

Regulatory Update – Summary of Final SEC Custody Rule

Note: This analysis is intended to provide a broad overview and should not be substituted for the advice of either a compliance or legal professional.

On December 30th, the [SEC issued a final rule, IA 2968](#), in which it adopted amendments to the custody [\[Rule 206\(4\)-2\]](#) and recordkeeping [\[Rule 204-2\]](#) rules under the Investment Advisers Act of 1940 and [Forms ADV and ADV-E](#). Earlier this year, the [AICPA commented](#) on the SEC's proposed amendments, which *revamped* an existing surprise examination requirement and *introduced* a new internal controls examination requirement. Under the proposal, it was estimated that 9,575 of 11,272 SEC-registered advisers would be subject to the surprise examination requirement and 372 advisers would be subject to the internal controls requirement. Under the final rule, the number of advisers estimated to be subject to the surprise examination and internal controls examination requirements is 1,859 and 337, respectively. We are pleased to report that AICPA's main points were incorporated in the final rule, some of which are detailed below.

Included in our comments was a suggestion that the SEC focus the surprise count requirement on those advisers presenting the highest degree of risk and with greater levels of access to client assets; this reduced scope, risk-focused approach is reflected in the final rule. We also recommended that the SEC consider modernizing its examination methodology, scope and applicable standards to increase efficiency and reduce the cost of the surprise examination. We are pleased to note that a [separate, companion SEC release \(IA 2969\)](#) provides guidance for accountants with respect to the surprise examination and internal control report required under the rule. The release replaces and updates Section 404.01.b of Financial Reporting Release No. 1. Also, while we expressed support for the internal controls examination requirement, we suggested that that SEC incorporate existing internal control reports to enhance efficiency and eliminate duplication. As noted by the SEC in IA 2968 (p. 27), revised accounting guidance allows for the accountant to leverage upon existing work by relying on their own relevant audit work performed for other purposes.

Another aspect of the proposed rule addressed PCAOB-registration of the adviser's auditor. The SEC proposed – and AICPA supported – a requirement that advisers *not utilizing an independent custodian* (and thus, required to obtain both types of exams) engage an auditor subject to PCAOB-registration, inspection and oversight. For the surprise examination requirement associated the vast majority of advisers using an independent custodian, the SEC elicited feedback as to whether they should require that such examinations be conducted by an accountant registered with, and subject to regular inspection by, the PCAOB. AICPA's position was that CPA professionals are singularly competent and capable of performing the types of examinations required with the integrity and competence required and expected, without being PCAOB-registered. The final rule reflects this viewpoint, and PCAOB-auditors are required only for advisers who do not use an independent custodian.

Below is a recap of the final, amended rule:

- 1. Advisers with “custody” by virtue of fee-deduction only will not be subject to a surprise examination.** Under the proposed rule, it was estimated that approximately 5,958 advisers could be drawn into its scope solely due to their ability to deduct advisory fees, since that is considered to be custody per definition [206\(4\)-2\(c\)\(1\)\(ii\)](#). The final rule's coverage does not extend to this category of advisers.
 - AICPA's comment letter drew attention to prior 2003 SEC guidance in which certain fee-deduction arrangements under which the qualified custodian acted as agent were not considered to be “custody.” In the final rule, the SEC reaffirmed this position. (See footnote 140 of IA 2968).

2. **Advisers with “enhanced” custody** (*ability to withdraw funds beyond fee-deduction, such as trusteeship or a power of attorney*) using an **independent qualified custodian**:
 - Surprise examination: Yes.
 - Internal controls examination: No.
3. **Advisers with “enhanced” custody** (*ability to withdraw funds beyond fee-deduction, such as trusteeship or a power of attorney*) using an **affiliated qualified custodian**:
 - Surprise examination: Depends on whether custody is attributed to adviser by related person or not. If affiliate is operationally independent and if adviser has such custody *solely* due to related person attribution, no surprise exam required. Otherwise, cannot rely on the exception to the surprise examination.
 - Internal controls examination: Yes.
4. **Advisers with physical custody subject to both exams** – irrespective of whether an independent custodian is used.
5. **Certain advisers to pooled investment vehicles (PIVs)**:
 - Surprise examination: Not required provided that the PIV is subject to an annual financial statement audit by a PCAOB-registered and inspected accountant and audited financial statements are distributed to the pool's investors. (As proposed, an estimated 2,069 advisers to PIVs would have been required to undergo a surprise examination in addition to an annual audit, which the SEC reasoned would be duplicative).
 - Internal controls examination: Yes, if adviser or a related person to the PIV acts as a qualified custodian.

AICPA will actively monitor any developments and will keep you apprised as they unfold. Email us at regulatoryreform@aicpa.org with any questions or concerns.