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UNDERSTANDING THE INVESTMENT ADVISER CUSTODY RULE: PART II – SAFEKEEPING REQUIREMENTS

Stung by its failure to uncover long-running Ponzi schemes by advisers in time to prevent massive losses to customers, the SEC has devoted new attention to the client safeguards of its custody rule. What constitutes custody under the rule was the principal subject of Part I of this article (issue of March 18, 2015). In Part II, the author addresses in detail the principal requirements of the rule.

By Robert E. Plaze *

I. OPERATION OF THE CUSTODY RULE

Rule 206(4)-2 under the Advisers Act is designed 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] An adviser may have custody because its client assets are held by a "related person" — *e.g.*, a parent or subsidiary company.[2] Subject to certain exceptions, a registered investment adviser with custody of client funds or securities must: (i) maintain the client funds and securities with qualified custodians, (ii) provide notice to clients of where and how their assets are being maintained, (iii) have a reasonable belief that qualified custodians are providing clients with account statements, and (iv) arrange for an annual surprise examination of client funds and securities at least once each year.

a. Maintain Client Funds and Securities with Qualified Custodians

Client funds and securities over which a client has custody must be maintained in accounts with a "qualified custodian."[3] Qualified custodians are limited to U.S. banks, registered broker-dealers, futures commission merchants (FCMs) that are registered with

[1] Adv. Act Rel. No. 123 (Feb. 27, 1962) (adopting rule 206(4)-2).

[2] As discussed in Part I of this article, a related person is any person, directly or indirectly controlling the adviser, controlled by the adviser, or under common control with the adviser. Rule 206(4)-1(d)(7).

[3] Rule 206(4)-2(a)(1). Rule 206(4)-2 does not impose an independent legal obligation on qualified custodians to protect client assets. *Lamm IRA v. State St. Street Bank and Trust*, 749 F.3d 938 (11th Cir. 2014).

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the CFTC, and foreign financial institutions that customarily hold financial assets for customers.[4]

Funds and Securities. Only client funds and securities must be maintained with a qualified custodian.[5] For example, real estate, commodities, or collectibles are not subject to the requirements of the custody rule, although the adviser's contractual obligations may provide otherwise, and its fiduciary obligations to its clients will require an adviser with custody over such assets to employ care in determining how and where to maintain them.

Multiple Custodians. A single qualified custodian or multiple custodians may be used to maintain client assets.[6] Some advisers require that all clients maintain funds and securities with a single custodian, while others will work with custodians selected by clients. In some cases, a single client will employ multiple custodians in order, for example, to facilitate domestic and foreign holdings. Rule 206(4)-2 accommodates all of these arrangements.

On Account with a Custodian. Assets must be maintained with qualified custodians, either (i) in a separate account in the name of each client or (ii) 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).[7] These requirements, set forth in the rule's definition of "qualified custodian," impose two important safekeeping requirements on registered investment advisers, and facilitate a third.

First, the rule operates to prohibit a registered adviser (that is not itself a qualified custodian) from having physical possession of client funds or securities other than a "privately offered security" discussed below — an adviser taking possession of a client's stock certificate would immediately have custody of the certificate that would not be maintained by a qualified custodian.[8] Second, the rule requires an adviser to keep its proprietary assets separate from its clients' assets, codifying the traditional prohibition on a fiduciary commingling client assets with its own.[9] Third, by requiring that all securities be held *on account with* the qualified custodian, the rule creates a basis for custodians to report to clients ownership of assets the custodian holds on its own books for the benefit of the client. This is why the SEC has taken the position that keeping stock certificates in the adviser's bank safe deposit box will not satisfy the requirement of the rule because they would not be held in "accounts" with the

[4] Rule 206(4)-2(d)(6). Client assets held with a futures commission merchant are limited to those funds, securities futures, and other securities incidental to transactions in commodity contracts, or options on commodity contracts. Rule 206(4)-2(d)(6)(iii).

[5] Question II.3 of *Staff Responses to Questions About the Custody Rule* ("SEC Staff FAQs"), *available at,* http://www.sec.gov/divisions/investment/custody_faq_030510.htm. 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. Adv. Act § 2(a)(18).

[6] Adv. Act Rel. No. IA 2176 (Sept. 25, 2003)(adopting amendments to rule 206(4)-2) ("2003 Adopting Release") at n. 17.

[7] Rule 206(4)-2(a)(1).

[8] *Clean Energy Capital, LLC*, Adv. Act Rel. No. IA 3955 (Oct. 17, 2014) (adviser to private equity funds held stock certificates owned by private funds at its office); *Further Lane Asset Mgmt., LLC,* Adv. Act Rel. No. IA 3707 (Oct. 28, 2013) (adviser had physical possession of promissory notes).

