

FS Regulatory Briefs*

SEC Sweep Examination of Custodial Controls

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Target Audience: Investment Advisers and Broker/Dealers

On Friday February 13th, the SEC sent notice letters to certain investment advisers and broker-dealers announcing an examination of their custodial controls and related arrangements for safekeeping of their client assets. The letter was sent from the SEC's Office of Compliance, Inspections and Examinations (OCIE), and it appears that OCIE is coordinating the exams. The SEC staff is requesting general information for the period January 1, 2008 to January 31, 2009 (ADV II, organization chart, list of pending suits or complaints, adviser's financials), as well as specific policy, procedure and testing information focused on the adviser's "safeguards surrounding its custodial arrangements and its verification procedures that support the existence of client assets."

Focus on Custody

The SEC's letter states that examiners will conduct interviews of key compliance and back-office personnel who are involved day-to-day with custodial reconciliations and trade settlements and who are knowledgeable about the process of authorizing custodians to receive/disburse client funds. The basic question seems to be: how does an adviser know that his clients' assets are safe and invested as reflected on custodial statements?

In addition to general policies and procedures related to custodial arrangements, the SEC is asking to review output of any compliance reviews, quality control analyses, surveillance and/or transactional testing performed by the firm regarding its custody arrangements.

Points to Consider

- Fund of funds managers should review and be prepared to discuss with the SEC the due diligence conducted on the custodial arrangements of underlying funds. The same holds true for primary advisers who have delegated account-custody arrangements to sub-advisers.

- If client assets are custodied with lesser-known broker-dealers or banks, advisers should be requesting and reviewing financial reports, audits, SAS 70 reports, etc. of those custodians.
- For large Wall Street banks and prime-brokers, advisers should review in detail their contractual agreements and their processes for monitoring the financial health of these custodians. When Lehman Brothers filed for bankruptcy, the assets of a number of hedge funds that were under Lehman's custody were wiped out or frozen. In particular, margin agreements allowed Lehman Brothers to "rehypothecate," securities posted as collateral for margin loans, meaning that Lehman Brothers had a right to use those assets and may have lent them to other investors, thereby terminating the hedge fund's proprietary rights in those assets.

Thus advisers should determine, through contract review, inquiry or otherwise, whether client assets are "segregated" or are commingled with the assets of the prime broker/bank custodian.

- Compliance officers should undertake a detailed review of all compliance policies and procedures related to custody of client assets and Rule 206(4)-2 under the Advisers Act. What is the basis for your reasonable belief that clients are receiving account statements directly from the independent custodian? For advisers managing private investment vehicles, are

you sure that audited financials have been sent to each limited partner (or the LP's representative) within 120 days of FYE? Alternatively, has the adviser sent out quarterly account statements summarizing the fund's positions and transactions, and also engaged an independent auditor to perform a surprise count of assets as required by the rule? If so, are you sure that the auditor has filed the required report on ADV-E with the SEC? Does the firm maintain physical custody of any assets (e.g. stock certificates) in contravention of the rule, even temporarily?

- Compliance and front-office managers should sit down with mid- and back-office staff to discuss and understand the detailed procedures for reconciling positions and transactions between the firm's records and custodian records. These important processes should be supported and evidenced by documented procedures and records maintained by the adviser.
- Compliance and front-office managers should review policies and procedures for authorizing certain employees to instruct custodians as to the movement, receipt and disbursement of client funds. Who is authorized to instruct the custodian? Has the custodian ever acted on instructions from a non-authorized person? How does the custodian identify authorized persons of the adviser? Do certain transactions require dual-authorization? If so, has the policy been followed?
- For advisers with investments in foreign countries it is important to review custodians' foreign sub-custody arrangements. Is the foreign sub-custodian an affiliate of the domestic custodian? Does the foreign country have adequate legislation and regulation in place to monitor custody arrangements for non-domestic clients? What due diligence has the primary custodian performed to gain comfort over the foreign custody arrangement? Is the foreign custodian qualified under the rule? Have you met your fiduciary obligations 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? Are you certain that the foreign-custodied assets are segregated from the foreign custodian's proprietary assets?

Additional Information

If you would like additional information about the topic discussed in this FS Regulatory Brief or a redacted copy of the SEC's letter, please call:

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