

Financial Bulletin

Regulations and developments affecting the financial services industry March 18, 2010

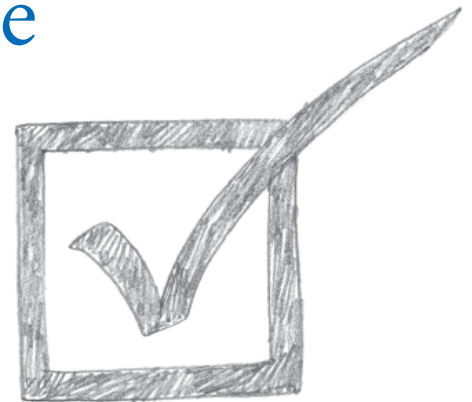
SEC updates Custody Rule requirements

In response to the high-profile investment scandals of recent history, the SEC proposed amendments¹ to Rule 206(4)-2 (Custody Rule) under the Investment Advisers Act of 1940 to improve the safekeeping of client assets. The SEC adopted the Final Rule, *Custody of Funds or Securities of Clients by Investment Advisers*,² on Dec. 16, 2009. Effective March 12, 2010, investment advisers³ must comply with amendments made related to Form ADV and new instructions to Item 9 of that form, as well as undergo surprise examinations.

Changes to the Custody Rule

The SEC has made the following significant changes to the Custody Rule:

- **Surprise examinations:** Registered investment advisers who have custody of a client's funds or securities, including advisers who are deemed to have custody through the ability to withdraw client funds or securities, would be required to undergo an annual surprise examination conducted by an independent public accountant commencing on or before Dec. 31, 2010. Investment advisers that become subject to the rule after March 12, 2010, must also undergo a surprise exam by the later of Dec. 31, 2010, or six months after the adviser becomes subject to the rule.
- **Internal control reports:** Registered investment advisers (and their related persons) who serve as qualified custodians for advisory client funds or securities would be required to obtain an annual report (e.g. Type II SAS 70⁴) by an independent accountant registered with, and subject to inspection by, the Public Company Accounting Oversight Board, demonstrating it has or its related persons have custodial controls in place.



continued>

¹ "Custody of Funds or Securities of Clients by Investment Advisers," Securities and Exchange Commission. <http://www.sec.gov/rules/proposed/2009/ia-2876.pdf>

² "Custody of Funds or Securities of Clients by Investment Advisers," Securities and Exchange Commission. <http://www.sec.gov/rules/final/2009/ia-2968.pdf>

³ The Rule provides for certain exceptions.

⁴ The Rule also permits a report in accordance with the standards of the American Institute of Certified Public Accountants AT Section 601, *Compliance Attestation*.

SEC updates Custody Rule requirements (continued)

Custodial controls would include the areas of:

- client account setup and maintenance,
- authorization and processing of client transactions,
- security maintenance and setup,
- processing of income and corporate action transactions,
- reconciliation of funds and security positions to depositories and other unaffiliated custodians, and
- client reporting.

The report will include tests of control effectiveness and provide the results of those tests, including verification that client funds and securities are reconciled to a custodian other than a related person. Advisers must obtain the report within six months of becoming subject to the requirement (e.g., Sept. 12, 2010, for advisers that become subject to the requirement on March 12, 2010).

- **Form ADV changes:** Registered investment advisers must now report all related persons who are broker-dealers in Item 7 and Section 7.A. of Schedule D of Form ADV. If a related person is found to be operationally independent, the investment adviser must report this in Section 7.A. of Schedule D. Investment advisers must provide responses to Form ADV in their first annual amendment after Jan. 1, 2011.

- **Item 9 instructions:** The SEC has made the clarification that an investment adviser must separately report the amount of assets it has in custody and the amount of assets the related person has in custody. In addition, investment advisers that have custody solely to deduct their advisory fee or because an operationally independent related person maintains client assets can answer “no” to Item 9.A.

What investment advisers can expect

The SEC has also been conducting examinations of investment advisers with the potential for greater-than-normal fraud risk. These investment advisers possess certain risk attributes, including:

- the use of an affiliate to maintain custody of advisory client assets,
- the management of hedge funds that have “smooth” or outlier returns,
- the use of a less prominent accounting firm or no accounting firm at all,
- a history of disciplinary actions, and
- broker-dealers that sell captive pooled investment vehicles.

These examinations include confirming the detail of cash and securities held by the adviser on behalf of the client; confirmations are conducted with independent custodians and a sampling of advisory clients. •

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