited into a single account where they will be commingled.

Next, the SEC pointed to a situation where an adviser improperly maintains clients' certificated securities in a safe deposit box under its control at a local bank. Despite the challenge of arranging for the custodying of certificated securities, this arrangement violates the Custody Rule's Account Statement Delivery Requirement because the qualified custodian would not hold and have direct access to the client assets to provide account information to the adviser's clients. Additionally, the SEC pointed to the fact that the securities in this situation would not qualify for the Privately Offered Securities Exception because the securities are certificated.

The SEC also pointed to two additional deficiencies in this area, including: (1) an adviser's failure to have a reasonable basis, after due inquiry, to believe that the qualified custodian was sending out quarterly account statements to the adviser's clients; and (2) an adviser's failure to include a legend on account statements it sends to its clients urging them to compare the adviser's account statements with those sent by the qualified custodian directly to the adviser's clients.

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