[9] Restatement (Third) of Trusts § 84 (2007). The SEC has brought several SEC enforcement actions in which advisers have commingled their own assets with those of client assets. *SEC v. Sentinel Mgmt. Group, Inc.,* 2012 WL1079961, N.D. Ill. (Mar. 30, 2012) (adviser commingled its clients' with proprietary assets held in a clearing account in violation of rule 206(4)-2, even though the client assets were held in the account for a short period of time); *SEC v. Slocum, Gordon & Co.*, 334 F.Supp.2d 144, 178 (D.R.I. 2004); *SEC v. Steadman*, 967 F.2d 636, 646 (D.C. Cir. 1992); *Clean Energy Capital, LLC*, *supra* note 8.

qualified custodian, and thus could not be reported on the quarterly statements.[10]

Privately offered securities. Some securities, such as limited partnership interests in private funds, are not typically held in book-entry form but do not present significant risk that they will be misappropriated because they are not transferable without the approval of the issuer. Clients will often receive subscription or partnership agreements, but nothing that a broker-dealer or bank can easily keep "on account." To accommodate this practice, rule 206(4)-2 includes a narrow exception to the requirement that client assets be maintained with a qualified custodian, but the exception is available only for securities that are: (i) acquired from the issuer in a transaction not involving any public offering; (ii) uncertificated, and ownership is recorded only on the books of the issuer or its transfer agent in the name of the client; and (iii) transferrable only with prior consent of the issuer or shareholder.[11]

The privately offered security exception is not available to assets of pooled investment vehicles that are not audited annually, *i.e.*, that do not qualify for the "audit approach" to compliance with the rule discussed below.[12] The SEC concluded that the restrictions on transferability that provided safeguards to abuses would be ineffective in the case of a pooled investment vehicle where often the adviser (or a related person) has authority to act on behalf of the fund that a custodian would recognize.[13] This limitation can present a significant challenge to advisers to pooled investment vehicles that do not distribute audited financial statements.

The SEC staff has issued some guidance that expands the utility of the privately offered security exception. First, the staff stated that it would not object if an adviser to an audited private fund does not maintain non-transferable 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."[14] The guidance essentially extends the private security exception to certificated securities and was issued in response to arguments that maintaining custody of non-transferrable securities does not provide any meaningful client protections to investors. This interpretation is only available for advisers to audited pools and does not alter the requirement that the securities be non-transferrable except by consent of the issuer or investors.

Second, the SEC staff stated that it considers partnership agreements, LLC agreements, subscription agreements, and securities evidenced by ISDA master agreements *and* the securities represented by the documents to be "privately offered securities" and thus eligible for the exception if they cannot be transferred without consent of the counterparty for purpose of the custody rule.[15] This interpretation cleared up a significant practical problem for investors who had invested in these types of securities and had struggled to address with their qualified custodians.

Shares of mutual funds. Shares of an open-end management investment company (mutual fund) may sometimes be purchased by clients directly from the fund through the fund's transfer agent. To accommodate this practice, rule 206(4)-2 permits the fund's transfer agent to fill the role of a qualified custodian, in which case the transfer agent must perform the other functions of a qualified custodian under the rule, including delivering a statement directly to the client.[16] This exception is available only when shares are held with the fund's own transfer agent.

Both the exception for privately offered securities and shares of mutual funds relieve an adviser only from the requirement that the securities be maintained with a qualified custodian — unless another exception is available, privately offered securities and shares of mutual funds still must be covered by the surprise verification and client statement requirements. In the

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[10] 2003 Adopting Release, *supra* note 6 at n. 18.

[11] Rule 206(4)-2(b)(2)(i).

[12] Rule 206(4)-2(b)(2)(ii). *See infra* Section II.a of this article.

[13] 2003 Adopting Release, *supra* note 6 at Section II.B.

[14] *IM Guidance Update 2013-04* (Aug. 2013), *available at* http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-04.pdf.

[15] *Id*. at n. 2. Although the relief for privately offered securities provided by the *IM Guidance Update* is available only to pooled investment vehicles, the SEC staff has informally stated that the interpretation set forth in footnote 2 of the update was not intended to be so limited. Nonetheless, because the private securities exception is available only to pooled investment vehicles that are audited, this position is not available to advisers with respect to all pools.

[16] Rule 206(4) 2(b)(1). If the transfer agent is a "related person" of the adviser, the adviser must receive a control report from the transfer agent. Question XV.1 of SEC Staff FAQs. *See also* discussion, *infra*, Section III.a.

case of mutual funds, the client statements will typically be delivered by the transfer agent.

Foreign Custodians. Subject to two requirements, rule 206(4)-2 permits advisers to maintain client securities and cash with foreign financial institutions. The foreign custodian must (i) be used customarily to hold financial assets for its customers and (ii) hold the client assets in an account segregated from its proprietary accounts.[17]

Other than the segregation requirement, the rule makes no effort to regulate or restrict the use of a foreign custodian.[18] The SEC has explained, however, that where an adviser has selected a foreign custodian, its fiduciary duty requires it to have "a reasonable basis for believing that the foreign institution will provide a level of safety for client assets similar to that which would be provided by a 'qualified custodian' in the United States or to fully disclose to clients any material risks attendant to maintaining the assets with the foreign custodian."[19]

An investment adviser that does not have custody of client assets held with foreign custodians would not be subject to any requirement of the rule — including the requirement that the custodian 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. Finally, all advisers are bound by contractual restrictions on custody arrangements, including the use of foreign custodians, although a contractual provision cannot waive a provision of the custody rule.[20]

b. Notice to Clients

When the adviser 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), the adviser must notify the client *in writing* of the name and address of the qualified custodian, and the manner in which the client funds or securities are being held, and must thereafter notify the client when this information changes.[21] If multiple custodians will be used, an adviser can satisfy the rule by providing a one-time notice of all custodians and does not have to provide a new notice each time assets move among custodians.[22]

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.[23] The account statements must identify (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.[24] Account statements may be delivered electronically, following the guidelines on electronic delivery set out in the SEC's electronic delivery interpretive releases.[25]

The delivery requirement precludes the adviser from being the sole provider of account information to clients and is designed as a check on the adviser's use of assets.[26] Although the rule does not preclude an adviser from sending its own account statements to clients, those statements alone will not satisfy the rule.[27] If the adviser does send clients its own account statements, the adviser must include a statement (i) in the notice that the qualified custodian sends upon opening an account for a client and (ii) in its own subsequent account statements, urging the client to compare the account statements from the qualified custodian with those from the adviser.[28]

One of the consequences of the account statement requirement is that the custodian must have access to the

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[17] Rule 206(4)-2(d)(6)(iv).

