

Regulation and Compliance

It should come as no surprise that the recent spate of criminal enforcement activity and high-profile trials including that of Bernie Madoff have prompted regulatory action. A good example is the proposed regulation relating to the “custody rule” under the Investment Advisor’s Act of 1940. (See Federal Register, May 27, 2009).

Background

Although registered investment advisors typically lack physical custody of their clients' assets, they are deemed to have custody of assets held at a bank or a broker-dealer if they possess the authority to obtain clients' assets by deducting advisory fees from a client account, writing checks or withdrawing funds on behalf of a client, or by acting in a capacity, such as general partner of a limited partnership, that gives an advisor or its supervised person the authority to withdraw funds or securities from the limited partnership’s account. Under current law and regulations, advisors that have custody of a client's funds are required to implement controls designed to protect those client assets from being lost, misused, misappropriated or subject to the advisors’ financial reverses, such as insolvency. The rule contains two primary protections to investors.

The proposed regulation, if finalized in current form could have a significant impact on Independent Financial Advisors (IFAs) who would have to choose between passing on the cost of compliance to their clients or incur the cost themselves.

- Advisors that have custody, with certain limited exceptions, must maintain client funds or securities with a bank, registered broker-dealers, or registered futures commission merchant.
- Advisors with custody of client assets must have a reasonable belief that the qualified custodian holding the assets provides account statements directly to clients, or investors in pooled investment vehicles, at least quarterly.

The Proposed Rule Change

Concerned, in light of Madoff and other cases involving misappropriation of client funds, that the current rule fails to provide adequate investor protection, the SEC's proposed rule imposes direct accountability for client funds on most investment advisers.

This is accomplished primarily by requiring all advisers deemed to have custody of client assets (physical or otherwise), to undergo a "surprise audit" annually by an independent public accounting firm. As radical as this may sound on the surface, the proposed rule is a return to the rule as it existed from 1962 to 2003 (at least with respect to registered investment advisers). According to the SEC, it believed in 2003 that the annual surprise examination, with respect to client accounts for which the adviser had a reasonable belief that "qualified custodians" provided account statements directly to clients, was no longer needed. At that time, the SEC "believed that direct delivery of account statements by qualified custodians would provide clients confidence that any erroneous or unauthorized transactions would be reflected and, as a result, would be sufficient to deter advisers from fraudulent activities."

Recent events have caused the SEC to change its view. It now believes "that a surprise examination by an independent public accountant would provide "another set of eyes" on client assets, and thus additional protection against their misuse. Moreover, an independent public accountant may identify misuse that clients have not, which would result in the earlier detection of fraudulent activities and reduce resulting client losses"

The annual surprise examination requirement would be *in addition* to the requirement that the adviser have a reasonable belief that qualified custodians deliver account statements directly to clients.

The adviser's agreement with an independent public accountant to conduct the surprise examination must require the accountant, among other things, to notify the SEC within one business day of finding material discrepancies, and to submit Form ADV-E to the Commission accompanied by a certificate within 120 days of the time chosen by the accountant for the surprise examination, stating that it has examined the funds and securities and describing the nature and extent of the examination.

Furthermore, the SEC is proposing a number of additional “enhancements” to the rule including additional adviser and accountant reporting requirements and independent review of custody controls in certain circumstances.

Comments to Proposed Rule

Thus far, most of the comments have been made by independent financial advisers that point out that; (1) implementation of the proposed regulation is unnecessary due to the fact that investment advisers are already required to maintain physical custody of client assets with banks and/or broker-dealers already subject to significant scrutiny and regulation; (2) client fraud like the Ponzi Scheme perpetrated by Madoff would not have been prevented by the proposed rule for the reason that most investment advisers are deemed to be custodians only because their fees are deducted from client accounts; and (3) compliance with the proposed rule will be costly with the cost of the audit likely passed on to investors.

Comments on the proposed rule can be made until July 28, 2009.

Bottom Line

With the SEC scrambling to restore credibility in light of the recent financial melt-down, and particularly the investor fraud occurring in the wake of the melt-down, proposals such as this are to be expected. Furthermore, given the Obama Administration’s commitment to transparency in both government and investor relations, the SEC is not likely to back down easily. The last thing the SEC wants is to look like it was “asleep at the wheel” when the next round of consumer complaints surface.

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