# Surprise! SEC Approves Amendments to the Custody Rule

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The Securities and Exchange Commission (SEC) has acted to strengthen controls over client assets held by registered investment advisers (RIAs) or their affiliates. Specifically, on December 16, 2009, the SEC acted at an open meeting to adopt amendments to Rule 206(4)-2, commonly referred to as the Custody Rule, under the Investment Advisers Act of 1940, as well as related amendments to Form ADV Part 1 and Rule 204-2 with respect to recordkeeping.[1] The amendments were the result of a surge of SEC enforcement actions in 2009 against several RIAs and broker-dealers[2] alleging fraudulent conduct, including misappropriation or other misuse of investor assets, most of which arose from ponzi scheme activity.[3]

On December 30, 2009, the SEC issued an adopting release[4] explaining the amendments and stating that the SEC believes the amendments will "provide for a more robust set of controls over client assets designed to prevent those assets from being lost, misused, misappropriated or subject to advisers' financial reverses." The changes are designed to protect investors through the strengthening of controls in order to curb potential abuses. The centerpiece of the amendments is the implementation of surprise inspections by independent public accountants of those RIAs who have custody of client funds or securities. These amendments went into effect March 12, 2010.

**Surprise Examinations**

Under the newly adopted amendments, RIAs who have custody of client assets or whose client assets are held by a related person are required to engage an independent public accountant to conduct a surprise examination of the client assets held by the adviser.[5] The RIAs required to obtain a surprise examination must enter into a written agreement with an independent public accountant stating that the first examination will take place by December 31, 2010, or, for advisers that become subject to the rule after the effective date, within six months of becoming subject to the requirement.[6] While the amendments require the RIA to arrange for the engagement of the independent public accountant, the inspection must be unannounced and at a time selected by the accountant.[7] Further, the inspection must occur annually and irregularly from year to year.[8] In other words, the inspection cannot happen at or around the same time each year. The SEC expects the inspection to truly be a surprise.

With respect to RIAs who are acting as qualified custodians because they maintain clients' assets or because a related person maintains client funds or securities, then the independent public accountant retained to perform the surprise inspection must be registered with and subject to regular inspection by the Public Company Accounting Oversight Board (PCAOB) as of the commencement of the professional engagement period and as of the end of each calendar year.[9] In this circumstance, RIAs must also obtain (or receive from their related person), a written internal control report within six months of becoming subject to the regulation and then at least once each following calendar year.[10] The internal control report must include an opinion of an independent public accountant as to whether controls have been placed in operation as of a specific date and whether they are suitably designed and operating efficiently to meet control objectives related to custodial services, including the safeguarding of client funds and securities;[11] and a verification by the accountant that the funds and securities are reconciled to a custodian other than the RIA or a related person.[12] The SEC noted that the internal control report can "significantly strengthen the utility of the surprise examination" to the extent it "provides a basis for the independent public accountant performing the surprise examination to obtain additional comfort that the confirmations received from the related custodian are reliable" and serves to "inform the surprise examination process."[13] The agreement with the independent public accountant for the surprise inspection must provide for the first examination to occur no later than six months after obtaining the internal control report.[14]

**The SEC amended the proposed rule to recognize an acceptable alternative to the surprise examination requirement for pooled investment vehicles.**

There are three significant exceptions to the new surprise annual examination requirement.

*Fee Deduction Exception*

RIAs who have custody of client assets solely for the purpose of withdrawing their advisory fees from client accounts are exempt from independent verification requirements.[15] The amendments provide increased controls over the account statements delivered to the client (discussed later in this article) that the SEC reasoned sufficiently enable the client to monitor the propriety of the amount of advisory fees

 

deducted.[16] This exception, however, is not available to an RIA that serves as trustee for its clients, despite the fact that many trustees do not charge a separate fee or charge only a minimal fee for this service.[17] The SEC reasoned that the level of authority that a trustee exercises over the trust assets makes these assets susceptible to misuse and thus in need of the protections afforded by the surprise examination.[18]

*Advisers to Pooled Investment Vehicles*

The SEC had originally also proposed requiring the surprise examination of advisers to a pooled investment vehicle, even though pooled investment vehicles are also subject to an annual financial statement audit by an independent public accountant.[19] In response to comment that surprise examinations would be duplicative of the annual financial statement audit, the SEC amended the proposed rule to recognize an acceptable alternative to the surprise examination requirement for pooled investment vehicles.[20] Specifically, if a pooled investment vehicle is subject to an annual financial statement audit by an independent public accountant and distributes audited financial statements prepared in accordance with GAAP to the pool's investors, it has satisfied the annual surprise examination requirement.[21] In order for the audit to serve as an alternative to the surprise examination requirement, the independent public accountant conducting the audit must be registered with and subject to regular inspection by the PCAOB as of the commencement of the professional engagement period and as of the end of each calendar year, and the audited financial statements must be provided to pool investors within 120 days of the end of the pool's fiscal year.[22] If, however, the pooled investment vehicle does not distribute audited financial statements to its investors, the adviser must obtain an annual surprise examination and have a reasonable basis, after "due inquiry," for believing that the qualified custodian sends an account statement of the pooled investment vehicle to its investors.[23]