[18] A foreign custodian can be used, for example, to hold domestically traded securities.

[19] 2003 Adopting Release, *supra* note 6 at n. 22.

[20] Under section 215(a) of the Advisers Act, any provision of a contract that conflicts with the custody rule is void.

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

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

[23] Rule 206(4)-2(a)(3).

[24] *Id.* 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. Question IX.1 of SEC Staff FAQs.

[25] Adv. Act Rel. No. IA 1562 (May 9, 1996). *See also* Question IV.1 of SEC Staff FAQs.

[26] 2003 Adopting Release, *supra* note 6. A custodian may use a service provider to deliver statements on its behalf as long as the statements are not routed though the adviser. *Id.* at n. 30.

[27] *Walter V. Gerasimowicz*, Adv. Act Rel. No. IA 3601 (May 23, 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).

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

identity of advisory clients whose assets may otherwise be held in an omnibus account under the adviser's name. Omnibus accounts have been used by advisers to protect the privacy of high-profile clients (from the eyes of the custodian's employees) and to deny access to the client list to custodians that might also be competitors. The SEC concluded that the protections afforded by direct delivery of account statements are of greater value than the privacy concerns. It suggested that advisers could seek to address privacy concerns by contractually limiting the custodian's use of confidential information.[29]

Reasonable Belief. The SEC has not prescribed a single method by which an adviser can form a reasonable belief after due inquiry, but has stated that adviser access to the custodian's web site alone would be inadequate, because access would only confirm that the account statements are available but not that they were sent.[30] The SEC has stated that advisers could satisfy the requirement by receiving a copy of custodial statements sent to advisory clients.[31] Many advisers today periodically obtain a certificate from custodians stating that the custodian has policies and procedures in place pursuant to which they send account statements to the adviser's clients (whether by paper or electronically), and that the policies and procedures address circumstances when account statements are returned as not deliverable. Some advisers survey a sample of their clients to determine that they have received custody statements. Other advisers establish proprietary accounts with client custodians, which permits them to observe the reporting practices of the custodian. These methods should satisfy the rule.

Under the rule, advisers have a burden of demonstrating that they made an inquiry and formed a reasonable belief that account statements are being delivered by custodians. To meet this burden, advisers need to adopt compliance policies setting forth the method(s) they will use to form a reasonable belief (such as those described above), and to create and retain records that can be provided to SEC examiners.

Independent Representatives. In some cases, a third person will have been granted a power of attorney (or has a similar source of authority) to act on behalf of the client who may be an estate, a minor, an incompetent, or who is in a position to hire other persons to manage their business affairs. Rule 206(4)-2 permits the account statements (and notices discussed above) to be delivered to an "independent representative" of a client instead of to the client.[32] The independent representative must be someone who: (i) acts as agent for the advisory client and must be obligated by law or contract to act in the advisory client's best interest; (ii) must be independent of the adviser – it must not control, be controlled by, or be under common control with the adviser; and (iii) cannot have (or have had within the past two years) a material business relationship with the adviser.[33]

d. Annual Surprise Exams

Advisers that have custody of client funds or securities generally must undergo an annual surprise examination by an independent public accountant that verifies the client funds and securities over which the adviser has custody.[34] Each adviser with custody must engage an accountant to determine annually that there are no material discrepancies between amounts that are supposed to be held in client accounts and those that actually are. Only client funds and securities over which the adviser has custody must be subject to the surprise examination. The rule provides for a few important exceptions, discussed below, which may permit an adviser to avoid the cost of obtaining a surprise examination or to narrow the client assets that the accountant must verify.

The rule also imposes a set of requirements on the accountants conducting the surprise examinations that, among other things, obligates them to alert the SEC to any discrepancies. Receipt of any alert will typically precipitate an SEC examination to determine whether client assets are at risk. Most of these requirements must be reflected in the terms of the contract between the adviser and its independent public accountant.

Exceptions. The rule includes three unrelated exceptions, which are discussed in more detail in other sections of this article. First, an adviser that has custody *solely* because it has authority to deduct advisory fees

[29] Adv. Act Rel. No. IA 2868 (Dec. 30, 2009) (2009 Adopting Release) at Section II.A.

[30] *Id.* at n. 21.

[31] *Id.* at Section II. C. Advisers whose clients receive electronic statements from the qualified custodian may satisfy this requirement by being copied on the e-mail 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. Question IV.1 of SEC Staff FAQs.

[32] Rule 206(4)-2(a)(7).

