

May 2019

## The Custody Rule

**The majority of advisers to Pooled Investment Vehicles that operate on a calendar year recently passed a significant deadline. If you have missed the 4/30 deadline, you still have options. Read the following article to learn more about the Custody Rule, the surprise exam requirements, and what to do if you haven't yet met your obligations:**

In general, the Custody Rule (Rule 206(4)-2) requires that advisers custody client funds and securities with a qualified custodian, that they notify their clients that they are doing so and identify who the custodian is, that they ensure that the custodian is sending at least quarterly statements to the clients, and that they verify the funds and securities held in custody by having an independent, surprise examination conducted annually by a Public Company Accounting Oversight Board (PCAOB)-registered public accounting firm.

It should be noted, however, that the Securities and Exchange Commission (SEC) has provided an exemption to Advisers of Pooled Investment Vehicles. That exemption, articulated in 206(4)-2(b)(4), relieves the adviser of its obligation to have a qualified custodian send statements to its clients and to reasonably determine that the custodian is delivering those statements. It also relieves the adviser of its obligation to undergo a surprise examination by a PCAOB-registered accounting firm.

To take advantage of the exemption, an adviser must annually distribute audited financial statements that have been prepared in accordance with generally accepted accounting principles (GAAP) audit by an independent public accounting firm that is registered with, and inspected by, the PCAOB within 120 days of the close of the adviser's year end. It must also provide a similarly completed financial statement to the fund's investors upon liquidation of the fund.

As such, advisers have 120 days from their fiscal year end to complete and distribute audited financial statements to their investors.

Those who fail to do so may find themselves in violation of their obligations under the Custody Rule.

### **Advisers should pay close attention to the following questions:**

1. Do I have custody as defined by the Custody Rule?
2. Are client assets being properly maintained with a qualified custodian?
3. Can I take advantage of the audited financial statements exemption?

If an adviser does indeed have custody and its client assets are being maintained with a qualified custodian, but has not provided audited financial statements, it is important that the adviser ensure compliance with the notice, statement delivery and surprise examination provisions of the Custody Rule.

May 2019

## Surprise Examination Requirements and Procedures

Once the determination has been made that a surprise examination is required and an independent public accounting firm has been engaged, what should an investment adviser expect as part of the examination process? In accordance with Rule 206(4)-2(a) (4) of the Investment Advisers Act of 1940, an examination of funds and securities must be conducted on an annual basis, at random dates chosen by the independent public accountant.

Once the accountant has notified the investment adviser of the date selected, the accountant will have 120 days to complete the surprise examination, ultimately uploading form ADV-E to the SEC's Investment Adviser Registration Depository (IARD) website upon successful completion of the examination. While completing the surprise examination, if the accountant determines that material discrepancies exist, the accountant is required to notify the SEC's Office of Compliance Inspections and Examinations within one business day. A material discrepancy is defined as an item that the accountant believes has a material effect on the entity's compliance with Rule 206(4)-2.

**Investment advisers should note that the completed ADV-E form is publicly available through the IARD website.**

The purpose of the surprise examination is to substantiate that all funds and securities held by the investment adviser for clients are held by a qualified custodian and that they are held in separate accounts for each client.

**This is accomplished by performing the following procedures:**

- Sending confirmation requests directly to the qualified custodian, as of the date of the examination, to verify that the funds and securities are in accounts held separately in the name of each client;
- Sending confirmation requests directly to the client of the investment adviser, as of the date of the examination, to verify account activity that has taken place since the last examination, including contributions and withdrawals of funds and securities;
- Reconciling the confirmations received by the accountant to the books and records of the investment advisor.

After the above procedures are completed and the independent accountant is satisfied that the investment adviser is in compliance with Rule 206(4)-2, an examination report is issued. The examination report states the opinion that the investment adviser is in compliance with Rule 206(4)-2 in all material respects as of the examination date and during the period since the last surprise examination.

## SEC Notices of Significant Deficiencies Involving Advisor Custody

As noted in a Risk Alert issued by the SEC's National Exam Program (NEP), significant deficiencies were identified surrounding investment adviser compliance with the Custody Rule for approximately one third of all advisors examined.

### **Some of the most common deficiencies identified were:**

- Failure by advisers to recognize they had custody in situations such as: performing bill paying services and having check writing authority, maintaining physical custody of client assets, and advising as a General Partner to a pooled investment vehicle such as a hedge fund.
- Surprise examination deficiencies such as: Form ADV-E not being completed within 120 days, and accountants failing to perform the examination on a surprise basis.
- Qualified custodian deficiencies such as: client funds and securities that were commingled with employee assets, security certificates that were held in a safe deposit box controlled by the adviser, and the adviser not having reasonable basis to believe that the custodian was sending out required quarterly statements to clients.
- Audit approach deficiencies in situations where the adviser relied on the audit provision for pooled investment vehicles such as: the public accountant performing the audit was not considered independent under Regulation S-X, financial statements were not prepared in accordance with GAAP, the auditor was not registered with the PCAOB, and a final audit was not performed on a liquidated investment vehicle.

## SEC Guidance on Areas of Weakness

The SEC has updated the most typical areas of weakness with respect to the custody rule. **Below are typical examples of deficiencies or weaknesses with respect to the Custody Rule identified by the staff:**

- Advisers did not recognize that they may have custody due to online access to client accounts. An adviser's online access to client accounts may meet the definition of custody when such access provides the adviser with the ability to withdraw funds and securities from the client accounts. The staff observed that certain advisers may not have properly identified custody as a result of them having access to online accounts using clients' personal usernames and passwords.
- Advisers with custody obtained surprise examinations that do not meet the requirements of the Custody Rule. The staff observed that certain advisers did not provide independent public accountants performing surprise examinations with a complete list of accounts over which the adviser has custody or otherwise provide information to accountants to permit the accountants to timely file accurate Form ADV-Es. In addition, staff observed indications suggesting that surprise examinations may not have been conducted on a "surprise" basis (e.g., exams were conducted at the same time each year).

May 2019

- Advisers did not recognize that they may have custody as a result of certain authority over client accounts. The staff observed that certain advisers did not appear to recognize that they may have custody over client accounts as a result of having (or related persons having) powers of attorney authorizing them to withdraw client cash and securities. Other examples of custody that appeared unrecognized include when advisers or their related persons served as trustees of clients' trusts or general partners of client PIVs.

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If you have questions or are in need of a surprise examination, please contact [Stephen Vlasak](#).