

Surprise Examinations and Other Key Aspects of the New SEC Custody Rules

Due to the barrage of investment frauds over the past two years, the SEC has been under intense pressure to update its rules protecting investors. The SEC recently issued two new releases that are designed to provide additional safeguards when an advisor has custody of client funds:

- SEC Release IA-2968 *Custody of Funds or Securities of Clients by Investment Advisors*
- SEC Release IA-2969 *Commission Guidance Regarding Independent Public Accountant Engagements*

IA-2968 amends Rule 206(4)-2 under the Investment Advisors Act of 1940 and related forms ADV and ADV-E. The amendments increase requirements that advisors must adhere to when they have custody of client funds or securities, including surprise examinations.

IA-2969 was issued by the SEC to provide guidance to accountants in performing surprise examinations to verify advisors' compliance with Rule 206(4)-2 [the Custody Rule] and Rule 204-2(b) [the Recordkeeping Rule].

What is Custody?

SEC Release IA-2968 indicates that an investment manager is deemed to have custody of client funds or securities if it holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, including:

- Possession of client funds or securities;
- Any arrangement (including power of attorney) under which an advisor is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the advisor's instruction to the custodian; and
- Any capacity (i.e., general partner of a partnership, managing member of an LLC, trustee of a trust, or comparable position for another type of pooled investment vehicle) that gives an advisor or a supervised person legal ownership of, or access to client funds or securities.

An investment manager also has custody if a related person holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them, in connection with advisory services the advisor provides to clients.

Impact of Changes to the Custody Rule on Advisors

Due Inquiry

The amended Custody Rule requires that an advisor's reasonable belief that the qualified custodian sends account statements directly to clients must be formed after "due inquiry". The advisor has some flexibility in determining how to meet this requirement, however the Custody Rule indicates that knowledge of client statements being available for download is not sufficient to meet the "due inquiry" requirement, as online availability only confirms that the statements are available. The advisor must take additional steps to determine whether the statements were sent to clients.

Notification to Clients

Rule 206(4)-2 requires advisors to notify clients promptly upon opening a custodial account on their behalf or when there are changes to the information on that account. The Custody Rule further requires advisors who send their own statements to clients, to include a legend in the notice urging clients to compare the account statements they receive from the custodian with those received from the advisor.

Additional Requirements – Surprise Examinations, Audits, and Internal Control Reports

The Custody Rule makes it illegal for an investment manager to have custody of client funds or securities unless certain requirements are met. In some cases, as noted below, the requirements may be met by employing the services of a CPA firm (such as audits of private pooled investment vehicles, surprise examinations, and internal control reports). A brief summary of these requirements is as follows:

Private Pooled Investment Vehicles – Advisors of Private Pooled Investment Vehicles have the following options to satisfy the amended custody requirements of Rule 206(4)-2:

1. Have an unqualified U.S. GAAP audit of the fund distributed to fund participants by 120 days (180 days for a fund of funds) after year end; or
2. Have a surprise custody examination;

If the advisor or a related entity serves as the custodian, then the advisor must receive an internal control report (such as a SAS70) in addition to the surprise custody examination or audit of the fund.

Registered Investment Companies

There are no additional requirements from Rule 206(4)-2 as these entities are already subject to several other SEC rules under the Investment Company Act that are designed to accomplish similar objectives.

Impact of Changes to the Custody Rule on Advisors, Continued

Separate Institutional or Retail Accounts – Advisors of Separate Institutional or Retail Accounts have the following options to satisfy the amended custody requirements of Rule 206(4)-2:

1. If the advisor does not have custody or only has custody by virtue of fee-deduction only, there is no requirement to have a surprise examination;
2. If the advisor has enhanced custody (ability to withdraw funds beyond fee-deduction, such as trusteeship or power of attorney) and uses an independent qualified custodian, the advisor must have a surprise examination;
3. If the advisor has enhanced custody and uses a related entity as the custodian, then the advisor must have a surprise examination and an additional internal control report (such as a SAS 70).

Disclosures

Advisor Disclosures

Form ADV has been revised to include several custody topics, including:

- Whether the advisor has custody of client assets;
- Total dollar amount and number of clients where the advisor has custody;
- Information on related persons with custody;
- Information relating the level of testing on client assets where the advisor has custody, such as surprise examination, pooled investment vehicle audits, and internal control reports;
- Identification of the public accountant performing services under the Custody Rule 206.

Accountant Disclosures - Surprise Examinations

Accountants are required to submit Form ADV-E and the examination report within 120 days of conducting the surprise examination. The Custody Rule has the following additional reporting requirements:

- If the accountant finds any material discrepancies during the surprise examination, the accountant must notify the SEC of such findings within one business day;
- If the accountant resigns or is dismissed from the surprise examination engagement, the accountant must file a statement notifying the SEC of date and reasons (such as problems relating to the examination) for the resignation or dismissal within four business days.

