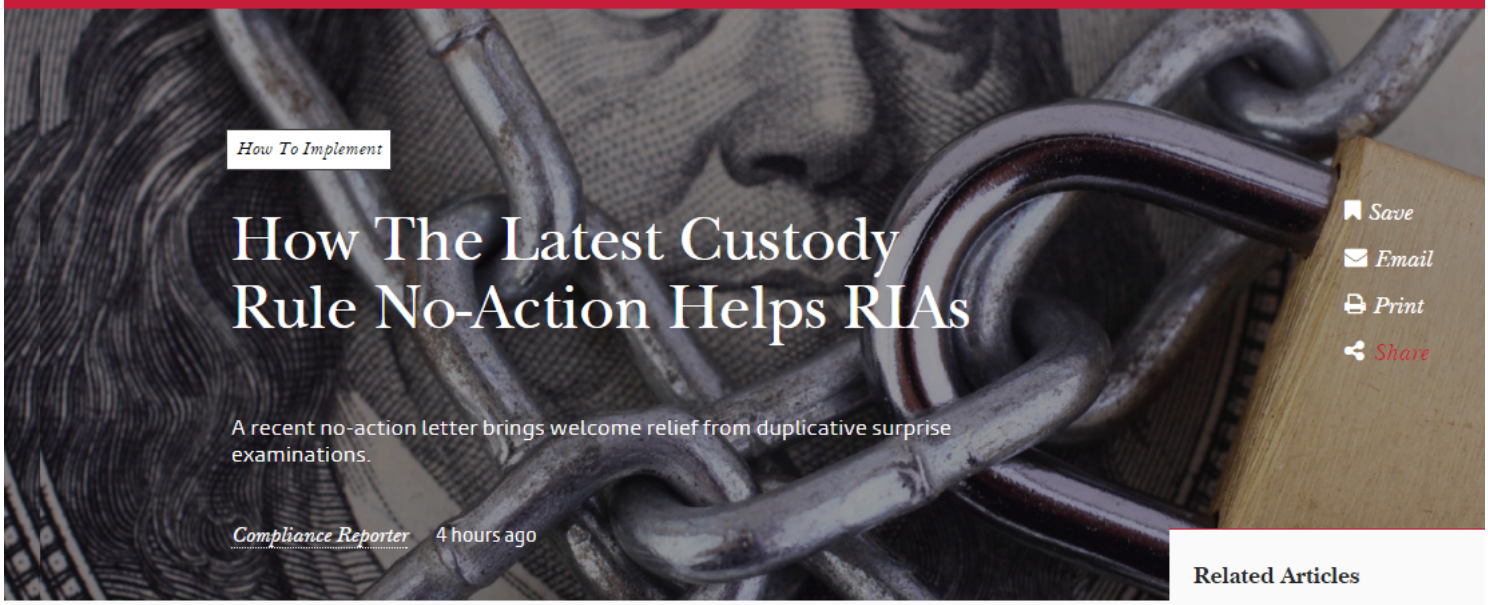


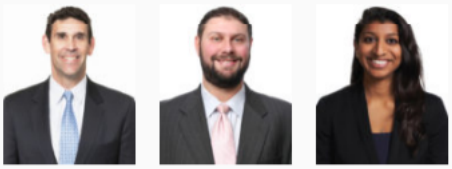
*How To Implement*

# How The Latest Custody Rule No-Action Helps RIAs

A recent no-action letter brings welcome relief from duplicative surprise examinations.

*Compliance Reporter* 4 hours ago





***By Mark Perlow, Michael Sherman and Priya Patel of Dechert***

Compliance with the **Securities and Exchange Commission**'s Custody Rule—Rule 206(4)-2 of the Investment Advisers Act—has become a significant focus for the agency and, in turn, an increasing compliance priority among registered investment advisers RIAs).

As part of its continuing effort to clarify and streamline firms' obligations under the Custody Rule, the SEC staff's most recent no-action letter on the topic provided relief from the rule's annual surprise audit requirement for sub-advisers participating in an investment advisory program where the primary adviser/sponsor and the qualified custodian of program clients' assets are both "related persons"—i.e. businesses under common control—and the primary adviser/sponsor is solely responsible for Custody Rule compliance.

As a result of this relief, certain sub-advisers that technically have custody pursuant to the Custody Rule would not be required to obtain a separate surprise examination by an independent accountant.

The Custody Rule generally regulates RIAs with respect to circumstances where an adviser or its affiliate has custody, possession or an ability to obtain client funds and securities. The rule was designed to protect client assets against loss, misuse and misappropriation and to ensure that they "will be insulated from and not be jeopardized by financial reverses, including insolvency," of an RIA.

An RIA is deemed to have custody of client assets if it holds client funds or securities "directly or indirectly" or if it has "any authority to obtain possession of them." Custody would include circumstances where client assets are directly or indirectly held by a related person as qualified custodian in connection with advisory services provided by the RIA to its clients. For instance, if a related person of an RIA has the ability to withdraw funds in connection with the RIA's services, the custody of the related person is also attributed to the RIA. While these advisers might not have actual, physical possession of client assets,

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they still have the authority to obtain possession.