**An independent public accountant must notify the SEC within one business day of finding any material discrepancy during an examination.**

In addition to obtaining an annual audit, advisers of pooled investment vehicles with custody of pool assets must also obtain a final financial statement audit upon liquidation of the pool and distribute the audited financial statements, prepared in accordance with GAAP, to the pool investors promptly after the completion of the audit.[24]

On a related note, the SEC recognized that investors in pooled investment vehicles will not receive the benefit of the controls discussed later in this article with respect to receiving regular reports that the assets underlying their investments are properly held.[25] However, the SEC has directed its staff to "explore ways in which we could remedy this potential shortcoming while respecting the confidential nature of proprietary information."[26]

*Advisers with Custody Through Related Persons*

The amendments provide that an RIA has "custody" of any client's securities or funds that are directly or indirectly held by a "related person" in connection with advisory services provided by the adviser to its clients.[27] Further, a "related person" is defined by the rule as any "person, directly or indirectly, controlling or controlled by you, and any person that is under common control with you."[28] The SEC indicated that several commentators had urged it to adopt the position that staff had taken in previous "no-action letters expressing the view that custody of client assets by a related person would not be attributed to the adviser if the related person was operationally separate."[29] The SEC noted, however, that it viewed advisers as having sufficient authority or influence over related persons to prevent risks resulting from the related person's ability to obtain client assets, so the adviser itself should be treated as having custody of the assets.[30]

As a result, the SEC adopted the amendment as proposed but provided for a limited exemption from the surprise examination requirements for RIAs that are deemed to have custody solely as a result of certain of their related persons holding client assets and to be "operationally independent" of the custodian.[31] The amendments include a detailed definition of "operationally independent" that provides that a related person is "presumed not to be operationally independent unless each of the following conditions is met and no other circumstances can reasonably be expected to compromise the operational independence of the related person":

- client assets in the custody of the related person are not subject to claims of the adviser's creditors;
- advisory personnel do not have custody or possession of, or direct or indirect access to, client assets of which the related person has custody, or the power to control the disposition of such client assets to third parties for the benefit of the adviser or its related persons or otherwise have the opportunity to misappropriate such client assets;
- advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision; and
- advisory personnel do not hold any position with

 

the related person or share premises with the related person.[32]

An adviser that is able to satisfy these requirements can overcome the presumption that it is not operationally independent of its related person and, as a result, would not have to obtain a surprise examination of client assets held by that related person. As noted by the SEC, however, the adviser would still "have to comply with the other provisions of the rule (unless an exception is available), including notifying the client where the assets are maintained, forming a reasonable belief after due inquiry that the qualified custodian sends the client account statements, and obtaining an internal control report from a related person that is a qualified custodian."[33]

**SEC Reporting**

The amendments provide that the written agreement with the independent public accountant must require, among other things, that the accountant notify the SEC within one business day of finding any material discrepancy during the course of the examination[34] and that the accountant submit Form ADV-E to the SEC with the accountant's certificate within 120 days of the time chosen by the accountant for the surprise examination, stating that the accountant has examined the funds and securities and describing the nature and extent of the examination.[35]

The agreement with the accountant must also require the accountant, upon resignation or dismissal, to file a statement regarding the termination with Form ADV-E within four business days.[36] This statement must include the date of such resignation, dismissal, removal, or other termination, and the name, address, and contact information of the accountant; and an explanation of any problems relating to examination scope or procedure that contributed to such resignation, dismissal, removal, or other termination.[37] Likewise, the RIA is required on its Form ADV Part I to disclose, among other things, the identity of the accountant that performs its surprise examinations and to amend its Form ADV in the event it changes accountants. Despite comments suggesting that the accountant termination filings should not be made public, the SEC noted that it believed it is "important that the public have access to the termination statements" and that "identifying frequent changes in accountants could put clients and prospective clients on notice to inquire about the reasons for these events."[38]

