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RIA FIRMS

WILL YOU NEED A SURPRISE AUDIT THIS YEAR?

In December 2009, the Securities and Exchange Commission (SEC) made the decision to amend the custody and recordkeeping rules under the Investment Advisers Act of 1940. The purpose of the amendment is to make it increasingly difficult for investment firms that have custody of client assets to abuse those assets. This amendment comes in the wake of recent investment scandals involving Bernie Madoff and other investment managers. While no rule or regulation will completely prevent all fraudulent advisor activity, the rule will help keep focus on safeguarding client assets and increase the chances that fraudulent activity will be detected earlier than it might have, in efforts to reduce client losses. The new rule went into effect on March 12, 2010.

WHO IS SUBJECT?

The SEC estimates that less than 1,900 advisors will be subject to a surprise audit. An RIA firm may be subject to a surprise audit if the firm is registered with the SEC, and fits any of the following qualifications:

- Has custody of any advisory clients' cash, bank accounts, or securities
- Is trustee or a fiduciary of an account
- Serves under a power of attorney for a client
- A related person or entity that has custody of any of advisory client's cash, bank accounts, or securities
- A related person or entity that acts as a qualified custodian for clients in connection with advisory services provided

WHO IS NOT SUBJECT?

The SEC received over 1,300 comments from advisors and industry professionals opposing the new rule. As a result, a wide range of RIAs have been excluded from having to undergo a surprise audit. The RIAs that are exempt from the surprise audit are those that have custody solely related to withdrawing fees from client accounts.

WHAT IS REQUIRED?

Rule 206(4)-2, the custody rule, requires registered advisers to maintain their clients' assets with a qualified custodian, such as a broker-dealer or a bank. To enhance the protections afforded to clients' assets, registered advisers that have custody of client assets, among other things, are required to i) undergo an annual



surprise audit by an independent public accountant who is registered with and subject to regular inspection by the PCAOB. The examination will, at a minimum, include examination of the books and records as they relate to the RIA's custody, confirmation with the qualified custodian(s) and client(s), and reconciliation of confirmations and other information received; ii) have a reasonable basis for believing that the qualified custodian maintaining client funds and securities sends account statements directly to the advisory clients; iii) unless client assets are maintained by an independent custodian, to obtain a report of internal controls relating to the custody of client assets. An example of such a report is a SAS 70 Type II report.

WHEN IS IT REQUIRED?

RIA firms that are required to have a surprise audit must do so by December 31, 2010. If the RIA firm becomes subject to the new requirement after March 12, 2010, the firm has 6 months to obtain a surprise audit.

WHY IS AN INTERNAL CONTROL REPORT NEEDED FOR RIAs THAT MAINTAIN CUSTODY OF CLIENT FUNDS OR SECURITIES?

If an RIA is required to have an internal control report, it must be obtained at least once in a calendar year. The objective of the internal control report is to provide reasonable assurance that the qualified custodian's controls have been implemented as of a specific date and are operating effectively to meet control standards. Other areas addressed in the report are client account setup, maintenance, authorization and processing of client transactions, security maintenance and setup, processing of income and corporate action transactions, reconciliation of funds and securities to depositories and other unaffiliated custodians, and client reporting.

ABOUT OUR EXPERTS

Frank Boutillette, CPA/ABV, is the Practice Leader of WS+B's Financial Services & Investment Group and has over 25 years of accounting and auditing experience. He specializes in investment companies (hedge, mutual and exchange traded funds) and broker-dealers.

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