By Jeffrey A. Kelley, Chief Operating Officer, Equity Institutional

Investment professionals woke up in March to read the kind of headlines to make them hope their clients overslept.

From InvestmentNews came this report: “SEC warns investors that advisors could be mishandling assets.” Financial Planning magazine weighed in with “SEC: Advisors Routinely Violate Custodial Rules.”

The catalyst behind all of this anxiety-provoking publicity – more than one reader made the association between “mishandling assets” and Ponzi schemes – was a sharply worded National Exam Program Risk Alert (downloadable at http://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf).

The Alert summarized the SEC’s experience following 140 mandated, annual, surprise examinations of Registered Investment Advisors (RIAs) to see how well the SEC’s most recent Custody Rule amendments under the Investment Advisers Act of 1940 were being enforced.

SERIOUS DEFICIENCIES

The results concerned the SEC enough to issue its Alert: One out of three advisors received failing grades for not observing their responsibilities in the control and custody of their clients’ assets.

“We take deficiencies in this area very seriously and want to put advisors on alert about the importance of complying with the custody rule,” Carlo V. di Florio, director of the SEC’s Office of Compliance and Inspections, said in a statement. “It is a key component in our investment advisor examination program.”

Advisors cited by the SEC have subsequently had to change their custody compliance policies and procedures, modify their business practices and devote more resources to custody issues. In some cases, the examiner has even referred the incident to the SEC’s Division of Enforcement.

Major shortfalls occurred primarily in three areas:

- **Custody role misunderstood** Advisors in some cases didn’t even know they were even responsible for the maintenance and control of their clients’ assets.

- **Inappropriate handling of assets** In other cases, an investor’s private stock certificates were improperly stored in office folders and file cabinets; making it potentially difficult to sort out the true ownership of the assets.

- **Lack of preparation** Still other advisors overlooked previous notices about the SEC’s intentions to conduct unexpected annual reviews to ensure enforcement of Custody Rules.
In addition, some financial planners who advise on audited pooled investment vehicles failed to hire an independent accountant, as well as ignored the requirement that quarterly financial statements should be distributed to all affected clients.

**SEC’S BROAD VIEW OF THE CUSTODIAL ROLE**

If you are an advisor who oversees client accounts, you are obligated to meet a number of SEC-mandated requirements to insulate those assets from unlawful activities, as well as the potential insolvency of your firm – just to name two custodial responsibilities.

*According to the SEC, any advisor who holds client assets directly or indirectly or has authority to access those assets is playing a custodial role. It is a fraudulent, deceptive or manipulative practice for an RIA to have custody of client assets unless certain requirements are met.*

Costodial oversight touches on:

1. Possession of client assets
2. A power of attorney or other arrangement authorizing the RIA to withdraw client assets
3. Acting in any capacity that gives the RIA legal ownership of, or access to, client funds or securities

**NEW RULES COLLIDE WITH HISTORICAL PRACTICE**

While many advisors may be operating legally and above-board as custodians, too many advisors still employ antiquated, informal practices when it comes to handling client assets and securities.

Many of the deficient advisors tend to view themselves as throwbacks to a not-too-distant past when the custody of non-qualified accounts (qualified accounts like IRAs always have had a custodian assigned) meant finding room in a file drawer for a client’s stock certificates.

*Control and custody go together: More often than not in non-qualified accounts, it has been the historical practice for financial advisors to maintain strict control over the assets.*

If an advisor assumes and utilizes the control they have over an account, they bump up against the governing custody rules. When paying bills for a client, for example, the advisor is obligated to provide a strict, regular accounting of all transactions and report each transaction at least once a quarter to each client.