With some exceptions, RIAs having custody of client funds or securities must:

- Maintain client assets with a "qualified custodian," which includes broker/dealers, banks, commodity futures merchants and certain foreign custodians, in the manner described in the Custody Rule;
- Notify clients, in writing, of the identity of the qualified custodian when a custody account is opened or when changes are made;
- Obtain reasonable belief that the qualified custodian is providing quarterly account statements to clients showing all holdings and transactions in the relevant account;
- Undergo surprise verification by an independent public accountant regulated by the **Public Company Accounting Oversight Board** on an annual basis; and
- Receive or obtain from the qualified custodian a written report of the internal controls relating to custody of client assets from an independent public accountant on an annual basis, if those assets are maintained by a qualified custodian that is a related person or the RIA itself.

Although the Custody Rule does not require the use of independent qualified custodians, the SEC "recognizes that affiliated custodial relationships present higher risks to advisory clients than where client funds or securities are maintained with an independent custodian." In particular, certain investment advisory programs involve a primary adviser/sponsor that is, or is a related person of, the qualified custodian; for example, wrap fee programs. Such programs may make use of sub-advisers that are affiliated with the primary adviser/sponsor.

Under the current regulatory regime, such sub-advisers would be deemed to have custody of client assets if the primary adviser/sponsor, as a related person to the sub-adviser, is or is affiliated with the sub-adviser. As such, both the sub-adviser and the primary adviser/sponsor would be subject to the Custody Rule requirements set forth above, including submitting to surprise examinations by, and obtaining written internal control reports from, an independent public accounting firm.

Accordingly, the recent no-action letter to the **Investment Adviser Association** provides welcome relief from duplicative surprise examinations of both the sub-adviser and the primary adviser/sponsor. The SEC staff confirmed that it would not recommend enforcement action if the sub-adviser does not itself obtain a surprise audit examination where the primary adviser/sponsor complies with the Custody Rule requirements.

**CONDITIONS**

However, the SEC's relief from surprise examination has the following conditions:

- The sub-adviser has custody solely because of its affiliation with the qualified custodian and primary adviser;
- The primary adviser continues to comply fully with the Custody Rule;
- The sub-adviser does not hold funds or securities itself, has no authority to obtain possession of funds or securities and has no authority to deduct fees from clients' accounts; and
- The sub-adviser continues to obtain from the primary adviser or the qualified custodian the required written internal control report from an independent accounting firm performing the surprise exam.

While surprise examinations by an independent auditor provide useful protections from custodial risks, the IAA no-action letter appears to recognize that any incremental benefit to duplicative surprise examinations relating to the same program accounts is outweighed by the related costs.

However, this relief should not be viewed as a sign of diminished regulatory emphasis. In March 2013, the SEC staff stated that roughly one-third of all recent agency exams that contained significant deficiencies involved custody-related issues—in particular, failures to

recognize custody, non-compliant surprise audit examinations, failures to satisfy the "qualified custodian" requirements and/or deficient audit processes.

The Custody Rule has been a top exam priority in 2014 and 2015 and the SEC will continue to bring enforcement actions against RIAs for violations of the rule, including the failure to conduct an adequate surprise examination. In light of these regulatory priorities and enforcement actions against RIAs for non-compliance with the Custody Rule, firms seeking to rely on the IAA no-action letter should ensure that they meet all of the required conditions.

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**Topics**

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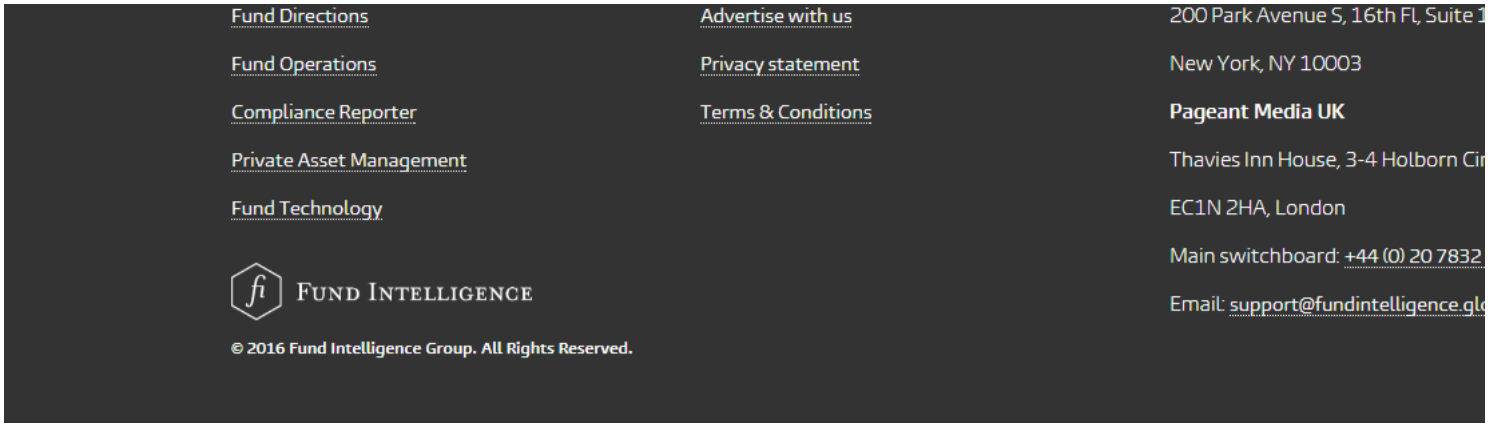
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