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Risk Reduction Strategies for IA Registration and Custody Issues

❖ Investment Adviser (IA) Registration Under the Regulatory Reform Acts

Under the financial reform provisions of the Dodd-Frank and Consumer Protection Acts, revisions have been made as to which investment advisers (IAs) must register and comply with the SEC's jurisdiction, and which IAs must register with an individual state's authority and supervision.

Currently, the IAs that must register with the SEC are those with:

- Greater than \$100 million in assets under management, unless their only clients are private funds

The IAs that must register with individual states are those with:

- Less than \$100 million in assets, or those who qualify for an exception as a foreign-domiciled adviser or an adviser to venture capital funds

Venture capital funds themselves are not required to register with the SEC, however they are subject to its record keeping and reporting requirements.

Advisers to private funds must now register if they have:

- Greater than \$150 million under management

Foreign advisers with no place of business in the United States must register with the SEC if they have:

- 15 or more U.S. clients and private fund investors; or
- \$25 million or more under management from U.S. investors

Another significant change is that advisers to private funds may no longer use an investor's primary residence as part of the investor's net worth to determine fund eligibility.

Reducing Regulatory Risks — Registration

Individuals in a supervisory capacity over an IA should institute the following activities to reduce regulatory risks in the area of registration:

- Review the firm's policies to ensure they are current with the revised eligibility guidelines for SEC registration
- Assess the firm's eligibility for SEC registration by determining the value of assets under management
- Determine if revisions instituted by the reform acts will allow for an exception to the SEC registration rule, or if the firm now qualifies for registrations with SEC



- Requalify investor eligibility to ensure that the value of the investor's primary residence has been excluded from the net worth calculation

❖ Custody of Funds and Securities

Because of high profile fraud cases during the economic crisis of 2008, the SEC amended Rule 206 (4)-2 (the Custody Rule) of the Investment Advisers Act of 1940. The revision not only requires IAs to maintain client funds and securities at a qualified custodian, but also imposes surprise independent verifications and internal control reports of client funds or securities held outside of a qualified custodian, or when that custodian is an affiliate of the IA.

In addition to having appropriate safeguards against theft, loss, and misuse of funds and securities, firms must be clear about what qualifies as "having custody." For instance, if an IA merely deducts advisory fees directly from a client custodial account, it does not have to comply with the surprise verification requirements and the preparation of internal control reports.

"Custody" means having direct or indirect access to a client's funds or securities, or having the authority to gain possession of them. Custody also includes:

- Any arrangements or client permission that authorizes the IA or IAR to withdraw client funds for securities
- Assignments to a person in their official capacity as a trustee of a trust, general partner, or managing member of a pooled investment vehicle, that gives them legal ownership of or access to client funds or securities

Custody does *not* include:

- Checks drawn by clients made payable to a third party
- Inadvertently receiving funds or securities and promptly returning them to the sender within three business days

Reducing Regulatory Risks — Custody

Individuals in a supervisory capacity over an IA should institute the following activities to reduce regulatory risks in the area of custody:

- Assess procedures to determine if the IA qualifies as having custody
- If applicable, establish and enforce procedures that would avoid inadvertently take custody of client assets
- Verify that a client's custodian is a "qualified custodian"
- Require IARs to report any new custodian accounts
- Verify that all custodians send the account statements, at least quarterly, directly to the clients, and not through the IAR
- Verify that the account statements show the appropriate deduction of fees



- Review the following documents and make the necessary amendments regarding custody to ensure they are current with the Reform Act amendments and appropriately disclosed:
 - Part 1 of Form ADV
 - Advisory contracts
 - Third-party agreements
 - Verify that an independent accountant has been retained to conduct an annual audit and that the appropriate internal control reports are prepared by the required deadline
 - Verify that the custodian has been provided with a list of individuals authorized to effect transactions in client accounts
 - Periodically review client trading patterns for signs of unauthorized trading
 - Ensure that a reconciliation process is in place to verify custodial statements with internal records and that differences are resolved in an appropriate and timely manner
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