



ADVISOR  
SOLUTIONS  
GROUP, INC

## COMPLIANCE UPDATE

### **Final Rule: Custody of Funds or Securities of Clients by Investment Advisers**

Release Date: December 30, 2009

Effective Date: March 12, 2010

**Compliance Date: On and after March 12, 2010, except as provided below**

The SEC has adopted amendments to the custody rule, Rule 206(4)-2 under the Investment Advisers Act of 1940. Advisers will need to obtain a surprise verification of client funds and securities for which they or a related person has custody from an independent accountant at least annually unless they qualify for an exception. Advisers who debit investment advisory fees from their clients' accounts continue to be deemed to have custody of client's funds and securities; however, these Advisers will not have to undergo annual surprise examinations if that is the sole reason they have custody. The SEC will separately be issuing new rules governing custody of customer assets by broker-dealers.

#### Definition of Custody:

"Custody" means holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. Advisers also have custody if a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services the Adviser provides to clients.

#### Custody Includes:

- Possession of client funds or securities.
- Forwarding client's funds and securities to the custodian, except as below.
- Authority to withdraw funds or securities from client's account, including power of attorney to:
  - sign checks on client's behalf;
  - withdraw funds or securities from client's account;
  - dispose of client funds or securities (other than for trading);
  - direct debit of management fees.
- Any capacity (e.g. general partner ("GP") of a limited partnership ("LP"), managing member of a limited liability company ("LLC"), or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives the Adviser or a supervised person of the Adviser legal ownership of or access to client funds or securities.

#### Custody does not Include:

- Inadvertent receipt of client funds or securities, so long as the Adviser returns them to the sender within 3 business days or receipt.
- Possession of checks drawn by client made payable to a third party.

#### Steps to Comply:

1. Qualified Custodian: A qualified custodian (broker-dealer, bank, or where appropriate: registered

futures commission merchant or foreign financial institution; or transfer agent with respect to mutual funds) maintains the client's funds and securities:

- a. in a separate account for each client under the client's name; or
  - b. in an account containing only the client's funds or securities, under the Adviser's name as agent or trustee for the client.
2. Notice to Clients: If the Adviser opens the account on the client's behalf, the Adviser must notify the client in writing, promptly after establishing the account and after any changes, of the custodian's name, address, and manner in which the assets are maintained. If the Adviser sends account statements to these clients, the notice and all subsequent account statements must include a statement urging the client to compare the account statements from the custodian with those from the Adviser.
3. Account Statements to Client: The Adviser must have a reasonable basis, after due inquiry, for believing that the custodian sends an account statement, at least quarterly, to each client, identifying the amount of funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period.
4. Independent Verification: Client funds and securities of which the Adviser has custody are verified by actual examination at least once during each calendar year, except as provided below, by an independent public accountant, pursuant to a written agreement between the Adviser and the accountant, at a time that is chosen by the accountant without prior notice or announcement to the Adviser and that is irregular from year to year.

Required Provisions of the Written Agreement:

- a. The first examination must occur within six months of the Adviser becoming subject to this requirement, except that, if the Adviser maintains client funds or securities as a qualified custodian, the examination must occur no later than six months after obtaining the internal control report (see below).

The written agreement must require the accountant to:

- b. File a certificate on Form ADV-E with the SEC within 120 days of the time chosen by the accountant for the examination, stating that it has examined the funds and securities and describing the nature and extent of the examination;
  - c. Notify the SEC within one business day of finding any material discrepancies during the examination; and
  - d. Upon resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed, file Form ADV-E within four business days, accompanied by a statement that includes:
    - i) The date of the resignation, dismissal, removal, or other termination, and the name, address, and contact information of the accountant; and
    - ii) An explanation of any problems relating to examination scope or procedure that contributed to the resignation, dismissal, removal, or other termination.
5. Special Rule for Pooled Investment Vehicles: If the Adviser or a related person is a GP of an LP, managing member of an LLC or holds a comparable position for another pooled investment vehicle, the account statements discussed in item 3 above must be sent to each limited partner (or member or other beneficial owner).
6. Investment Advisers acting as qualified custodians: If the Adviser maintains, or if the Adviser has custody because a related person maintains, client funds or securities as a qualified custodian in connection with advisory services the Adviser provides to clients:
- a. The independent public accountant the Adviser retains to perform the examination must be registered with, and subject to regular inspection by the Public Company Accounting Oversight Board ("PCAOB") as specified under *PCAOB* below; and