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

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

from client accounts need not obtain a surprise examination.[35] Second, an adviser to a hedge fund or other pooled investment vehicle that issues audited financial statements does not need to obtain a surprise examination (with respect to the fund's assets) if the audited financial statements are delivered to investors within the prescribed period of time.[36] Finally, advisers that are deemed to have custody *only* because a related person has custody of their client's assets are not required to obtain a surprise examination if the adviser establishes and documents that the related person is "operationally independent."[37]

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 Regulation S-X.[38] Typically, an accountant will make representations to advisers before the beginning of the engagement, and periodically thereafter, that it has determined that it meets the SEC's independence requirements.[39] The failure of an accountant to maintain its independence from the adviser will result in a violation of the *adviser's* obligations under rule 206(4)-2.[40]

PCOAB Registered. In some circumstances, an accountant performing services for an adviser under the rule must be registered with and subject to regular inspection by the PCAOB. The practical effect of this requirement is to force an adviser to engage a larger accounting firm (that audits financial statements of public companies), or one that specializes in auditing brokers. Advisers will need to engage a PCOAB-registered and inspected independent public accountant when the accountant must: (i) perform an annual audit of a pooled investment vehicle that is taking advantage of the "audit exception;"[41] (ii) perform an annual surprise examination of an adviser that itself maintains client assets (*i.e.*, self-custody) or maintains them with a related person;[42] or (iii) prepare an internal control report with respect to a related person that serves as a qualified custodian.[43]

Mechanics of the Surprise Examination. An adviser subject to the surprise examination requirement must enter into a written agreement with an independent public accountant.[44] The written agreement should (and in some cases must) include the following provisions, which will largely govern the mechanics of the examination:

- *Annual Examination*. The accountant must verify the client's funds and securities at least once each calendar year. The exams should be a "surprise" to the adviser — scheduled so that their timing is

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[35] Rule 206(4)-2(b)(3)(i), discussed in Section II.b of Part I.

[36] Rule 206(4)-2(b)(4), discussed, *infra* Section II.a.

[37] Rule 206(4)-2(b)(6), discussed, *infra* Section III.a.

[38] Rule 206(4)-2(d)(3). Independence of an accountant may be affected by its (or members of its engagement team's) financial interests in the adviser, employment relationships, business relationships, or provision of non-audit services. Independence must be maintained throughout the term of the engagement. In the case of an accountant performing a surprise examination, the engagement period begins the earliest of: (i) the date the accountant signs the initial agreement to perform the surprise examination; (ii) the date the accountant begins attest procedures; or (iii) the beginning of the period subject to the surprise examination. Question XVI.1, 2 and 3 of the of SEC Staff FAQs.

[39] The accountant's independence may be affected not only by business relationships with the adviser but also with business relationships with its affiliates. Auditing the financial statements of a pooled investment vehicle sponsored by the adviser would not, however, disqualify an auditor from being independent if it otherwise met the SEC independence requirements. Question XVI.4 of SEC Staff FAQs.

[40] *Total Wealth Management, Inc.*, Adv. Act Rel. No. IA 3818 (Apr. 15, 2014) (adviser violated custody rule because, among

footnote continued from previous column…

other things, the accounting firm auditing pooled investment vehicle did not meet SEC independence requirements).

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

[42] Rule 206(4)-2(a)(6)(i).

[43] Rule 206(4)-2(a)(6)(ii)(C).

[44] 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. Rules 204-2(a)(17)(iii) and (e)(1). Although the rule is written in a manner that suggests 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,* Adv. Act Rel. No. IA 3737 (Dec 12, 2013) (settled administrative action in which the SEC observed that the adviser "violated the Custody Rule because it took no action to determine whether the independent public accountants it retained to conduct annual surprise exams to verify the assets over which it had custody performed those exams.").

irregular from year to year.[45] The scope and methodology used by the accountant is governed by professional attestation standards and guidance provided by the SEC (and discussed below).[46] After the examination, the accountants will provide the adviser 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.[47]

- *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.[48] 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.[49]

- *Material Discrepancies*. If the accountant finds any material discrepancies during the course of an exam, such as a shortfall in the amount of assets reported to clients, the accountant must notify the SEC's Office of Compliance Inspections and Examinations (OCIE) within one business day of the finding.[50] A material discrepancy includes a material non-compliance with rule 206(4)-2 or rule 204(b) under the Act.

- *Noisy Withdrawal*. If the adviser terminates the accountant's 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.[51]

- *New Advisers*. The rule requires a newly registered adviser to entered into a written agreement 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.[52]

Guidance for Accountants. In connection with the 2009 amendments to the custody rule, the SEC issued an interpretive release to update its guidance for accountants.[53] Under the new guidance, accountants may verify client positions on a sample basis, overturning earlier guidance that required the accountant performing the surprise examination to verify *all* client assets.[54] Accountants must confirm client balances and transactions based on the records of custodians.

Potential liability of accountants. Although accountants performing a surprise examination pursuant

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[45] *Kaufman, Bernstein, Oberman, Tivoli & Miller, LLC*, Adv. Act Rel. No. IA 2194 (Nov. 20, 2003) (settled enforcement action against adviser whose independent auditor began its examination on the same date each year).

[46] *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 204(4)-2 Under the Investment Advisers Act of 1940*, Adv. Act Rel. No. IA 2969 (Dec. 30, 2009) (hereafter, "Commission Guidance").

[47] *Id*. Rule 204-2(b) under the Advisers Act requires that an investment adviser that has custody of funds or securities of any client must record all transactions for the client in a journal and in separate ledger accounts for each client, and must maintain copies of confirmations of all transactions in such accounts and a position record for each security in which a client has an interest.

