

From FAMILY WEALTH REPORT

Viewpoint: Costly changes to custody rules weighed

Eric Clarke - 3 June 2009

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On 14 May 2009, the **SEC** proposed changes to the custody rule under the **Investment Advisers Act of 1940**, Rule 206(4)-2 that will affect investment advisory firms deemed to have custody of client assets. This definition covers advisors who have custody of client accounts directly, through affiliated custodians, and by virtue of being able to take fees from client accounts.

The proposed changes affect more than 9,600 RIAs that have the authority to deduct fees from custodial client accounts. *These firms would be subject to an annual "surprise" audit at their own expense.* To this end, every advisory would be responsible for engaging an independent public accounting firm -- at a potential cost, the SEC estimates, of \$8,000 or more a year. These changes hit very close to home for us as they stand to affect most of the firms we serve.

And what exactly would accounting firms be auditing during these surprise audits? They'd be verifying all client funds and securities by contacting your custodians and clients to make sure everything matches up. This process would make more work for custodial firms as they respond to auditor requests, and it would trigger queries from clients trying to understand why an outside auditor is asking them to verify their own account holdings -- with this in mind, pay special attention to footnote **33** of the **2003 Custody Rule Amendment**.

Another shoe

Meanwhile, another group of firms would be impacted by section **II(B)** of the proposed amendment affecting RIAs that work with affiliated custodians. For these firms, engaging a standard accounting firm as auditor won't be an option. Instead they'll be required to hire an auditing firm that is a member of the **Public Company Accounting Oversight Board** -- which is likely to dwarf the \$8,000 price tag I mentioned earlier.

This amendment would also require the custodial firm to conduct (and pass) an "SAS 70 Type 2" audit, presumably by 2010. If your affiliated custodian doesn't already happen to have its SAS 70 Type 2, they have some additional work to do. To be in position to pass a Type 2, a firm would most likely need to first complete a SAS 70 Type 1.

The third proposed amendment is to allow advisors to work with independent custodians only -- functionally disallowing broker-dealers with affiliated RIAs, or banks with internal trust departments, to custody their own accounts.

In my opinion, this third amendment is less likely to pass, but it, along with the "one-two" punch of the first two, it certainly warrants some comment from all advisors right now.

Let your voice be heard by the SEC, which is soliciting comments from advisors -- though only until 28 July 2009. You can submit your comments [here](#) and you can also read the existing comments from advisors [here](#).

Prudence

I also think it would be prudent to interview a public accounting firm or two to find out how much a surprise audit of all of your clients' funds and securities is likely to cost.

Whether these regulations pass now, or a new Ponzi-scheme comes along next year to agitate industry even more, it's likely that compliance costs will increase.

The trend over the past decade has been a large increase in the number of advisors, and a decrease in the number of SEC regulators. This suggests a shift of the costs of auditing and regulatory compliance from the government to advisors responsible for them. Understanding these audits and associated costs is critical, and advisors should be especially aware of additional costs to their practice as a possible factor in considering pricing structure of your client accounts.

Orion helps RIAs cope with audits by reconciling and scrubbing the firm's books to that of the custodian. We also work with CPA firms that specialize in auditing advisors to help find a match for advisories who need (or may soon need) their services. If any or all of these amendments pass, advisors will need to act quickly to comply with them. While it will be a large undertaking, and an additional expense, our goal is to see it be as small of a distraction as possible so you can spend less time dealing with SEC changes and more time with clients. -FWR

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