As a power-of-attorney, too, an advisor may freely make payments out of a checking account to help a client stay on top of their bills – which places them squarely in the custodial role.
No Surprises: Seven Steps to a Successful SEC Custody Rule Advisor Audit

A LOOK BACK

<table>
<thead>
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<th>Date</th>
<th>Event Description</th>
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<tr>
<td>December 30, 2009</td>
<td>SEC publishes its final rule amending certain custody requirements under the Investment Advisors Act of 1940, as amended for RIAs. The SEC indicated that the amendments were adopted to enhance the safekeeping of investor assets in the wake of several high-profile fraud cases against investment advisors and broker-dealers.</td>
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<td>2010 to 2011</td>
<td>SEC Audits of RIAs intensifies. Throughout this period the SEC becomes gradually more aware about how unprepared advisors are to meet the SEC Custody Rule requirements. Ironically, the new rules are in direct conflict with the commonly accepted practice of ad hoc treatment of non-qualified securities and assets. Even in cases where the RIA employs a custodian; the firm must still meet another set of requirements to ensure the custodian service provider is doing its job correctly. Oversight responsibility for ensuring that a third-party custodian is in compliance falls unambiguously on the shoulders of financial advisors. To meet this challenge, some advisors turn to the services offered by qualified, passive custodians.</td>
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<td>March 7, 2013</td>
<td>Surprise Custody Rule audits of advisors reveal shocking shortfalls on the part of unsuspecting, unprepared financial advisors, leading the SEC to issue its National Examine Program Risk Alert.</td>
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AVOIDING SEC CUSTODY SURPRISES MAY BE SIMPLER THAN YOU THINK

HERE ARE SEVEN STEPS YOU CAN TAKE NOW

1. **KNOW THE RULES**

SEC-registered investment advisors with custody of client assets must comply with the SEC Custody Rule. That means an advisor has custody if it holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them.

For example, an advisor that serves as the general partner of a pooled investment vehicle generally has custody of client assets because the position of general partner provides ownership or access to client funds and securities.

The SEC rules are clearly spelled out in the National Exam Program Risk Alert (downloadable at [http://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf](http://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf)) and associated sources. Here are the rules in summary:

- **Use of “qualified custodians” to hold client assets** An advisor with custody generally must maintain client funds and securities at a qualified custodian (e.g., a bank or a broker-dealer), either in a separate account for the client under the client’s name or in an account under the advisor’s name as agent or trustee for the advisor’s clients that contains only client assets (i.e., client assets may not be commingled with the advisor’s).
• **Notices to clients detailing how their assets are being held** An advisor that opens an account with a qualified custodian on the client’s behalf must notify the client in writing they have done so and provide the client with certain other information.

• **Account statements for clients detailing their holdings** An advisor must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends account statements to clients at least quarterly.

2. **DETERMINE YOUR DEGREE OF LIABILITY IN CUSTODY RESPONSIBILITY**

The Custody Rule generally provides that it is a fraudulent, deceptive or manipulative practice for an RIA to have custody of client assets unless certain requirements are met.

Importantly, even when an advisor provides uncompensated investment advice to a client, the firm still must comply with the Custody Rules.

In a non-qualified account, if the advisor has control of the assets, they are considered by the SEC to be the custodian on the account.

3. **USE THIS CHECKLIST TO READY YOURSELF FOR AN SEC EXAM**

☐ Review all client contracts; identify which are subject to custody

☐ Update all related contact information (addresses, phone numbers, email addresses) for clients and resources

☐ Keep internal control documents up-to-date on how systems and processes work, especially as related to record-keeping and reconciliation

☐ Maintain organized records supporting all transactions

☐ Maintain an updated account listing to identify accounts subject to examination

☐ Ensure contracts with clients and custodians are accessible and up-to-date

☐ Perform position and transaction reconciliations on a timely basis

☐ If you have any questions, engage custodian compliance experts to ascertain whether a custody situation has been triggered – or not

This diagram is designed to illustrate a few of the ways the SEC Custody Rule impacts an advisor’s custody responsibilities. It is not intended to be comprehensive or serve as legal advice.
4. **UNDERTAKE A PRACTICE AUDIT**

To determine if your firm is ready for its annual SEC visit, consider hiring an independent service provider, like an accounting firm or a law office, to undertake a practice drill to see if your internal procedures meet the SEC Custody Rule standards.

