

The Custody Rule Revisited

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Advisors to Pooled Investment Vehicles that operate on a calendar year are quickly approaching a significant deadline.

In general, the Custody Rule (Rule 206(4)-2) requires that advisors custody client funds and securities with a qualified custodian, that they notify their clients that they are doing so and identify who the custodian is, that they ensure that the custodian is sending at least quarterly statements to the clients, and that they verify the funds and securities held in custody by having an independent, surprise examination conducted annually by a Public Company Accounting Oversight Board (PCAOB)-registered public accounting firm.

It should be noted, however, that the Securities and Exchange Commission (SEC) has provided an exception to Advisors to Pooled Investment Vehicles. That exception or exemption, articulated in 206(4)-2(b)(4), relieves the advisor of its obligation to have a qualified custodian send statements to its clients and to reasonably determine that the custodian is delivering those statements. It also relieves the advisor of its obligation to undergo a surprise examination by a PCAOB-registered accounting firm.

To take advantage of the exemption, an advisor must annually distribute audited financial statements that have been prepared in accordance with generally accepted accounting principles (GAAP) by an independent public accounting firm that is registered with, and inspected by, the PCAOB within 120 days of the close of the advisor's year end. It must also provide a similarly completed financial statement to the fund's investors upon liquidation of the fund.

As such, advisors with calendar year-ends have until April 30 to complete and distribute audited financial statements to their investors.

Those who fail to do so may find themselves in violation of their obligations under the Custody Rule.

Advisors should pay close attention to the following questions:

1. Do I have custody as defined by the Custody Rule?
2. Are client assets being properly maintained with a qualified custodian?
3. Can I take advantage of the audited financial statements exemption?

If an advisor does indeed have custody and its client assets are being maintained with a qualified custodian, but has not provided audited financial statements, it is important that the advisor ensure compliance with the notice, statement delivery and surprise examination provisions of the Custody Rule.

If you are in need of a custodian, please contact Scott Foster at SFoster@KingdomTrustCo.com.

Surprise Examination Requirements and Procedures

Once the determination has been made that a surprise examination is required and an independent public accounting firm has been engaged, what should an investment advisor expect as part of the examination process? In accordance with Rule 206(4)-2(a) (4) of the Investment Advisers Act of 1940, an examination of funds and securities must be conducted on an annual basis, at random dates chosen by the independent public accountant.

Once the accountant has notified the investment advisor of the date selected, the accountant will have 120 days to complete the surprise examination, ultimately uploading form ADV-E to the SEC's Investment Adviser Registration Depository (IARD) website upon successful completion of the examination. While completing the surprise examination, if the accountant determines that material discrepancies exist, the accountant is required to notify the SEC's Office of Compliance Inspections and Examinations within one business day. A material discrepancy is defined as an item that the accountant believes has a material effect on the entity's compliance with Rule 206(4)-2.

Investment advisors should note that the completed ADV-E form is publicly available through the IARD website.

The purpose of the surprise examination is to substantiate that all funds and securities held by the investment advisor for clients are held by a qualified custodian and that they are held in separate accounts for each client. This is accomplished by performing the following procedures:

- Sending confirmation requests directly to the qualified custodian, as of the date of the examination, to verify that the funds and securities are in accounts held separately in the name of each client;
- Sending confirmation requests directly to the client of the investment advisor, as of the date of the examination, to verify account activity that has taken place since the last examination, including contributions and withdrawals of funds and securities;
- Reconciling the confirmations received by the accountant to the books and records of the investment advisor.

After the above procedures are completed and the independent accountant is satisfied that the investment advisor is in compliance with Rule 206(4)-2, an examination report is issued. The examination report states the opinion that the investment advisor is in compliance with Rule 206(4)-2 in all material respects as of the examination date and during the period since the last surprise examination.

SEC Notices of Significant Deficiencies Involving Advisor Custody

As noted in a Risk Alert issued by the SEC's National Exam Program (NEP), significant deficiencies were identified surrounding investment advisor compliance with the Custody Rule for approximately one third of all advisors examined. Some of the most common deficiencies identified were:

- Failure by advisors to recognize they had custody in situations such as: performing bill paying services and having check writing authority, maintaining physical custody of client assets, and advising as a General Partner to a pooled investment vehicle such as a hedge fund.
- Surprise examination deficiencies such as: Form ADV-E not being completed within 120 days, and accountants failing to perform the examination on a surprise basis.
- Qualified custodian deficiencies such as: client funds and securities that were commingled with employee assets, security certificates that were held in a safe deposit box controlled by the advisor, and the advisor not having reasonable basis to believe that the custodian was sending out required quarterly statements to clients.
- Audit approach deficiencies in situations where the advisor relied on the audit provision for pooled investment vehicles such as: the public accountant performing the audit was not considered independent under Regulation S-X, financial statements were not prepared in accordance with GAAP, the auditor was not registered with the PCAOB, and a final audit was not performed on a liquidated investment vehicle.

If you have questions or are in need of a surprise examination, please contact Daniel O'Connor at danny@richeymay.com or Stephen Vlasak at svlasak@richeymay.com.

About Us

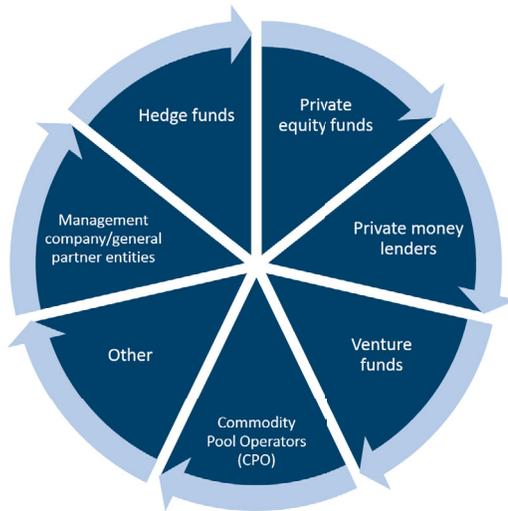
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Richey May's Cayman Island Office

The opening of a Cayman Island office is a significant milestone in the history of Richey May. It marks our first international office and will allow us to conduct audits of pooled investment vehicles, such as hedge funds, registered under the Cayman Island Monetary Authority (CIMA) Mutual Funds Law. With this Cayman Island office, Richey May is committed to meeting the unique needs of our alternative investment clients.

Fund Structures
Fund of funds
Master-feeder
Mini-master
Domestic fund
Foreign fund
PFIC
'40 Act
REIT



Specialized Industry Services

- Audits, reviews, compilations, agreed upon procedures and other assurance services
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- Federal and state tax returns
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- Tax estimates
- Valuation consulting
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- Fund document reviews
- Performance examinations
- Offshore Cayman filing requirement (FAR form) assistance

Memberships:

Public Company Accounting Oversight Board (PCAOB)

American Institute of Certified Public Accountants (AICPA)

Colorado Society of Certified Public Accountants (COCPA)

The International Accounting Group:



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Best Places to Work in Colorado

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