**Delivering Account Statements and Notice to Clients**

The amended rule eliminates the option for RIAs to deliver account statements themselves; all account statements must be delivered directly by the custodian.[39] The SEC indicated that this amendment was motivated by the belief that, "direct delivery of account statements by qualified custodians will provide greater assurance of the integrity of account statements received by clients."[40] All custodians holding advisory client assets, subject to applicable consumer privacy laws, must deliver custodial statements directly to the advisory clients rather than through the RIA. The RIA may still elect to send account statements to clients in addition to the statements sent by the custodian, but if the RIA does send additional statements, it must instruct those clients to compare the account statements they receive directly from the custodian with the statements they receive from the RIA.[41] This instruction must be communicated to the client by way of a legend included in the notification to clients upon opening an account with a qualified custodian on their behalf, upon changes to their account information, and in any subsequent account statements.[42]

If the RIA elects not to send separate account statements to the client, the RIA is not absolved from all responsibility with respect to sending the statements. The amended rule requires that the RIA must have a reasonable basis, after "due inquiry," for believing that the qualified custodian is, in fact, sending account statements to clients on at least a quarterly basis, detailing the assets and transactions in the clients' accounts, directly to each client for which it maintains custody.[43] The SEC has not provided extensive guidance as to what will constitute "due inquiry" and instead is "providing advisers with flexibility to determine how best to meet this requirement."[44] However, in the adopting release, the SEC provided limited guidance by indicating that the "due inquiry" requirement is satisfied "if the qualified custodian provides the adviser with a copy of the account statement that was delivered to the client" but not if the RIA accesses "qualified custodian account statements through the custodian's website."[45] The SEC advised that accessing the statements through the custodian's website "merely confirms that they are available" and that the RIA must take "additional steps to determine whether account statements were sent to clients."[46]

**Compliance Policy and Procedures**

Rule 206(4)-7 of the Advisers Act requires RIAs to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules.[47] In its adopting release, the SEC noted its belief that "an adviser's maintenance of strong policies and procedures" in addition to the new rule amendments "is an essential component of a comprehensive approach to addressing the potential risks raised by an adviser's custody of client assets."[48] Further, the SEC provided guidance regarding the specific types of policies and procedures relating to the safekeeping of client assets that RIAs should consider including in their compliance programs:[49]

- conducting background and credit checks on employees of the investment adviser who will have access (or could acquire access) to client assets

 

to determine whether it would be appropriate for those employees to have such access;
- requiring the authorization of more than one employee before the movement of assets within, and withdrawals or transfers from, a client's account, as well as before changes to account ownership information;
- limiting the number of employees who are permitted to interact with custodians with respect to client assets and rotating them on a periodic basis;
- if the adviser also serves as a qualified custodian for client assets, segregating the duties of its advisory personnel from those of custodial personnel to make it difficult for any one person to misuse client assets without being detected;
- requiring that any problems be brought to the immediate attention of the management of the adviser;
- developing policies regarding the ability of individual employees to acquire custody of client assets, because their custody may be attributable to the firm, which will thereby acquire responsibility for those assets under the custody rule;
- consider developing procedures by which the chief compliance officer (CCO) periodically tests the effectiveness of the firm's controls over the safekeeping of client assets; and
- advisers that have custody as a result of their authority to deduct advisory fees from client accounts held at a qualified custodian should have policies and procedures in place that address the risk that the adviser or its personnel could deduct fees to which the adviser is not entitled under the advisory contract, which could violate the contract and constitute fraud under the Advisers Act including:
  - periodic testing on a sample basis of fee calculations for client accounts to determine their accuracy;
  - testing of the overall reasonableness of the amount of fees deducted from all client accounts for a period of time based on the adviser's aggregate assets under management; and
  - segregating duties between those personnel responsible for processing billing invoices or listing of fees due from clients that are provided to and used by custodians to deduct fees from clients' accounts and those personnel responsible for reviewing the invoices and listings for accuracy, as well as the employees responsible for reconciling those invoices and listings with deposits of advisory fees by the custodians into the adviser's proprietary bank account to confirm that accurate fee amounts were deducted.[50]

The SEC noted, however, that the propriety of certain policies and procedures is dependent upon variances in the operations and size of each adviser. The foregoing guidance is "primarily in the form of examples," and the SEC "expects advisers to tailor their custody policies and procedures to fit both the size and the particular risks that are raised by their business model."[51]

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**Endnotes**

1. The recordkeeping amendments may be found at 17 C.F.R. § 275.204-2 (2010).

2. The SEC indicated that the amendments impacting RIAs are the "first step in the effort to enhance custody protections, with consideration of additional enhancements of the rules governing custody of assets by broker-dealers to follow." *See* Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2968, at 4 (Dec. 30, 2009), available at http://www.sec.gov/rules/final/2009/ia-2968.pdf.

