

Related Individuals

[Robert G Leonard](#)
Partner
t: 212.969.3355

[Christopher M Wells](#)
Partner
t: 212.969.3600

[Michael F Mavrides](#)
Partner
t: 212.969.3670

[Howard J Beber](#)
Partner
t: 617.526.9754

[Sarah K Cherry](#)
Partner
t: 617.526.9769

[Daniel P Finkelman](#)
Partner
t: 617.526.9755

[Sean J Hill](#)
Partner
t: 617.526.9805

[David T Jones](#)
Partner
t: 617.526.9751

[Scott S Jones](#)
Partner
t: 617.526.9772

[Mary B Kuusisto](#)
Partner
t: 617.526.9760

[Arnold P May](#)
Partner
t: 617.526.9757

[Stephen T Mears](#)
Partner
t: 617.526.9775

[Timothy W Mungovan](#)
Partner
t: 617.526.9412

[Malcolm B Nicholls III](#)
Partner
t: 617.526.9787

[Robin A Painter](#)

Repeated Violations of the Custody Rule Result in SEC Administrative Action

Client Alert

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On October 29, 2014, the Securities and Exchange Commission (SEC) [announced](#) an administrative proceeding against a registered investment adviser, its principals and its chief compliance and operating officer for violating Rule 206(4)-2 of the Investment Advisers Act of 1940 (Custody Rule). In particular, the SEC found that the investment adviser failed to timely provide audited financials to private fund investors, even though the investment adviser and its principals had been sanctioned by the SEC for Custody Rule violations in 2010.

The Custody Rule requires investment advisers with custody of client assets to implement certain safeguards designed to protect client assets against the risk of loss, misuse or misappropriation. Among other things, it requires client assets held in custody by an investment adviser to be subject to surprise annual examinations by an independent public accountant that is registered with and subject to inspection by the Public Company Accounting Oversight Board (PCAOB-Registered Accountant). With respect to private fund clients, however, an investment adviser, rather than complying with the surprise audit requirement, may comply with the Custody Rule by (i) having a PCAOB-Registered Accountant conduct an annual audit of the private fund and (ii) delivering audited financial statements to the private fund's investors within 120 days of the private fund's fiscal year-end (or 180 days for funds-of-funds) (Annual Audit Alternative).

The [SEC order](#) alleges that the investment adviser failed to deliver audited financial statements to private fund investors within 120 days of the 2010, 2011 and 2012 fiscal year-ends. The investment adviser delivered financial statements at least 40 days late for all years and was up to six to eight months late with respect to certain private fund investors. Notably, the SEC found that the investment adviser continued to violate the Custody Rule even though it and its principals had been sanctioned by the SEC in 2010 for Custody Rule violations. [1] The SEC found that the investment adviser failed to take any remedial action and that the investment adviser's principals and its chief compliance and operating officer aided and abetted the investment adviser's Custody Rule violations by, among other things, failing to implement policies and procedures necessary to prevent further violations.

This enforcement action underscores the risk that persistent non-compliance can lead to SEC enforcement action. Investment advisers should be aware that the SEC has consistently identified Custody Rule compliance as an examination priority for investment advisers and should promptly remedy any deficiencies noted during an SEC examination. Please contact your regular Proskauer attorney or any of the attorneys listed on this alert if you have any questions on Custody Rule compliance.

Partner
t: 617.526.9790

[Jamiel E Poindexter](#)
Partner
t: 617.526.9773

[Michael R Suppappola](#)
Partner
t: 617.526.9821

[David W Tegeler](#)
Partner
t: 617.526.9795

[Ira G Bogner](#)
Partner
t: 212.969.3947

[Bruce L Lieb](#)
Managing Partner
t: 212.969.3320

[Amanda H Nussbaum](#)
Partner
t: 212.969.3642

[Charles \(Chip\) Parsons](#)
Partner
t: 212.969.3254

[Marc A Persily](#)
Partner
t: 212.969.3403

[Peter McGowan](#)
Partner
t: +44.20.7539.0669

[Oliver Rochman](#)
Partner
t: +44.20.7539.0617

[Kate Simpson](#)
Partner
t: +44.20.7539.0650

[Nigel van Zyl](#)
Partner
t: +44.20.7539.0609

[Michael Fernhoff](#)
Partner
t: 310.284.5671

[Ying Li](#)
Partner
t: +852.3410.8088

[Yong Ren](#)
Partner
t: +86.10.8572.1899

[1] In 1999, the SEC issued a deficiency letter to the investment adviser for misstating that the investment adviser did not have custody of client assets. Subsequently in 2010, the SEC sanctioned the investment adviser and its principals after examinations from 2004 and 2009 revealed that the investment adviser had improperly relied on the Annual Audit Alternative.

Practices