

ACCOUNTING AND AUDITING ALERT JUNE 2010

NEW REQUIREMENTS FOR REGISTERED INVESTMENT ADVISERS – JULY 10TH DEADLINE

Registered investment advisers face new SEC custody requirements: The Custody Rule

The US Securities and Exchange Commission (SEC) has amended its custody rule — Rule 206(4)-2 under the Investment Advisers Act — to help safeguard investor assets. Now it's time for certain SEC-registered investment advisers (RIAs) to start taking steps to facilitate compliance with two major new SEC requirements.

The SEC amendments impose substantial new obligations — which may include 1) annual surprise examinations and 2) internal control reports — on RIAs that have custody or have access to client funds or securities. RIAs have until July 10, 2010 to engage qualified outside independent accountants to perform these services.

What does “custody” mean?

The amended rule defines “custody” as “holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them.” It includes arrangements under which an RIA is permitted to withdraw client funds or securities held by a qualified custodian (such as a bank or broker-dealer), as well as situations where an RIA has access to client assets by virtue of the RIA's dual role as general partner of and investment adviser to a limited partnership.

In a significant change, the amended rule provides that an RIA is deemed to have custody of client assets when held directly or indirectly by an affiliate or other “related person,” defined as any person directly or indirectly controlling or controlled by the RIA or under common control with the RIA.

What's required?

Under the amendments that went into effect on March 12th, RIA's with custody of client assets generally must have a reasonable basis, after due inquiry, for believing that any qualified custodian who maintains funds or securities sends the RIA's clients quarterly account statements. RIAs also generally must provide a notice to clients — on opening an account and on future account statements — urging them to compare account statements received from the qualified custodian with any statements received from the RIA.

Perhaps more burdensome are the requirements for surprise examinations and internal control reports that affected RIAs generally must begin later this year:

1. If the RIA has custody of client assets, the RIA generally must undergo annual surprise examinations of client assets by an independent public accountant.
2. If the RIA or a related person acts as the qualified custodian, the RIA generally must obtain (or receive from the related person) an annual internal control report (such as a Type II SAS 70 report) prepared by an independent Public Company Accounting Oversight Board (PCAOB)-registered accountant, and the surprise examination must also be performed by an independent PCAOB-registered accountant.

Generally, the first surprise examination must *commence* by Dec. 31, 2010, or within six months after an RIA becomes subject to the custody rule (by registering with the SEC, for example). RIAs subject to the internal control report requirement must obtain the first report by Sept. 12, 2010 (or within six months after becoming subject to the rule), and the first surprise examination must then commence within six months after the internal control report is obtained.

Additionally, RIAs subject to the surprise examination requirement must have a written agreement with the accountant requiring the accountant to 1) file Form ADV-E within 120 days after the examination commences, describing its nature and extent, 2) notify the SEC of any material discrepancies within one business day after discovering them, and 3) file Form ADV-E within four business days after its dismissal, resignation, or voluntary or involuntary removal from consideration for reappointment, explaining any problems relating to the examination that contributed to such termination.

What are the exceptions?

Under the amended rule, the following RIAs are exempt from the *surprise examination requirement*:

- RIAs deemed to have custody of client assets *solely* because they have the authority to deduct advisory fees,
- RIAs to hedge funds or other pooled investment vehicles that distribute financial statements under Generally Accepted Accounting Principles — audited by an independent PCAOB-registered accountant — to investors within 120 days after the vehicle’s fiscal year end (180 days for a fund of funds) and “promptly” after completion of a liquidation audit (these RIAs are also exempt from the reasonable belief requirement regarding quarterly account statements), and
- RIAs deemed to have custody of client assets *solely* because the qualified custodian is a related person from whom the RIA is “operationally independent.”

In general, an RIA is operationally independent from a related-person custodian if the client assets aren’t exposed to the RIAs creditors; advisory personnel have no authority over client assets; and the two entities are distinct in terms of personnel, supervision and office space.

What do you need to do?

Here’s a quick recap of how the new exam and report rules might apply to you:

- If you use an independent custodian and have the authority to deduct only advisory fees, you *need not* undergo surprise examinations *or* obtain internal control reports.
- If you use an independent custodian and have custody of client funds, you *must* undergo surprise examinations *but need not* obtain internal control reports.
- If you or a related person who’s not operationally independent act as a qualified custodian, you *must* undergo surprise examinations *and* obtain internal control reports.
- If an operationally independent related person acts as a qualified custodian, you *need not* undergo surprise examinations *but you must* obtain internal control reports.

Let Marks Paneth & Shron help you comply with the new custody rules

The deadline for complying with the SEC’s new custody rule (surprise examinations and internal control report requirements) is rapidly approaching. RIAs must engage a qualified independent accountant by July 10, 2010.

RIAs should review their advisory contracts and custodial practices to determine whether they are subject to the requirements. If you have custody of client assets, or if you or a related person act as a qualified custodian of your clients' assets, we'd be pleased to help you comply with these new requirements.

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FOR MORE INFORMATION

For more information, please contact Steven L. Berse, CPA, by phone at 212.503.8896 or by email at sberse@markspaneth.com, Michael J. Fosorile, CPA, by phone at 212.201.3125 or by email at mfosorile@markspaneth.com or any of the MP&S professionals who serve the financial services industry.

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