- b. The Adviser must obtain, or receive from the related person, within six months of becoming subject to this requirement and thereafter at least once each calendar year a written internal control report prepared by an independent public account:
  - i) The internal control report must include an opinion as to whether controls have been placed in operation as of a specific date, and are suitably designed and are operating effectively to meet control objectives relating to custodial services, including the safeguarding of funds and securities held by either the Adviser or a related person on behalf of the Adviser's advisory clients, during the year;
  - ii) The independent public accountant must verify that the funds and securities are reconciled to a custodian other than the Adviser or the Adviser's related person; and
  - iii) The independent public accountant must be registered with, and subject to regular inspection by, the PCAOB as specified under *PCAOB* below.
- 7. Independent Representatives: A client may designate an independent representative to receive, on his behalf, notices and account statements.
  - a. An "independent representative" acts as agent for an advisory client and by law or contract is obliged to act in the best interest of the advisory client;
  - b. the agent must not control, be controlled by, or be under common control of the Adviser;
  - c. the agent must not have, or had in the past two years, a material business relationship with the Adviser.
- 8. Exceptions:
  - a. Certain privately offered securities.
    - i) Privately offered securities are not required to be maintained by a qualified custodian if the securities are:
      - (1) Acquired by the issuer in a transaction or chain of transaction not involving a public offering;
      - (2) Uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client; and
      - (3) Transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.
    - ii) This exception is also available with respect to securities held for LPs, LLCs, or other pooled investment vehicles only if the pooled investment is audited, and the audited financial statements are distributed as described below.
  - b. Fee Deduction. Advisers are not required to obtain an independent verification of client funds and securities maintained by a qualified custodian if:
    - i) The Adviser has custody solely as a consequence of the Adviser's authority to make withdrawals from client accounts for the advisory fee; and
    - ii) If the qualified custodian is a related person, the Adviser can rely on the "Certain Related Persons" exemption below.
  - c. Limited partnerships subject to annual audit. Advisers are not required to comply with the "Notice to Clients" and the "Account Statements to Clients" requirements and are deemed to have complied with the "Independent Verification" requirement with respect to an LP (or LLC or other pooled investment vehicle) that is subject to audit:
    - i) At least annually, and distributes its audited financial statements prepared in accordance with GAAP to all limited partners (or members or other beneficial owners) within 120 days (180 for fund of funds) of the end of its fiscal year.
    - ii) By an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB as specified under *PCAOB* below; and
    - iii) Upon liquidation, and distributes its audited financial statements prepared in accordance

- with GAAP to all limited partners (or members or other beneficial owners) promptly after the completion of the audit.
- d. Registered investment companies. Advisers are not required to comply with this rule with respect to the account of an investment company registered under the Investment Company Act of 1940.
  - e. Certain Related Persons. Advisers are not required to obtain an independent verification of client funds and securities if:
    - i) The Adviser has custody solely because a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services the Adviser provides to clients; and
    - ii) The related person is *operationally independent* of the Adviser. A related person is presumed not to be operationally independent. The Adviser must overcome this presumption by demonstrating, and maintaining records that support, that each of the following circumstances are met and no other circumstances can reasonably be expected to compromise the operational independence of the related person:
      - (1) Client assets in the custody of the related person are not subject to claims of the Adviser's creditors;
      - (2) Advisory personnel do not have custody or possession of, or direct or indirect access to, client assets of which the related person has custody, or the power to control the disposition of such client assets to third parties for the benefit of the Adviser or its related persons, or otherwise have the opportunity to misappropriate such client assets;
      - (3) Advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision; and
      - (4) Advisory personnel do not hold any positions with the related person or share premises with the related person.
  - f. Delivery to Related Person. The account statements and the audited financials of pooled investment vehicles that are delivered to limited partners (or members or other beneficial owners) that themselves are LPs (or LLCs, or another type of pooled investment vehicle) and are a related person of the Adviser, do not satisfy the requirements of the rule.
  - g. PCAOB. When the rule specifies that the independent accountant be registered with and subject to regular inspection by the PCAOB, the independent account must be both registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by the PCAOB in accordance with its rules.

Recordkeeping:

Records that Advisers must keep in compliance with the rule, to the extent applicable, include:

1. The written agreements with the independent public accountants for surprise exams and audits of pooled investment vehicles;
2. Internal control reports that are required when the Adviser or a related person maintains client assets as a qualified custodian; and
3. Memorandum describing the relationship with the Adviser's related person and the basis for the determination that it has overcome the presumption that it is not operationally independent.

These records must be kept for five years from the last date of entry in the record, with the most recent two years kept on site.

Form ADV Amendments:

With this rule, the SEC has also adopted amendments to Form ADV which will primarily affect only Advisers that have custody of client assets, and/or who have a related person that is a broker-dealer or a bank. Advisers will first have to provide the new information with their first annual updating amendment after January 1, 2011.

This is only a summary of the new rule. Advisers should not rely on this summary to determine compliance with the rule. For further clarification on how these changes affect you or for help in complying with the rule, please contact us at [info@advisorsolutionsgroup.com](mailto:info@advisorsolutionsgroup.com) or at the number below.

1300 Bristol Street North | Suite 100 | Newport Beach, CA 92660 | 949.250.1855  
[www.advisorsolutionsgroup.com](http://www.advisorsolutionsgroup.com)