3. *Id.* at 3 n.1 (listing multiple SEC enforcement actions).

4. *Id.*

5. *See* 17 C.F.R. § 275.206(4)-2(a)(4) (2010). Additionally, the SEC acknowledged the concerns raised regarding the impact the cost of the surprise examinations will have on smaller advisers that have authority to obtain possession of client funds or securities and whose client assets are maintained by an independent qualified custodian. The SEC indicated that, after the first round of surprise examinations, the SEC staff will conduct a review with respect to these smaller RIAs and make recommendations to the SEC for amendments to improve the effectiveness of this rule or address any unnecessary burdens it may impose upon these RIAs. *See* adopting release, *supra* note 2, at 13-14.

6. *See id.* at 13 n.37; 17 C.F.R. § 275.206(4)-2(a)(4) (2010).

7. *Id.*

8. *Id.*

9. 17 C.F.R. § 275.206(4)-2(a)(6)(i) (2010).

10. 17 C.F.R. § 275.206(4)-2(a)(6)(ii) (2010).

11. The SEC indicated that in order to form this opinion, the internal control report should address "control objectives and associated controls related to the areas of client account setup and maintenance, authorization and processing of client transactions, security maintenance and setup, processing of income and corporate action transactions, reconciliation of funds and security positions to depositories and other unaffiliated custodians, and client reporting." *See* adopting release, *supra* note 2, at 29.

12. 17 C.F.R. § 275.206(4)-2(a)(6)(ii)(A) & (B) (2010).

13. *See* adopting release, *supra* note 2, at 27-28.

14. 17 C.F.R. § 275.206(4)-2(a)(4) (2010).

15. 17 C.F.R. § 275.206(4)-2(b)(3) (2010).

 

16. *See* adopting release, *supra* note 2, at 14-15.

17. *Id.* at 14 n.38.

18. *Id.*

19. *Id.* at 15.

20. *Id.* at 15-16.

21. *See* 17 C.F.R. § 275.206(4)-2(b)(4) (2010).

22. *See* 17 C.F.R. § 275.206(4)-2(b)(4)(ii) (2010).

23. *See* 17 C.F.R. § 275.206(4)-2(b)(4) (2010).

24. *See* 17 C.F.R. § 275.206(4)-2(b)(4)(iii) (2010).

25. Adopting release, *supra* note 2, at 18.

26. *Id.*

27. *See* 17 C.F.R. § 275.206(4)-2(d)(2) (2010) (defining "custody").

28. *See* 17 C.F.R. § 275.206(4)-2(d)(7) (2010) (defining "related person").

29. Adopting release, *supra* note 2, at 32 & n.104.

30. *Id.* at 33.

31. *See* 17 C.F.R. § 275.206(4)-2(b)(6)(i) & (ii) (2010).

32. *See* 17 C.F.R. § 275.207(4)-2(d)(5) (2010) (defining "operationally independent").

33. Adopting release, *supra* note 2, at 35.

34. The notification to the SEC must be transmitted by "means of a facsimile transmission or electronic mail, followed by first-class mail, directed to the attention of the Director of the Office of Compliance Inspections and Examinations." 17 C.F.R. § 275.206(4)-2(a)(4)(ii) (2010).

35. *See* 17 C.F.R. § 275.206(4)-2(a)(4)(i) & (ii) (2010). Further, the SEC has issued a companion release to provide guidance for accountants with respect to the surprise examination and internal control report required under 17 C.F.R. § 275.206(4)-2(a)(6)(ii)(A) (2010) Rule 106(4)-2. *See* Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940, Investment Advisers Act Release No. 2969 (Dec. 30, 2009), available at http://www.sec.gov/rules/interp/2009/ia-2969.pdf.

36. *See* 17 C.F.R. § 275.206(4)-2(a)(4)(iii) (2010).

37. *See* 17 C.F.R. § 275.206(4)-2(a)(4)(iii)(A) & (B) (2010).

38. Adopting release, *supra* note 2, at 20.

39. 17 C.F.R. § 275.206(4)-2(a)(3) (2010).

40. Adopting release, *supra* note 2, at 7.

41. 17 C.F.R. § 275.206(4)-2(a)(2) (2010).

42. *Id.*

43. 17 C.F.R. § 275.206(4)-2(a)(3) (2010).

44. Adopting release, *supra* note 2, at 8.

45. *Id.* at 9 n.21.

46. *Id.*

47. 17 C.F.R. § 275.206(4)-7 (2010).

48. Adopting release, *supra* note 2, at 42.

49. *Id.*

50. *Id.* at 43-46.

51. *Id.* at 46-47.

 