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SEC Compliance Issues – A Discussion

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Today's Discussion

- Investor Protection Act
- Custody
 - Definition
 - What triggers custody?
 - What are the SEC's Expectations?
 - When do the compliance requirements outweigh the benefits to the client?
 - Surprise Annual Exam
 - Proposed Changes to Rule 206(4)-2

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- **Protecting Investors and Righting Wrongs.** Reforming the Securities and Exchange Commission (SEC) to strengthen its powers, better protect investors, and efficiently and effectively regulate our securities markets.
- **Comprehensive Securities Review and Reorganization.** An expeditious, independent, comprehensive study of the entire securities industry by a high caliber body will identify reforms and force the SEC and other entities to put in place further improvements designed to ensure superior investor protection.
- **Enhanced SEC Enforcement Powers and Funding.** Doubling the authorized funding for the SEC over 5 years and providing dozens of new enforcement powers and regulatory authorities.
- **Fiduciary Duty.** Every financial intermediary who provides advice will have a fiduciary duty toward their customers. Through a harmonized standard, broker-dealers and investment advisers will have to put customers' interests first.

- **Whistleblower Bounties.** A whistleblower bounty program will create incentives to identify wrongdoing in our securities markets and reward individuals whose tips lead to successful enforcement actions.
- **Ending Mandatory Arbitration.** Because mandatory arbitration has limited the ability of defrauded investors to seek redress, the SEC will gain the power to bar these clauses in customer contracts.
- **Closing Loopholes and Fixing Faulty Laws.** The Madoff fraud revealed that the Public Company Accounting Oversight Board lacked the powers it needed to examine the auditors of broker-dealers. The \$65 billion Ponzi scheme also exposed faults in the Securities Investor Protection Act, the law that returns money to the customers of insolvent fraudulent broker-dealers. The Investor Protection Act closes these loopholes and fixes these shortcomings.

1. What is *Custody*?

"Custody" means holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them.

2. Does my firm have *Custody*?

- ✓ Automatically debiting management or other fees
- ✓ Serving as a Trustee or holding General Power of Attorney on a Client account
- ✓ Providing bill pay services
- ✓ Serving as the General Partner or Managing Member to a pooled vehicle
- ✓ Holding authorization to withdraw Client assets from custodial account
- ✓ Holding Client securities in an Omnibus account (e.g. FBO adviser with adviser providing sub-accounting)

My firm has custody – what must we do?

- Conduct all business operations in such a way that Client cash and investments will be preserved in safekeeping of independent Qualified Custodians.
- Disclose in its Form ADV that it has custody of Client assets (unless *Custody* is solely a result of automatically debiting management fees.)
- Maintain all Client securities separate from the Firm's proprietary assets.
- Ensure that the Qualified Custodian sends quarterly account statements to Clients.
- If no account statements are being sent, Adviser must have a "surprise audit"
- Maintain the following records for each Client for which the Adviser is deemed to have custody:
 - a journal or other record showing all transactions for such accounts and all debits and credits;
 - a record for each Client of all transactions, the date and price of each, and all debits and credits
 - copies of confirmations for all transactions effected in the account; and
 - a Client security cross reference.
- Advisers to pooled vehicles must ensure that all investors receive an audited financial statement on an annual basis within 120 days of the Client's fiscal year end (180 days for Clients of Clients)

Proposed Changes

- **Expanded Custody Definition.** The proposed changes would expand the definition of “custody” to include circumstances in which an adviser has custody of any client securities or funds that are directly or indirectly held by a *Related Person* in connection with advisory services.

A Related Person is one who directly or indirectly controls or is controlled by the adviser and any person under common control with the adviser. Control would further be defined as the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract or otherwise.

- **Expanded Annual Surprise Examination.** All advisers with custody, regardless of type, would be required to engage an independent public accountant to conduct an annual surprise examination of client assets.
- **Electronic ADV-E Filing.** Reporting by the accountant will be required via an electronic ADV-E form filed under the IARD system.

Proposed Changes Cont'd

- **Direct Delivery of Quarterly Account Statements.** Eliminating the ability of firms to provide their own statements to clients in order to meet the requirements of the Custody Rule, the Commission proposes *requiring qualified custodians to directly deliver statements in all cases, potentially in addition to those sent by the adviser.*
- **Requirement of “Due Inquiry”.** As proposed, advisers would be required to conduct “due inquiry” to ascertain whether the qualified custodian is delivering account statements as required.
- **Liquidation Audit.** The proposed amendments clarify that a liquidation audit, one held at other than year end upon liquidation of a partnership, is required to rely on the provision of annual audited financial statements to meet custody requirements.
- * **The Commission asked a number of questions of commenters and received hundreds of responses. It remains to be seen how this proposal may change in light of these responses.**



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