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SEC Tightens Custodial and Audit Requirements for Registered Investment Advisers who Control Client Assets

All Advisers, Registered or Not, Should Update Compliance Procedures for Protection of Client Assets

If you are a registered investment adviser who – directly or indirectly – has authority to obtain possession of client funds or securities ("custody"), the SEC has increased your compliance burden beginning March 12, 2010.[1]

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It is now harder for registered advisers to avoid being deemed to have custody of advisory assets controlled by affiliated companies or funds.

Registered advisers with custody must, with several exceptions, begin having surprise annual audits of the custody assets before year-end.

- The SEC did not adopt its most controversial proposal – to require surprise annual audits for the many advisers who have custody only because their fees are deducted directly from client accounts. However, it did stress the importance of compliance procedures on fee deduction.
- Registered advisers deemed to have custody over assets of affiliated private investment funds may still avoid the surprise audit and custodial account statement provisions, but the requirements of the alternative audit procedure have been enhanced.

All investment advisers, registered or not, should review their supervisory / compliance procedures to make sure they are reasonably adequate to prevent misuse of client assets.

- Advisers that are not required to be registered still owe fiduciary duties to investors and other clients and are subject to the Advisers Act's antifraud provisions, including SEC Rule 206(4)-8.

Do You Have Custody of Client Assets?

"Custody" for this purpose typically has little to do with physical possession.

- A registered adviser can never take actual possession of client funds or securities without violating the custody rule except in certain limited, temporary, circumstances (or if it is also a "qualified custodian").

Your firm has custody if it, directly or indirectly (including through "supervised persons" and other "related persons"), has any authority to obtain possession of client funds and securities. This includes where:

- You or a related person have access to advisory funds or securities other than for trading.
  - The most common custody situation is where the adviser's fees are paid directly from the account upon request to the custodian.
  - It could also, e.g., be under a general power of attorney in your advisory agreement or by having check-writing authority on a client's account.
- You or a related person have legal ownership of advisory funds or securities in any capacity.

[1] Rule 206(4)-2, as amended by Rel. IA-2968 (12/30/09).

- For example, where the adviser (or its supervised or other related person) is trustee or executor of a trust or estate[2] or general partner or managing member of a pooled investment fund.

Basics of the Current Custody Rule

Historically, advisers could hold client assets but were required to have custody accounts audited on a surprise basis at least annually. However, there were a number of SEC administrative positions that exempted many advisers from this requirement. The SEC revised the custody rule beginning in 2004 to eliminate the surprise annual audit, for the most part, and to provide that:

- Assets for which an adviser has custody must be maintained with a "qualified custodian" – typically a bank or a registered broker-dealer – and the adviser must notify the clients of the custodial details.
- The client or its independent representative must receive account statements at least quarterly, either from the custodian or (assuming it had a surprise annual audit) the adviser.
- For pooled investment funds, the account statements must be sent to each investor, but this requirement may be avoided if the partnership is obligated to have an annual audit and distributes the audited financials to its investors within 120 days after the fiscal year end (180 days in the case of a fund of funds).

The 2010 Rule Changes

Advisers to Separate Accounts

- You must now have a surprise annual audit of any custody assets unless the only reason you are deemed to have custody is that:

  (i) your fees are deducted directly from client accounts and/or
  (ii) the assets are held or controlled by a related person that is "operationally independent" from you.[3]
  - By March 12, you should enter into an audit agreement with your accountant containing specified terms.
  - The accountant must report the results of the audit (as well as the circumstances of any termination of the engagement) to the SEC on Form ADV-E, a publicly-available form. Once the system is upgraded, this will be done electronically through the IARD.
- You no longer have the option to avoid having the qualified custodian send account statements to custody accounts by having a surprise annual audit.
  - This essentially rules out using an omnibus account at the custodian and doing your own subaccounting.
- If you send your own account statements (in addition to the custodian's), you must include a legend advising the client to compare your account statements with the custodian's.

Advisers to Pooled Investment Funds

- You must now have a surprise annual audit of any custody assets unless

  (i) the only reason you are deemed to have custody is that the assets are held or controlled by a related person that is "operationally independent" from you (*see note 3*) and/or
  (ii) you comply with the alternative audit requirement described below.
- You may still avoid having quarterly custodial account statements sent to your investors, and you need not comply with the legend requirement described above, if you comply with the alternative audit requirement.

As under the current custody rule, the alternative audit requirement entails providing audited financial statements to the fund investors or their independent representatives. However:

- The audit must now be performed by a PCAOB-registered and inspected accountant and
- You must commit to providing audited financial statements to the investors upon liquidation of the fund, as well as annually.
  - By March 12, you should enter into an audit agreement with your accountant containing specified terms.

Note that the SEC suggests that this may not be enough to protect fund investors and warns that more regulation may be on its way.

A "related person" is any person directly or indirectly controlling or controlled by the adviser, or under common control with the adviser.

Until now, the SEC generally took the view that an adviser would not have "custody" over assets held by an affiliate unless the degree of operational interaction allowed adviser personnel to exercise control over the assets or over the relevant affiliate personnel. The revised custody rule adopts a *per se* approach.

[2] The adviser would not be deemed to have custody of the trust or estate assets if the supervised person has been appointed in one of these capacities as a result of a family or personal relationship and not as a result of employment with the adviser.

[3] Related persons are presumed not to be operationally independent unless a number of requirements are met.

Where the Adviser or its Affiliate is the Qualified Custodian

- A surprise annual audit is required for accounts that are held by a qualified custodian that is a related person of the adviser unless (a) the adviser has custody solely because of the relationship (without regard to whether the RIA may deduct fees from the account and (b) the related person is "operationally independent" from the adviser.
- If the adviser or a non-operationally independent related person is itself the qualified custodian, the surprise annual audit must be conducted by a PCAOB-registered and inspected accountant.
- The adviser must obtain annual internal control reports prepared by a PCAOB-registered and inspected independent public accountant.

All Advisers

- You should review your supervisory / compliance procedures to make sure they are reasonably adequate to prevent misuse of client assets and to assure prompt detection of any misuse or appropriate action if any does occur.
  - The SEC has provided a lengthy list of suggested topics to address.
  - Your recordkeeping procedures may also need to be updated.
- Form ADV, Part 1 is also being amended to solicit further information about custody relationships and assets.

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