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

[49] "Illustrative Report of Independent Accountant on Examinations of Securities Pursuant to Rule 206(4)-2" (Feb. 12, 2012), *available at* http://www.aicpa.org/InterestAreas/FRC/IndustryInsights/DownloadableDocuments/Surprise_Exam_Report.pdf.

[50] Rule 206(4)-2(a)(4)(ii). A shortfall in funds or securities might not implicate Rule 206(4)-2. Interestingly, no provision in the rule prohibits an adviser from misappropriating client assets, and the SEC typically asserts in such cases a violation of the general anti-fraud provisions. A shortfall would, however, create inconsistencies in the adviser's records, implicating rule 204-2, and creating a discrepancy the accountant must report if material.

[51] Rule 206(4)-2(a)(4)(iii). The report must also be filed if the accountant removes itself or is removed from consideration for being appointed. Commission guidance, *supra* note 46.

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

[53] Commission Guidance, *supra* note 46.

[54] Adv. Act Rel. No. IA 201 (June 1, 1966).

to rule 206(4)-2 are not regulated under the Advisers Act (which is why their obligations arise pursuant to a contract with the adviser), the SEC has instituted settled enforcement proceedings under the Advisers Act against accountants that failed to complete a surprise examination and file form ADV-E for "aiding and abetting" the adviser's violation of the custody rule.[55] The SEC also asserted improper professional conduct under the SEC's rules of practice.

II. POOLED INVESTMENT VEHICLES

Because many hedge funds and other pooled investment vehicles are structured so that the adviser or a related person serves as the general partner, or otherwise has control of or access to fund assets, advisers to pooled investment vehicles will generally have custody of the assets of the pool. Rule 206(4)-2 provides for exceptions from the safekeeping requirements of the rule (other than the requirement to maintain assets with a qualified custodian) for pooled investment vehicles that issue audited financial statements.[56] Advisers need not take advantage of this exception and advisers to small pools of assets may find the cost of the required annual audit is prohibitive.

The rule does not include a definition of "pooled investment vehicle," but the audit approach is clearly available to "private funds," which include pools of securities that would be subject to the Investment Company Act of 1940 ("Investment Company Act") but for sections 3(c)(1) (pools offered to 100 or fewer persons) or 3(c)(7) (pools offered to an unlimited number of qualified investors) of that Act.[57] The audit approach should also be available to other types of collective investment vehicles holding funds or securities, including those that do not meet the definition of "private fund."[58]

This discussion assumes that the adviser is subject to the custody rule with respect to assets of the pooled investment vehicle. The adviser may not have custody, or it might not otherwise be subject to rule 206(4)-2 because it is not registered with the SEC. Under SEC interpretations of the Advisers Act, a registered adviser with a principal office and place of business outside the United State would not be subject to the custody rule at all with respect to offshore pooled investment vehicles, even if some or all of the investors were U.S. persons.[59]

a. Audit Approach

An adviser to a pool that issues financial statements prepared in accordance with Generally Accepted Accounting Principles ("GAAP") and (i) whose financial statements are 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, with respect to the assets held by the pool, is:

- deemed to have complied with the surprise examination requirement;
- exempt from the notice and account delivery requirements; and
- permitted to self-custody certain privately offered securities.[60]

An adviser able to take advantage of the "audit approach" is required by the custody rule only to maintain client assets with a qualified custodian. This

[55] *Rodney A. Smith, Michael Santicchia, CPA, and Stephen D. Cheaney, CPA*, Adv. Act Rel. No. IA 3738 (Dec. 12, 2013).

[56] Rule 206(4)-2(b)(4).

[57] *See* Section 202(a)(29) of the Advisers Act (defining the term "private fund"), which was added by the Dodd-Frank Act in 2010, after the 2009 amendments to the custody rule. The SEC staff permits certain college savings plans ("529 plans") to be treated as a pooled investment vehicle for purposes of rule 206(4)-2 notwithstanding some differences in audits and financial statement delivery practices. *Prudential Insurance Company of America,* Mar. 1, 2003.

[58] The term "pooled investment vehicle" is also used in Item 5 of Form ADV, but is defined only in rule 206(4)-8 under the

footnote continued from previous column…

Advisers Act (which prohibits advisers from defrauding investors in pooled investment vehicles they advise) to limit the scope of that rule to advisers to private funds (or, more precisely, those pools that would today be defined as "private funds") and registered investment companies. The policy considerations that led the SEC to narrowly define the scope of rule 206(4)-8 would not seem relevant to the availability of the audit exception. *See* Adv. Act Rel. No IA 2628 (Aug. 3, 2007) at Section II.A.3.

[59] *ABA Subcommittee on Private Investment Entities,* Aug. 10, 2006.

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

approach reflects the SEC's understanding that the annual audit of the fund's financial statement provides "meaningful" protections for investors.[61] Most advisers to private funds use the audit approach because the funds' operating agreements already require the fund to annually issue audited financial statements (and thus imposes no additional costs), and few wish to send account statements to investors that contain what most consider proprietary information (portfolio holdings) to investors in pooled investment vehicles, as required by the "surprise examination approach," discussed below.

The audit approach is available *only* with respect to clients that are pooled investment vehicles, such as hedge funds, private equity funds, and venture capital funds.[62] The approach is available regardless of the number of investors or amount of assets in the pool — a fund with a single investor can qualify.[63] 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 for all or some of the pooled investment vehicles. Care must be taken that *each* of the conditions for use of the audit approach are met.