5. **PUT YOUR CUSTODY RESPONSIBILITIES IN THE CONTEXT OF YOUR LARGER BUSINESS GOALS**

To meet your fiduciary obligations to your clients, you need to put their financial interests first. While you have to make sure custodial policies and procedures are current and complete in order to be prepared for the inevitable, annual surprise SEC examination, you do not have to assume these responsibilities in a vacuum – or on your own.

By delegating your custodial responsibilities to a qualified custodian, you can redeploy your valuable resources from custodial oversight to developing your business and serving your clients.

6. **DELEGATE CUSTODIAL RESPONSIBILITIES TO A QUALIFIED CUSTODIAN**

While financial professionals may have a problem that they don't realize, solving the problem is not as difficult as it might seem if they shift the burden of custody control to a qualified, licensed custodian.

*To avoid lawsuits, advisors are well-served if they turn to third parties to hold assets and oversee reporting to clients.*

There are a number of regulated trust companies that have the resources and experience to assume the custody burden, while organizations like yours do what they do best – raise and retain assets under management, and provide sound guidance in helping clients achieve their financial goals.

7. **UNDERTAKE A RIGOROUS REVIEW OF CUSTODIAN QUALIFICATIONS PRIOR TO ASSIGNING ASSETS**

The immediate benefits to the investment professional of delegating custody to a qualified resource include convenience, low cost, and freedom from worry when it comes to SEC Custody Alerts hitting their in-boxes. Behind the scenes, a custodian integrates with your firm’s back office to ensure that account administration and reporting are taking place in a timely and accurate manner. A review of potential qualified custodians should be conducted at least annually and should touch on their menu of services, industry experience and whether or not they maintain above-average standing among their industry peers.

While you maintain operational control over your clients’ investments on their behalf, you can elect how much control you want to exercise over the documents associated with their investment transactions. Essentially, the more control you want over your clients’ documents, the more you should prepare for your annual SEC surprise Custody Rule Audit. If you serve as a trusted fiduciary to your clients, however, the services of a qualified, passive custodian can offer a cost-efficient, transparent, back office solution for keeping all of your custody documents in order. In contrast to an active custodian, which can provide investment advice and products to a client, a passive custodian generally operates as a technology-based back office service.
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ABOUT THE AUTHOR

Jeffrey A. Kelley, Chief Operating Officer, Equity Institutional (EI) has been with EI’s predecessor company, Sterling Trust, since 1999 and was named its Chief Operating Officer in January of 2008. Mr. Kelley is responsible for providing leadership, management and the vision necessary to ensure EI has the proper systems, operational controls, administrative and reporting procedures in place to grow the organization and maintain financial strength and operating efficiency. Mr. Kelley earned his Bachelor of Business Administration degree from Baylor University and has earned the Accredited Retirement Plan Consultant (ARPC) distinction from the Society of Professional Asset-Managers and Record Keepers.

ABOUT EQUITY INSTITUTIONAL

As a division of privately owned Equity Trust Company, Equity Institutional, a passive custodian, continuously invests in new technologies and staffing, while opportunistically evolving its menu of services. Our affiliated companies include Equity Trust, Equity Advisor Solutions, and ETC Brokerage Services.

Equity Institutional’s mission focuses principally on making it easy for clients to manage their alternative investment portfolios. With more than $12 billion under custody, their 130,000 clients include more than 10,000 of the nation’s leading financial professionals.

Equity Institutional’s staff participates in a continuous training program of technical and industry-specific topics. The firm also maintains an expansive network of resources and partnerships to ensure its clients receive the answers and services they require. Equity Institutional can help financial professionals meet their obligations under the SEC Custody Rules in a low pressure, cost-efficient fashion.

THE ALTERNATIVE CUSTODIAN

EXPERIENCE EQUITY INSTITUTIONAL

Contact us today at: 855-355-ALTS (2587)

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