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# SEC Settlements Highlight Importance of Custody Rule Compliance

November 1, 2013

On Monday, October 28, 2013, the Securities and Exchange Commission ("SEC") issued orders settling administrative proceedings against three registered investment advisers for violations of Rule 206(4)-2 (the “Custody Rule”) and Section 206(4) of the Investment Advisers Act of 1940 (“Advisers Act”).[1] The Custody Rule provides that it is a fraudulent act under Section 206 of the Advisers Act for an investment adviser to have “custody” of client funds or securities without implementing certain controls designed to protect those assets from loss, misappropriation, misuse, or insolvency.[2] The three SEC orders highlight the SEC’s continuing focus on Custody Rule compliance and the consequences of non-compliance.

***Key Takeaways For SEC-Registered Investment Advisers***

- Your activities or arrangements may cause you to have custody in connection with a particular client. You should carefully assess your activities or arrangements with each client to identify any that cause you to have custody in connection with that client. The SEC settlement orders emphasize that an adviser has custody for purposes of the custody rule where the adviser:
  - Maintains blank and/or pre-signed letters of authorization (“LOA”) permitting the firm to transfer client funds without obtaining a contemporaneous signature from the client;

- Possesses log-in credentials for a client's account with a third party, such as a pension account, and can access that account with more than "read only" rights;
- Has been granted check-writing privileges on a client's account; or
- Serves in a legal capacity, such as managing member or general partner of a fund client or trustee for a client, that provides control of or access to client funds.

- You may violate more than the Custody Rule if you fail to recognize that you have custody in connection with a client. In all three settled proceedings, the SEC found that the investment advisers also willfully violated:
  - Section 207 of the Advisers Act through misstatements or omissions in SEC filings by failing to identify on Form ADV Part 1 that the adviser has custody, understating on Form ADV Part 1 the amount of assets for which the adviser has custody, or omitting from the Brochure certain types of custody arrangements the adviser has with clients.
  - Section 206(4) of the Advisers Act and Rule 206(4)-7 (the "Compliance Rule") by failing to include processes for safeguarding client assets and assuring compliance with the Custody Rule in the adviser's compliance procedures; and
  - Section 204 of the Advisers Act and Rule 204-2 (the "Books and Records Rule") by failing to maintain records related to custody of client assets and certain specific categories of records required in connection with advisory services on behalf of a client for which the adviser has custody.

- Penalties and other remedial measures may be steep. In the three settled proceedings, the SEC imposed civil penalties and disgorgement in amounts ranging from $60,000 to $347,000, required significant recordkeeping and governance changes, and barred some firm principals from working with SEC-registered entities for one to three years.

***Further Lane Asset Management Group***[3]

The SEC found that Further Lane Asset Management Group ("FLAM") had custody of certain fund clients' assets due to the firm's physical possession of promissory notes into which the funds had invested. FLAM had custody of other fund clients' assets because the firm, or an affiliate, served as general partner of the fund. FLAM failed to undergo a surprise examination and satisfy the other requirements of the Custody Rule or, alternatively, to obtain an audit of the funds and distribute the audited financial statements to fund investors. These violations followed a 2003 deficiency letter from the SEC's examination program in which FLAM was cited for failure to meet its obligations under the Custody Rule, which includes the surprise examination requirement.

***GW & Wade***[4]

The SEC determined that GW & Wade had custody of client assets because it maintained blank and/or pre-signed LOAs, which permitted the firm to transfer client funds without having to obtain client signatures in every instance. The firm also had third party delegation on check writing accounts, and login access on more than a "read only" basis for accounts that clients held with third parties.

***Knelman Asset Management Group***[5]

The SEC found that Knelman Asset Management Group ("KAMG") had custody of private fund assets because it served as managing member of the fund, and that the adviser failed to comply with the Custody Rule's surprise exam and other requirements or, alternatively, satisfy the audit exception by obtaining an audit of the fund and distributing audited financial statements to the fund's investors. The SEC's enforcement action followed deficiency letters issued by the SEC's examination staff in 2005 and 2011, which advised KAMG that it had custody of the private fund's assets and was not meeting its Custody Rule obligations as they related to those assets.

O'Melveny & Myers is available to advise investment advisers and fund managers about compliance and regulatory obligations, including the specific requirements of the Custody Rule. For questions, please contact Heather Traeger at (202) 383-5232, Kris Easter at (202) 383-5364, or Mattie Hutton at (202) 383-5290.

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[1] Exempt Reporting Advisers are not subject to the Custody Rule but they are subject to the anti-fraud rules.
[2] These controls involve (i) maintaining such client assets with a qualified custodian and notifying the client of the custodial arrangement; (ii) having a reasonable belief that the qualified custodian sends quarterly statements to the client; (iii) and undergoing a surprise exam by a PCAOB-registered accountant to verify client assets and the adviser's process for safeguarding such assets. Private fund advisers may comply with the custody rule in an alternative manner by obtaining an audit of each fund by a PCAOB-registered accountant and delivering the audited financial statements to each investor in the fund.
[3] See *In the Matter of Further Lane Asset Management, LLC*, Investment Advisers Act of 1940 Act of 1940 Release No. 3707 (Oct. 28, 2013).
[4] See *In the Matter of GW& Wade, LLC*, Investment Advisers Act of 1940 Release No. 3706 (Oct. 28, 2013).
[5] See *In the Matter of Knelman Asset Management Group, LLC*, Investment Advisers Act of 1940 Release No. Release No. 3705 (Oct. 28,

2013).

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