PCAOB registered and inspected. To prevent the type of auditor implicated in the Madoff fraud from certifying financial statements of funds under the audit approach, the rule requires that the annual audit be conducted by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB."[64]

When the SEC adopted the surprise audit 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. In 2010, the Dodd-Frank Act addressed this problem, in part, by extending PCAOB authority to auditors of broker-dealers.[65] 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 regular inspection program for auditors of broker-dealers.[66]

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 ("GAAS"), with some exceptions for non-U.S. pools.[67] Financial statements do not meet these requirements if the auditor cannot give an unqualified opinion. Thus, problems with the pool's financial statements will create a serious problem under the custody rule for the adviser, because it is unlikely it will be able to retroactively comply with the rule using the surprise examination approach. Not only would the adviser have to obtain a surprise examination, but it would have needed to comply with the rule's notice and quarterly account statement requirements during the course of the year, and it would not have been able to self-custody any privately offered securities.

An adviser to non-U.S. pooled investment vehicles that are subject to the custody rule may have financial statements prepared in accordance with other accounting standards (*e.g.*, IFRS) so long as the financial statements (i) contain information substantially similar to financial statements prepared in accordance with U.S. GAAP and (ii) are reconciled to U.S. GAAP.[68] An adviser may

[61] 2003 Adopting Release, *supra* note 6 at Section II.D.2.

[62] Question X.1 of SEC Staff FAQs. In one enforcement matter, 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,* Adv. Act Rel. No. IA 3705 (Oct. 28, 2013). However, the audit approach is likely to be available to a broader range of pooled investment vehicles. *See*, *supra* note 58.

[63] Question VI.11 of SEC Staff FAQs. The SEC approaches the use of a single investor private fund differently depending upon whether it views the arrangement as an evasion of a regulatory obligation. *See* Adv. Act Rel. No. 3222 (June 22, 2011) at n. 324 and accompanying text. Here, it did not view the use of the audit approach as evading the surprise examination approach.

[64] Rule 206(4)-2(b)(4)(ii). The SEC stated that it "has greater confidence in the quality of such audits." 2009 Adopting Release, *supra* note 29.

[65] Section 982 of the Dodd-Frank Act.

[66] *Robert Van Grover, Esq., Seward & Kissel LLP*, Nov. 5, 2013; *Seward & Kissel LLP*, July 21, 2001; *Seward & Kissel LLP*, Oct. 12, 2010.

[67] Rule 206(4)-2(b)(4); Question VI.6. of the SEC Staff FAQs.

[68] 2003 Adopting Release, *supra* note 6 at n. 41.

forgo reconciliation with U.S. GAAP where the financial statements are not delivered to U.S. persons.[69]

Special Purpose Vehicles and Escrow Accounts. Advisers to pooled investment vehicles may from time to time use special purpose vehicles (SPVs) to facilitate the pool's investment 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 conditions discussed below, treating the pooled investment vehicle and the SPVs as a single client and distributing the combined audited financial statement to the investors ("consolidation").[70]

The SEC staff has issued guidance that where an SPV is owned by one or more pooled investment vehicles controlled by the same investment adviser, then the adviser may (whether the SPV holds one or multiple securities) treat the assets of the SPV as the assets of the pooled investment vehicle for purposes of the custody rule. 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.[71]

Advisers to private equity funds sometimes establish temporary escrow accounts to hold a portion of the proceeds of a sale of a security that belongs to both the seller and purchaser. The SEC staff has stated it will not object if the adviser maintains client funds in such escrow accounts provided, among other things, the client is a pooled investment vehicle that relies on the audit approach, and includes the portion of the escrow attributable to the pooled investment vehicle in its financial statements.[72]

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.[73] The liquidation audit is designed to provide information to investors that they can use to protect their rights, but unless assets are retained to pay for the cost, the audit can impose significant costs on the remaining investors.

Delivery of Financial Statements. The financial statements must be delivered to investors within 120 days of the pool's fiscal year end. The failure to timely deliver financial statements to investors will cause the adviser relying on the audit approach to be in violation of the custody rule. The SEC staff has advised that when failure to distribute financial statements in a timely fashion is due to "unforeseeable circumstances," it will not recommend an enforcement action against the adviser for violating the custody rule.[74] If the adviser is repeatedly late in receiving the financial statements from the fund's auditor, the SEC will likely view the circumstances as foreseeable.[75]

Advisers to pooled investment vehicles that invest in other pools (funds of funds) have particular challenges in meeting the 120 day delivery requirement because preparation of the fund of funds' financial statements is dependent on receipt of those of the underlying funds. The SEC staff has therefore extended the time the adviser to the pooled investment vehicles has to deliver financial statements to 180 days in the case of a fund of funds, and 260 days in the case of a fund of funds of funds.[76] For the adviser to qualify for the extension of time, the fund of funds (the top-tier fund) has to invest at least 10 percent of its assets in other pooled investment vehicles.

b. Surprise Examination Approach

If a pooled investment vehicle cannot comply with the audit approach, the adviser must obtain a surprise examination for the pooled investment vehicle, an approach that, as noted above, works well for advisers to smaller pooled investment vehicles (who may be

[69] *Goodwin, Proctor & Hoar*, Feb. 28, 1997.

[70] 2009 Adopting Release, *supra* note 29 at Section II.F.

[71] *IM Guidance Update 2014-07* (June 2014).

[72] *Id*.

