

February 2012

Is Your Firm in Compliance? **Amended SEC Custody and Recordkeeping Law**

The Securities and Exchange Commission adopted amendments to the custody and recordkeeping rules (Rule 206(4)-2) under the Investment Advisers Act of 1940, which were effective March 12, 2010. In addition to revising the definition of the term *custody*, the amendments include several new regulatory requirements to be adhered to by the registered adviser. Proper consideration of what constitutes *custody* is a key component of ensuring your firm's compliance.

Custody Includes:

- Possession of client funds or securities (but not checks drawn by clients and made payable to third parties), even if briefly, unless the advisor receives them inadvertently and returns them to the sender promptly but in any case within three business days of receiving them;
- Any arrangement (including general power of attorney) under which the investment advisor is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the investment advisor's instruction to the custodian (does not apply when the advisor has custody of client assets solely because of its authority to deduct advisory fees from client accounts); and
- Any capacity (such as general partner of a limited partnership, managing member of a limited liability company or comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives the investment advisor or their supervised person legal ownership of or access to client funds or securities.

AN INVESTMENT ADVISOR DEEMED TO HAVE CUSTODY MAY BE SUBJECT TO:

Annual Surprise Examination

When an adviser is deemed to have custody of the client funds or securities, the advisor is required to undergo an annual surprise examination by an independent public accountant to verify client assets. Certain exemptions exist for advisors who: a) have custody only because of ability to deduct advisory fees from client accounts; b) are advisors to pooled investment vehicles IF they obtain an audit by an accounting firm registered with, and subject to regular inspection by, the PCAOB; and c) have custody of client assets due to a related party who is *operationally independent*.

Internal Control Report

When an advisor or its related person serves as qualified custodian, the advisor is required to obtain, or receive from its related person, no less than once each calendar year, a written report and opinion addressing controls relating to custody of client assets. This is referred to as an "internal control report" and must be performed by an accounting firm registered with, and subject to regular inspection by, the PCAOB.

For more information on compliance with the SEC's custody rules and to explore how Brown Smith Wallace can assist you with this and other regulatory matters, please contact Lincoln K. Gray, CPA at 314.983.1235, lgray@bswllc.com or Anthony J. Caleca, CPA at 314.983.1267, tcaleca@bswllc.com.

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