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Surprise Annual Audit Proposed for Investment Advisers with "Custody" of Client Assets

The Securities and Exchange Commission proposes to reinstate surprise annual audits for registered investment advisers with "custody." This applies to any adviser that has authority to obtain possession of client funds or securities. Advisers whose affiliates (e.g., fund general partners or trustees) control advisory client assets are deemed to have custody, so this would apply to the fund or trust assets. In an overreaction to the Madoff scandal, it will also apply to all advisers who have custody only because their fees are deducted directly from client accounts.

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The proposal does not include the exceptions to the surprise audit requirement that such advisers relied on (without significant problems) before 2004. It has generated a number of comments; the vast majority object to including advisers whose only indicia of custody are direct fee deductions. Commenters also have proposed mandating independent custodians, applying the annual audit only to advisers with affiliated custodians, and requiring custodians to monitor fee withdrawals, among other alternatives. No comments have yet been filed that propose alternatives to the surprise audit for investment fund or trust assets. The SEC is accepting comments from the public until July 28, so you should consider submitting your own.

Do You Have Custody of Client Assets?

Custody for this purpose may have little to do with physical possession. Your firm has custody if it, directly or indirectly (including through certain affiliates), has any authority to obtain possession of client funds and securities, even if it never actually holds them. This includes where:

- You or a control affiliate have physical possession of client funds or securities.
  - For example, where you hold client stock certificates in your safe or accept funds or securities for forwarding to a custodian.
- You have access to client funds or securities for other than trading.
  - Such access could, e.g., be under a general power of attorney or by having check-writing authority on a client's account.
  - The most common custody situation is where the adviser's fees are paid directly from the account upon request to the custodian.
- You or your control affiliate have legal ownership of client funds or securities in any capacity.
  - This includes where the adviser or affiliate is trustee or executor of a client trust or estate or general partner or managing member of a client limited partnership or LLC.

Current Requirements

Until 2004, an adviser that had custody was required to comply with costly safeguards, in particular having surprise annual audits and providing an audited balance sheet with Form ADV. However:

- an adviser that had fees deducted directly could avoid the audit requirement by having a separate invoice and periodic custodial statement sent directly to the client, and
- an adviser deemed to have custody of trust or partnership assets could avoid the audit requirement by having

a third party review distributions to the adviser.

Following rule changes in 2004, surprise audits have been required only as a fallback. For accounts where an adviser has custody:

- the assets must be maintained with a "qualified custodian" – typically a bank or broker – either in a separate account for each client under that client's name or in accounts that contain only client funds and securities, under the adviser's name as agent or trustee for the clients, and
- either (a) the custodian sends a quarterly account statement directly to each client or (b) the adviser sends the statement and has a surprise annual audit of the client assets. (Alternative (b) was adopted at the request of advisers who did not want to disclose client identities to third parties for competitive reasons.)
    - For pooled investment funds, the quarterly statements must be sent to each investor. However, 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 SEC's Proposed Rule Changes

Definition of "Custody" – The SEC proposes to provide that an adviser has "custody" if a person in a control relationship with the adviser holds or has any authority to obtain possession of client funds and securities in connection with the adviser's advisory services.

- This will sweep in arrangements that are not now deemed "custody" because the adviser has no control over or access to the assets. Among other things, it makes clear that a registered adviser to a pooled investment fund has custody of the fund's assets if a control affiliate is the general partner or managing member.

Surprise Annual Audit – For all advisers with custody, the SEC proposes reinstituting the annual surprise audit by an independent public accountant to verify client assets of which the adviser has custody.

- The securities subject to the audit will now include privately placed, book-entry securities, which are not currently covered by the custody rule.
- As under the current rule for elective surprise audits, the accountant would need to flag any material discrepancies to the SEC by the next business day.
- The accountant would have to report to the SEC the termination of its engagement with the adviser and, if applicable, any problems with the examination that led to the termination of its engagement.
- When the adviser or an affiliate acts as qualified custodian for client assets, both the surprise audit and a SAS 70 custody control review would have to be conducted by a PCAOB-registered accountant.

Additional Requirements – An adviser with custody of client assets would also be required to:

- make inquiry to confirm that the independent custodian is sending account statements,
- disclose in its Form ADV information about its custody of assets, including the identity of the accountant that performs the surprise audits, and
- instruct clients to compare account statements they receive from the custodian with those received from the adviser.

Pooled investment vehicles that wish to avoid having quarterly custodial statements sent to each investor will be required to provide investors with audited financials upon liquidation, as well as annually. In addition, funds of funds would have only 120 days after year-end to distribute the annual audit, not 180 (although this may have been an oversight in the proposal).

Opportunity to Comment – The SEC is accepting public comments on the proposed rules until July 28. Among other things, it has solicited suggestions for alternative approaches to achieve its goals. If you would like to discuss the substance of a comment, or any assistance in preparing one, please contact one of the lawyers listed below.

Related Developments

These proposed rules are not the only responses to Madoff's reported practices. In addition to a significant increase in enforcement actions against alleged Ponzi schemes:

- SEC examiners are now, as a matter of routine examination practice, requesting

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confirmation from third parties, such as custodians, brokers, counterparties and clients, to verify the existence of assets under management in a sample of client accounts, as well as the transactions in those accounts, and

- clients and their advocates are insisting that their assets be held in the clients' names with independent custodians.

These developments will undoubtedly also affect your business.

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