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

[74] Question VI.9 of SEC Staff FAQs. *See Sands Brothers Asset Mgmt., LLC*, Adv. Act Rel. No. IA 3960 (Oct. 29, 2014). (Violation of the rule is based on strict liability, *i.e.*, it does not matter whether failure to deliver was a result of the advisers intentional or even negligent conduct, although in instituting this enforcement matter, the SEC observed that the circumstances surrounding the failure to timely deliver financial statements were "predictable and not unforeseeable.").

[75] *See Sands Brothers Asset Mgmt., LLC, supra* note 74 (circumstances causing adviser to distribute financial statements late for three consecutive years deemed not unforeseeable because "auditors had repeated difficulty obtaining the information they needed . . . year over year").

[76] Question VI.8A and B of SEC Staff FAQs.

required to engage an accountant for a surprise examination of other clients for which it has custody), but provides challenges for advisers to hedge funds and other larger pooled investment vehicles because the adviser must also:

- *Private securities*. Maintain all client funds and securities, including privately offered securities, with a qualified custodian.[77] Because many prime brokers will not accept custody of these securities, many advisers have had to make arrangements with other custodians.

- *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 representatives.[78] 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).[79]

III. SPECIAL CIRCUMSTANCES

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

As discussed in in Part I of this article, following the Madoff scandal the SEC was suspicious of self-custody arrangements that might permit an adviser unchecked access to client funds. The SEC did not, however, require advisers to exclusively use independent third-party custodians, in part, because such a requirement could have made unlawful many common brokerage programs, such as wrap-fee programs and fee-based brokerage that combined brokerage and advisory services.

Instead, the SEC amended rule 206(4)-2 to impose additional controls when client assets are maintained by the adviser itself or by a related person. In either case, the entity maintaining the client assets must be a qualified custodian so that only advisers and related persons that are qualified custodians may maintain their clients' assets. In addition, and subject to exceptions discussed below, an adviser that maintains client assets or whose related person maintains those assets must (i) itself obtain a surprise examination and (ii) obtain a report on the internal controls of the entity maintaining the assets, as described below.[80]

Surprise Examination. This is the same examination that any other adviser with custody of client assets must undergo, with two significant differences. First, the report must be performed by an independent public accountant registered with, and subject to regular inspection by, the PCAOB.[81] 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 should affect its report.[82]

The adviser may forgo the surprise examination if (i) the adviser has custody solely because a related person is maintaining those client assets[83] and (ii) the related person is "operationally independent" of the investment adviser.[84] Thus, an adviser that is part of the same corporate organization as a broker-dealer will not have to obtain a surprise examination merely because some of its clients maintain brokerage accounts with the broker-dealer.[85] The availability of this exception is

[77] Question VII.1 of SEC Staff FAQs.

[78] Rule 206(4)-2(a)(5).

[79] Question VI.2 of SEC Staff FAQs; *Walter V. Gerasimowicz, supra* note 27 (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).

[80] Rule 206(4)-2(a)(6).

[81] Rule 206(4)-2(a)(6)(i).

[82] Commission Guidance, *supra* note 46.

[83] Rule 206(4)-2(b)(6)(i). If, for example, the adviser has custody because it is also a trustee of a 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.

[84] Rule 206(4)-2(b)(6); Question XIII.2 of SEC Staff FAQs (adviser must receive an internal control report from the related person that acts as a qualified custodian for the adviser's clients, even if that person is operationally independent).

[85] An adviser that maintains client assets itself, however, must obtain a surprise examination because, as discussed below, it could not be "operationally independent" of itself. Both paragraph (a)(4) (requiring independent verification of securities over which the adviser has custody) and (a)(6) (requiring adviser or related person maintaining client assets as a qualified custodian) of the rule would apply in this circumstance to the adviser.

important for large financial firms with affiliated broker-dealers because it reduces the cost of complying with the custody rule.[86]

Generally, an adviser and a related person are operationally independent when they operate as separate businesses without common employees. The rule presumes that a related person is *not* operationally independent of the adviser unless each of the following conditions are met: (i) client assets in the custody of the related person are not subject to claims of the adviser's creditors; (ii) 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; (iii) advisory personnel and those personnel of the related person who have access to advisory client assets are not under common supervision; (iv) advisory personnel do not hold any position with the related person or share office space with the related person;[87] and (v) no other circumstance can reasonably be expected to compromise the operational independence of the related person.[88]

An adviser relying on this "operationally independent" exemption must maintain a file memo describing the basis for its determination that the related person is operationally independent,[89] and should establish compliance policies designed to preserve operational independence. Compliance officials of the advisers should be tasked with periodically testing their operation.

Internal Control Report. An adviser that maintains client assets itself or with a related person must also, at least once each year, obtain (if the adviser is the qualified custodian) or receive from the related person (if the related person is the qualified custodian) an annual report of internal controls of the qualified custodian.[90] The internal control report must relate to the qualified custodian's custody of client assets and be prepared by an independent public accountant registered with, and subject to regular inspection by, the PCAOB, such as an SSAE 16 report. The control report provides the accountant with a basis for verifying client assets other than relying on custody reports issued by the adviser or the related person.[91]

The report must contain an opinion of the accountant as to whether controls of the qualified custodian (either the adviser or its related person) are suitably designed and operate effectively to meet the control objectives relating to custodial services, including the safeguarding of funds and securities held by the adviser or its related person.[92] As part of the control report, the auditor must confirm or test the client funds and positions against those held by an independent third party (such as the Depository Trust Company). This verification can be done by testing a sample of accounts.

