



STRATEGIC COMPLIANCE AND GOVERNANCE, LLC

## The Hanks Report

June 15, 2009

### SEC PROPOSES AMENDMENTS TO INVESTMENT ADVISER CUSTODY RULE

In response to the growing number of enforcement actions related to the theft, misappropriation and other misuses of client assets that have shaken investor confidence, the SEC has proposed amendments to the '40 Act Custody Rule<sup>1</sup>. Issued on May 14th, the proposed amendments are designed to enhance the controls that apply to the more than 9,600 SEC-RIAs deemed to have custody of client assets. Investment advisers are deemed to have custody when they either have physical control over the assets directly or through an affiliate. They are also deemed to have custody when they have the authority to withdraw their clients' funds, typically for the purposes of receiving payment of their fees.<sup>2</sup> This Report is a summary of the highlights of the proposed amendments.

The SEC is required to estimate the costs of proposed amendment changes that would be borne by advisers who meet the various definitions herein. This Report includes that summary information.

The proposed amendments would require:

- That all RIAs with custody of client assets engage an independent public account to conduct an annual surprise examination of client assets.
- An adviser, or an affiliate who maintains client assets, obtain a written report from an independent public accountant that provides an opinion regarding the custodian's controls relating to custody of client assets annually. There is also a discussion in this section that would **prohibit outright** an adviser from maintaining custody. Advisers would be required to use the services of an independent qualified custodian.
- All custodians who hold advisory client assets to deliver custodial statements directly to advisory clients, rather than through the investment adviser. This section would also require advisers, who open custodian accounts for clients, to instruct those clients to compare account statements they receive from the custodian with those received from the adviser.

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<sup>1</sup> Specifically, Rule 206(4)-2

<sup>2</sup> Release No. IA-2876; File NO. S7-09-09

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The 95 page proposal poses many questions to its audience and it behooves interested parties to respond in order to provide some framework around the extent of the costs and operational changes that would be required were these proposed amendments be enacted.<sup>3</sup>

### **ANNUAL SURPRISE EXAMINATION OF CLIENT ASSETS**

The proposed amendments would require all RIAs who have control of client assets to engage an independent public accountant to conduct an annual on-site surprise examination to verify client assets. Accountants conducting these surprise examinations would have to report any inconsistencies they would uncover during their examinations to the SEC's OCIE<sup>4</sup> within one day. The accountant would also be required to file with the SEC, within 120 days of the time chosen by the accountant for the surprise examination<sup>5</sup>, a Form ADV-E and a certificate that states that the accountant has examined the assets and details the nature and extent of such examination.

The accountant would also have to submit a Form ADV-E to the SEC within four business days of its resignation from, or dismissal by, the investment adviser. Along with the Form ADV-E, the accountant would also be required to provide a termination statement to the SEC detailing the accountant's contact information, the date of resignation or dismissal and an explanation of any problems that may have contributed to the resignation or dismissal.

The proposed amendments extend the requirement of a surprise examination to apply to RIAs who hold privately offered securities on behalf of their clients. Privately offered securities are currently exempt from all requirements of the custody rules.

The estimated total accounting fees for all surprise examinations would be \$77,557,500.

### **CUSTODY BY THE ADVISER AND ITS RELATED PERSONS**

The proposed amendments would change such that an adviser would be deemed to have custody of any client securities or funds that are directly or indirectly held by a "related person" in connection with advisory services provided by the adviser to its clients. A "related person" would be a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser.

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<sup>3</sup> Comments on the proposed amendments must be received by the SEC by July 28, 2009.

<sup>4</sup> Office of Compliance Inspections and Examinations.

<sup>5</sup> The current rule requires notice within 30 days of the completion of the examination.

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For purposes of this definition, “control” is defined as the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract or otherwise.

In situations in which the custodian is not independent from the investment adviser i.e., the investment adviser itself or a “related person” of the investment adviser acts as custodian, the proposed amendments would require the adviser to obtain, or receive from the related person acting as custodian, an “internal control report” that includes an opinion from an independent, reputable public accountant who is registered with, and inspected by, the Public Company Accounting Oversight Board (PCAOB) on at least an annual basis, describing the custody controls in place and the effectiveness thereof (“Type II SAS 70 Reports”). These examinations would be required to be conducted, and the Type II SAS 70 Reports would be required to be prepared, in accordance with PCAOB standards.<sup>6</sup>

The SEC estimates the average cost to prepare an internal control report relating to custody would average \$250,000 per year, for total costs attributable to this section of the proposed rule to be \$93,000,000.

## **DELIVERY OF ACCOUNT STATEMENTS AND NOTICE TO CLIENTS**

The proposed amendments would require RIAs with custody of client funds or securities to have a reasonable basis for believing that the qualified custodian delivers custodial statements, at least quarterly, directly to each advisory client for whom the qualified custodian maintains funds or securities. The current rule permits investment advisers to send custodial statements to clients, provided that the investment adviser undergoes an annual surprise examination by an independent public accountant. The proposed amendments would eliminate this option, making it mandatory that all custodial statements be sent directly to clients by the custodian.

This mandate is aimed at making it harder for investment advisers to create false account statements, reducing the likelihood that client assets are placed at risk and allowing clients the opportunity to compare the statements they receive from the custodian with those they receive from the investment adviser. The proposed amendments also require investment advisers who open custodial accounts on behalf of their clients to send notices to those clients encouraging them to compare any account statements they receive from the custodian with any they may receive from the investment adviser.

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<sup>6</sup> The PCAOB is a private, nonprofit corporation created by the Sarbanes-Oxley Act of 2002 to oversee the auditors of public companies and to protect investors and the public interest by promoting informative, fair and independent audit reports. It consists of five members who are appointed by the SEC and is headquartered in Washington, D.C., with regional office locations across the United States.

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The SEC estimates that each adviser would spend about 10 minutes per client drafting and sending the notice.

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