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Risk Management Update
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CUSTODY CONSIDERATIONS FOR INVESTMENT ADVISERS

In March 2013, the SEC's Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert regarding compliance with Rule 206(4)-2 of the Investment Advisers Act of 1940 ("Custody Rule")[1]. The Risk Alert provided a summary of the requirements of the Custody Rule and outlined a number of significant deficiencies found in recent exams of SEC registered investment advisers that were performed by OCIE. Such deficiencies included the failure of investment advisory firms to: (i) identify that they have custody; (ii) obtain required surprise examinations;[2] (iii) ensure client assets are held with a qualified custodian; and/or (iv) comply with the audit approach for pooled investment vehicles.

In this month's Risk Management Update, we explore a number of situations that could potentially trigger an investment advisory firm to be deemed to have custody and provide important considerations regarding certain requirements and practical tips to assist such firms in ensuring compliance with the Custody Rule.

I. Custody Situations

The definition of custody under the Custody Rule is fairly broad, contemplating not only situations where an investment adviser, its employees or affiliates maintain physical custody of client assets, but also arrangements whereby the firm, affiliate, or one or more employee has unobstructed access to such assets (commonly referred to as "constructive custody").[3] Perhaps the most common example of constructive custody exists when an adviser obtains written authority from a client to withdraw advisory fees from the client's account upon instruct to the custodian. In the adopting release of the Custody Rule, the SEC clarified that for advisers with limited custody due to fee deduction, a surprise examination by an independent accounting firm is not necessary as "it will not provide materially greater protection to advisory clients….solely because of its [the adviser's] authority to deduct fees from client accounts."[4]

In other situations, this exception would not be available. For example, there are a number of scenarios where investment advisers would most likely be considered to have constructive

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[1] See the Office of Compliance Inspections and Examinations National Exam Program Risk Alert, "Significant Deficiencies Involving Adviser Custody and Safety of Client Assets" (Mar. 4, 2013) found at http://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf.

[2] In accordance with Rule 206(4)-2, surprise audits must be performed by an independent accounting firm that is registered with and subject to the review of the Public Company Accounting Oversight Board ("PCAOB") if the adviser or an affiliate serves as the qualified custodian.

[3] Under Rule 206(4)-2(d)(2) "Custody" means holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. The rule states a firm 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 provided to clients.

[4] 17CFR275, 279 (IA Release No. 2968) at page 14.

custody that would trigger a surprise examination, even where the adviser does not have actual possession of client funds or securities. This includes:

- Serving as a trustee, executor, guardian or similar capacity for a client's managed account;[5]
- Serving as a general partner or managing member of one or more pooled investment vehicles (notwithstanding the exception provided for in Section II., below);
- Having the authority to transfer (or give instructions to transfer) client account assets to a third party;
- Having electronic access to a client's account at a custodian or broker-dealer via the client's username and password;
- Having signatory authority of a client's account (*e.g.*, this typically involves providing bill paying or check writing services to clients);
- Having an affiliate that serves as qualified custodian of client managed assets;
- Being a dually registered firm with the broker-dealer division maintaining custody of client managed assets on a temporary or on-going basis; and
- Serving as investment adviser to the firm's participant-directed defined contribution plan (*e.g.*, 401K plan), or any investment option in such plan, when the trustee to the plan is the firm, an affiliate, or employee.

II. Important Requirement Considerations

The Custody Rule contains the following three main requirements that all investment advisers with custody must comply with:

- Maintaining clients' assets with a qualified custodian;[6]
- Having a reasonable belief, after due inquiry, that each qualified custodian is delivering at least quarterly account statements to clients;[7] and
- Providing written notice to clients on where and how their assets are held if an adviser opens (or assists the client with opening) custodian accounts on behalf of clients.

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[5] Notably, this does not include accounts of family members or clients that have a long standing relationship with an associated person of the firm that is not due to the advisory relationship.

[6] As defined in Rule 206(4)-2(d)(6), a qualified custodian is defined as: (i) A bank as defined in section 202(a)(2) of the Advisers Act (15 U.S.C. 80b-2(a)(2)) or a savings association as defined in section 3(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(b)(1)) that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act (12 U.S.C. 1811); (ii) A broker-dealer registered under section 15(b)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(b)(1)), holding the client assets in customer accounts; (iii) A futures commission merchant registered under section 4f(a) of the Commodity Exchange Act (7 U.S.C. 6f(a)), holding the client assets in customer accounts, but only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; and (iv) A foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets.