The control report does not have to be prepared at any particular time each year, and the requirement does not include the "surprise" element. An adviser receiving the report must retain the report as a required record and make it available to the SEC upon request.[93]

Broker-Dealers. Under rule amendments adopted by the SEC in 2013, a broker-dealer that maintains custody of customer funds and securities must similarly obtain a written internal control report prepared by an independent public accountant registered with and examined by the PCAOB.[94] The SEC has stated that this report will satisfy the internal control report requirement of rule 206(4)-2.[95] The broker-dealer control report does *not,* however, satisfy the surprise examination required of broker-dealer/advisers that self-custody client assets, as well as advisers that maintain custody with a related person that is not operationally independent.[96]

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[86] Indeed, as discussed below, because under broker-dealers' internal control reports prepared to satisfy other SEC rules satisfy the rule 206(4)-2 requirement, maintaining client assets with an affiliated broker-dealer may impose no additional costs.

[87] Rule 206(4)-2(d)(5). 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. 2009 Adopting Release, *supra* note 29 at n. 111.

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

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

[90] Rule 206(4)-2(a)(6).

[91] 2009 Adopting Release, *supra* note 29.

[92] Control objectives are listed in the Commission Guidance, *supra* note 46.

[93] 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 the Staff FAQs.

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

[95] Rel. No. 34-70073 (July 20, 2013) at Section II.H.

[96] *Id.*

b. Advisers to Registered Investment Companies

Advisers are exempt from all provisions of the rule with respect to clients that are registered investment companies.[97] These accounts are subject to the requirements of section 17(f) of the Investment Company Act of 1940 and related SEC custody rules.[98]

c. 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.[99] 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 were registered under the Advisers Act. If the partnership holds interests in REITs, limited partnerships, or limited liability companies that own real estate, the general partner will likely be giving advice regarding securities, and the rule will apply.

d. Non-U.S. Advisers

The custody rule applies to registered advisers with a principal place and 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.[100] For purposes of this policy, an individual's residence determines whether he 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,[101] and its place of organization determines whether it is a U.S. person.[102] Consequently, the custody rule is 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.

e. Advisers to Pooled Investment Vehicles in which Principals Invest

The SEC staff has issued a no-action letter permitting an adviser with custody of assets of a pooled investment vehicle to forgo compliance with the notice, account statement, and surprise verification (including the audit option) provisions of the custody rule where the investors in the pooled investment vehicle are limited to certain principals of the adviser, and any of their spouses, or minor children, or investment vehicles established on their behalf.[103] The letter requesting no-action relief suggested that the principals of the adviser were in a position to protect themselves and their families from custodial risks.

IV. FORM ADV

Advisers must report whether they have custody of client funds or securities on Form ADV and extensive information about their custody practices if they do.

a. Information about whether the Adviser Has Custody of Client Assets

Items 9A and B of Part 1.A of form ADV 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 the sole reason the adviser has custody is because it has authority to deduct the amount of its fee from client accounts. The SEC staff views advisers with custody as presenting more significant compliance risks and thus schedules them for more frequent examinations.[104]

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[97] Rule 206(4)-2(b)(5). The staff has extended this exception to unregistered money market funds that exclusively sell their shares to other 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.

[98] Rules 17f-1 to 17f-7 under the Investment Company Act.

[99] 2003 Adopting Release, *supra* note 6 at n. 16.

[100] *Uniao de Banco de Brasileiros S.A.,* (July 13, 1992).

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

[102] Rule 203(m)-1(d)(8) (defining "United States person" by reference to Regulation S under the Securities Act of 1933).

[103] *16th Amendment Advisors LLC*, Mar. 23, 2015.

[104] The SEC staff also uses the information collected on Form ADV to identify advisers that have custody and to identify those who fail to comply with the surprise examination requirement by comparing those advisers who have reported custody of client assets with those whose accountants have filed Form ADV-E.

b. Information about Related Persons

As discussed above, when the adviser's related person has custody, the adviser may have different options regarding how it complies with the safekeeping requirements of the rule. Item 9.C requires the adviser to report how it complies (*e.g.*, does it take advantage of the audited approach for a pooled investment vehicle). Item 9.D requires it to identify in Schedule D any custodian that is a related person. The identification must be made regardless of whether the related person is determined to be operationally independent.

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.[105]

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 e-mail to registered advisers, the SEC staff has explained that such advisers will likely respond "no" to Items 9.C and 9.D, and most likely would not have to report information in response to Items 9.C or 9.E but must always report at least one custodian in response to Item 9.F, which requires advisers to report the total number of persons (including the adviser and related persons) that act as qualified custodian for the adviser's clients.[106]

V. CONCLUSION

The SEC would prefer that advisers not have custody of their client's assets and rule 206(4)-2 establishes significant incentives for an adviser to avoid acquiring custody. Advisers that do have custody must comply with the safekeeping requirements of rule 206(4)-2. The rule operates to create a control environment in which regulated custodians, auditors, and the adviser compliance personnel each play a role in preventing client losses as a result of operational failures. The complexity of the rule requires that advisers be attentive and dedicate resources to compliance with its requirements. ■

[105] Form ADV Item 9(E); 2009 Adopting Release, *supra* note 29 at Section II.H.

[106] This item was added to Form ADV in 2011. Adv. Act Rel. No. IA 3221 (June 22, 2011) at Section II.C.5.