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SEC Adopts Madoff-Inspired Custody Rules for Investment Advisers

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The SEC recently adopted new rules related to the Custody of Funds or Securities of Clients by Investment Advisers (SEC Release No. IA-2968). The new rules become effective March 12, 2010. They were inspired by the Bernie Madoff scandal and have as their centerpiece a requirement that investment advisory firms which maintain "custody" of client funds subject themselves to surprise examinations by independent accounting firms.

As originally proposed, the surprise examination requirement would have applied to all advisers deemed to be custodial, even smaller firms who have "custody" only because they deduct their fees directly from the customer account. As finally adopted by the SEC, the new surprise examination rule fortunately does not apply to advisory firms which are deemed to have asset custody solely because they automatically deduct their advisory fees from client accounts. There are, however, a number of features in the amended rules which nevertheless apply to such firms:

- The adviser must exercise "due inquiry" to ensure that its independent custodial firms do in fact send account statements directly to clients (which could be as simple as requiring the custodian to provide the adviser with copies of all statements sent).

- If the adviser chooses to send its own account statements to clients, those statements must contain a prominent "cautionary legend" urging the clients to compare the adviser's statements to the custodian's statements.

- Advisory firms which sponsor pooled investment vehicles (hedge funds, venture funds, etc.) must arrange for annual financial statement audits by PCAOB-registered accounting firms.

- Advisory firms which deduct fees from client accounts must have policies and procedures in place to "address the risk that the adviser or its personnel could deduct fees" they are not entitled to. Examples of possible policies include:

    - periodic testing of fee calculations

    - testing of the overall reasonableness of aggregate fees collected based on aggregate assets under management over a period of time

    - segregating duties among billing personnel.

- Several additional questions to answer in Form ADV, parts I and II (note that the March 12 effective date means these changes must be addressed in the annual March Form ADV update).

Those advisers which do become subject to the new surprise asset examination rule will be required to enter into binding written contracts with PCAOB-registered accounting firms not later than December 31, 2010. These agreements must:

- require the accountant to notify the SEC within one business day of finding any material discrepancies
- file a final examination report with the SEC electronically on Form ADV-E within 120 days of conducting an examination
- file a report with the SEC upon dismissal by the advisory firm
- and, of course, to conduct a surprise examination at a time of the accountant's choosing.

The cost of obtaining surprise examinations is likely to be quite significant, particularly since the universe of PCAOB-registered accounting firms is generally limited to larger and more expensive firms.