[7] The SEC noted in their amended Custody Rule (17CFR275, 279 (IA Release No. 2968)) that an adviser could form a "reasonable belief" if the adviser were receiving duplicate copies of the client's account statements as issued by the custodian.

For advisory firms that send account statements or other types of reports (*e.g.* performance reports) to clients, the Custody Rule requires a legend to be included urging the client to compare the custodian statements with the statements received by the adviser.

Additionally, in the adopting release of the Custody Rule, the SEC specified that it expects advisory firms to implement policies and procedures that specify the requirements of the Custody Rule and explain the reason(s) as to why the firm has or does not have custody. Moreover, procedures should be robust enough to safeguard client assets and mitigate risks of misappropriation. For example, an adviser that deducts fees directly from client accounts should have procedures in place to periodically review and test fee calculations to help ensure that clients are not overbilled. They also should be reasonably designed to ensure prompt detection and corrective action.

Notably, an adviser that serves as a general partner or managing member of a private fund will not be required to obtain an annual surprise exam, so long as annual audits are completed on the fund's financial statements. Such audits must be conducted by an independent public accountant registered with and subject to the review of the PCAOB, and the adviser must send copies of the audited financial statements to the fund's investors within 120-days of the private fund's fiscal year end (or 180 days for fund of funds).

Finally, there are additional requirements for advisers that serve as, or have an affiliate that serves as a qualified custodian and maintains advisory client assets. Such requirements include obtaining (or receiving from an affiliate) an annual internal control report prepared by an independent public accountant registered with and subject to the review of the PCAOB.[8]

III. Practical Tips

While having custody of client assets creates a conflict of interest that must be disclosed, it is not prohibited by the SEC and advisory firms have choices on how they wish to address any potential or actual conflicts. For example, a firm may decide to discontinue the activity causing custody, thereby eliminating the conflict of interest. Alternatively, once identified, the activity may be allowed in very limited circumstances and with the implementation of strong procedures and internal controls to mitigate the conflict. A firm also may determine that the activity is important to its client base and should be continued, and therefore takes additional steps to ensure the activity is closely monitored on an ongoing basis in order to properly manage the conflict.

As shown above, there are a variety of ways that advisory firms could be deemed to have custody, so it is very important for firms to carefully and continually examine all aspects of their business practices to determine what activities, if any, could result in custody.

[8] For more information, please refer to the 17CFR275, 279 (IA Release No. 2968) at page 24.

The following Risk Management Tips are provided to help assist firms with remaining compliant with the Custody Rule and safeguarding clients' assets:

1. Ensure the CCO is informed of all situations that may (or does) cause the firm to have custody.
2. Ensure that the firm's disclosures regarding custody are accurate in both Form ADV Part 1 and Part 2A.
3. Perform periodic reviews and testing to ensure that the firm's procedures and controls surrounding custody activity are being followed and remain reasonably designed to protect clients' assets (the timing of reviews and testing should be based on the type of custody arrangements in place).
4. Perform reconciliations of custodian statements with portfolio accounting records and firm reports/statements provided to clients to confirm accuracy and ensure required legend is included on firm statements.
5. Perform sampling reviews of clients' custodian statements to confirm withdraws match the instructions received by the firm.
6. Compare client name and address on custodian statements to the name and address in the firm's portfolio accounting system and reports/statements sent to clients.
7. Implement required vacations for employees that have authority over and/or access to, client assets.
8. Require two signatures or written approval for situations where the firm is allowed to withdraw and/or transfer client assets.
9. Periodically confirm with clients that they are receiving custodian statements.
10. Compare advisory fees deducted from client accounts with the amounts calculated and received by the adviser.

Importantly, state registered advisers may want to consider the above steps, but should additionally ensure they are aware of their state's custody regulations as they may be different than requirements under the Custody Rule.

For more information, or to learn about how CCLS may be of assistance, please do not hesitate to contact us at (619) 278-0020.

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