Compliance Dates

Advisors registered with the SEC must comply with the Custody Rule, on or after March 12, 2010. Advisors registered with the SEC are required to provide responses to the revised Form ADV with their first annual amendment after January 1, 2011.

Compliance Dates, Continued

As of March 12, 2010 (the effective date), advisors that have custody of client assets must, upon opening a custodial account or changing custodial account information, send notification to the client. If the advisor sends account statements to clients, the advisor must include the required legend urging the client to compare account statements the client receives from the custodian to those account statements received from the advisor.

As of March 12, 2010, advisors with custody of client assets also must have reasonable belief that a qualified custodian sends account statements directly to clients, at least quarterly.

If required, the surprise examinations noted above must initially be performed by December 31, 2010 and annually thereafter. The Custody Rule does not indicate a date requirement for signing an engagement letter for a surprise examination. However, it makes sense to get an engagement letter earlier in 2010 so that there is enough time for the examination to truly be a surprise. The specific date of the examination is picked by the accountant and is not provided to the advisor in advance. For advisors that become subject to the Custody Rule after the effective date, the surprise examination must be completed within 6 months of the advisor becoming subject to the Custody Rule.

Internal control reports are required within six months of becoming subject to the Custody Rule.

What to Expect During a Surprise Examination

The SEC requires that the accountant performing the examination issue an opinion noting whether the advisor was in compliance, in all material respects, with paragraph (a)(1) of the Custody Rule as of the examination date and had complied with the Recordkeeping Rule during the period since the prior examination.

Paragraph (a)(1) of Custody Rule requires advisors with custody of client funds to utilize a qualified custodian to maintain those funds in a separate account for each client under that client's name, or in accounts that contain only the client's funds under the advisor's name as agent or trustee for the clients. The Recordkeeping Rule requires advisors with custody of client funds to maintain certain books and records of client transactions and positions. An accountant needs to address both the Custody Rule and Recordkeeping Rule requirements in its surprise examination.

In order to assess an advisor's compliance with the Custody Rule, the accountant first needs to obtain, from the advisor, a list of open and closed accounts that are subject to surprise examination due to an advisor's custody of client funds. A sample of accounts subject to the surprise examination will be selected for further testing.

What to Expect During a Surprise Examination, Continued

But how does the accountant know that the list provided by the advisor was accurate and that the sample is being drawn from a population that contains all accounts that *should* be subject to surprise examination? The accountant will discuss with the advisor its process for determining which accounts are subject to surprise examination and will also select a sample of accounts initially deemed not subject to surprise examination. The accountant will read client and custodian contracts looking for provisions that would trigger custody.

For the sample of accounts subject to the surprise examination, the accountant will confirm funds and securities with both the qualified custodian and the client, and will confirm contributions and withdrawals with clients. If the list of securities held includes privately offered securities, then the accountant will confirm the terms with the counterparties. All confirmations will be reconciled to the advisor's records.

In order to assess an advisor's compliance with the Recordkeeping Rule, the accountant will select a sample of transactions and request supporting documentation, such as trade confirmations.

How to Prepare for a Surprise Examination

Although an advisor will not know the date of an examination in advance, there are certain steps an advisor can take to prepare for a surprise examination. These including the following:

1. Proactively review client and custodian contracts to identify which accounts are subject to custody;
2. Consider engaging legal / compliance experts for complex situations where it's not immediately clear whether custody has been triggered;
3. Maintain an updated account listing which identifies those accounts that are subject to examination;
4. Make sure all contracts with clients and custodians are readily accessible and include the latest amendments, if any;
5. Maintain current contact information (addresses, phone numbers, email addresses) for clients, custodians, and counterparties for privately offered securities;
6. Create and update internal control documentation explaining how systems and processes work - in particular, these should address trading, reconciliation, process for evaluating custody concerns, and other key areas;
7. Maintain organized records supporting all transactions;
8. Perform position and transaction reconciliations on a timely basis.

Additional Considerations

The SEC is clearly focusing on custody issues to reduce the likelihood of investors being defrauded. Advisors with custody of client funds should review their existing policies and procedures that impact accounts with custody. Sound controls should be in place, such as policies that require more than one employee to authorize disbursements of client funds. Policies and procedures should be created to provide segregation of duties, such that one employee doesn't have the ability to authorize a payment, make the related accounting entries, and perform reconciliations of the cash activity.

If you have any questions on this or other matters, please feel free to contact us.

Sincerely,



Thomas A. Peters
Director, Investment Industry Group
Kreischer Miller
tpeters@kmco.com



Todd E. Crouthamel
Director, Investment Industry Group
Kreischer Miller
tcrouthamel@kmco.com