



The Custody Rule & Surprise Custody Examinations

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Moderator:
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Agenda

1. Background and Key Requirements
2. Private Funds and Privately Offered Securities
3. Best Practices
4. Panel Discussion and Q&A

Background and Key Requirements

- Rule 206(4)-2
- Originally adopted in 1962
- Amended in 2003
- 2009 Amendments
 - Thanks Bernie Madoff!



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Background and Key Requirements

- Summary of Requirements / Primary Safeguards
 - Maintenance with a Qualified Custodian
 - Client Notification of Custodian
 - Quarterly Account Statements
 - Surprise Annual Verification
 - Possibly also need an internal control report



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Background and Key Requirements

- Custody
 - Holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. You have custody if a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services you provide to clients.
 - Custody includes:
 - Possession of client funds or securities (but not of checks drawn by clients and made payable to third parties) unless you receive them inadvertently and you return them to the sender promptly but in any case within three business days of receiving them
 - Any arrangement (including a general power of attorney) under which you are authorized or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian
 - Any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives you or your supervised person legal ownership of or access to client funds or securities.



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Background and Key Requirements

- Possession of Client Funds or Securities
 - Inadvertent Receipt
 - Return to sender within 3 business days
 - Cannot forward to custodian; must return to actual sender
 - Exceptions:
 - Tax refunds
 - Settlement proceeds / class action lawsuit stock certificates or dividend checks



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Background and Key Requirements

- Possession of Client Funds or Securities
 - Checks

Drawn on Client's Account Payable to 3 rd Party	Not Custody	
Payable to Adviser for Purpose of Making Investment		Custody
3 rd Party Checks Made Payable to Client		Custody (subject to exception for tax refunds and settlements)
Payable to Adviser for Fees	Not Custody	



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Background and Key Requirements

- Authority to Withdraw Funds or Securities from a Client's Account
 - Trading Authority
 - Not Custody
 - First-Party Transfers
 - Not Custody if:
 - Client has authorized adviser to make transfer in writing with specificity
 - Copy of such authorization provided to custodian



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Background and Key Requirements

- Authority to Withdraw Funds or Securities from a Client's Account
 - Third-Party Transfers
 - Single Transfers
 - Custody
 - Standing Letters of Authorization (SLOAs)
 - Custody, but relief from Surprise Examination requirement, if:
 - The client provides a signed written instruction to the custodian identifying the third party and specific account to which the transfers will be made
 - The client provides a written SLOA to the adviser, which authorizes third party transfers either on a specified schedule or from time to time;
 - The custodian verifies the SLOA, and provides a transfer of funds notice to the client promptly after each transfer
 - The client has the ability to terminate or change the instruction to the custodian
 - The adviser does not have the ability to change the client's instructions
 - The adviser maintains records showing that the third party is not a related party of the investment adviser
 - The custodian sends the client a written initial notice confirming the instruction and an annual notice reconfirming the instruction



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Background and Key Requirements

- Authority to Withdraw Funds or Securities from a Client's Account
 - Inadvertent Custody
 - Custodial Agreement Terms
 - Agreement between Adviser's client and custodian may cause custody
 - Password Access
 - Custody, if not restricted
 - Deduction of Fees
 - Custody, but relief from Surprise Examination requirement, if that is the only reason for custody



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Background and Key Requirements

- Legal Ownership of, or Access to, Client Funds or Securities
 - Acting as General Partner
 - Generally Custody
 - Acting as Trustee or Executor
 - Generally Custody (including employees / supervised persons), with certain exceptions:
 - Family or personal relationship
 - Co-Trustees
 - Revocable Trusts under certain circumstances



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Private Funds / Privately Offered Securities



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SEPTEMBER 27, 2022

CUSTODY – RISK MANAGEMENT

Prioritize custody compliance within the Firm’s inventory of risk management

- Activities that trigger or are associated with Custody Rule are “risk on” in the areas of safeguarding client assets and information and regulatory compliance.
- Tight controls, in the form of well-defined functional processes, specific and targeted training, front line accountability, and compliance oversight are called for.

Practice Tip

Identify and record custody scenarios on the daily

Build out robust and complete policies and processes with your team.

Avoid the heavy lift and potential inaccuracies of a process that only identifies custody scenarios during audit, exam time, or regulatory filings.

THE FOUNDATION

Understand and continuously review the Firm's service offering to identify custody scenarios and controls

- Do you accept checks in for deposit to client accounts?
What processes are in place to identify receipt of third-party checks?
- Do you perform bill pay activities?
What processes are in place to authorize the activity and ensure account control logs are in place and maintained?
- Do you permit the taking of credentials?
What processes are in place to authorize the activity, and document access in account control logs?
- Do you permit Standing Letters of Authorization to be applied to client accounts for money movement?
What processes are in place to identify first, and third-party SLOAs and confirm whether scenarios are exempt from examination?
- Do you permit employees to act as trustees?
What processes are in place to authorize the activity, document access in control logs including custody over private equity and status of assets being held at qualified custodian?
- Do you sponsor private Funds?
What processes are in place to ensure timely distribution of audited financial statements?

CUSTODY POLICIES

Create policies and procedures within the Compliance Manual, that

- Provide a complete description of the Firm's custody policy – include regulatory background (description of the rule, exemptions and risk alert and other of moment regulatory guidance).
- Within the manual name the individuals who have responsibility for the implementation and monitoring of the policies, practices, disclosures, recordkeeping and other requirements relating to maintaining custody of client funds securities, or assets.

Describe the required procedures

- i.e. Operations and Accounting Personnel Supervisors will
- Undertake quarterly reviews to confirm they have authorization to withdraw client funds and securities and that they maintain a custody list that includes account numbers, custody trigger, custody trigger date
- Are responsible for daily recordkeeping of check receipt, payor, payee, check#, date of disposition (including client funds or securities received inadvertently from third parties)
- Supervise and maintain control systems demonstrating separation of duties, and confirming that transfers are authorized properly, reason for transfer, and that transfers went to intended recipient.

TRAINING AND DEVELOPMENT

Train front line team members on their role and accountability to maintaining required controls

- Training should provide specific guidance on each custody scenario and the corresponding Compliance policies and procedural controls required by departmental supervisors and personnel.
 - Proper training creates Compliance partners who are versed and able to issue spot or raise new scenarios that may have not been contemplated by existing policies.
 - Minimally Custody training should be delivered firm wide during the annual training.

Practice Tip

Create frequent opportunities for training and development.

Develop a regular meeting cadence with team members who service clients, manage sponsored funds, or are involved in the initiation or approval of money movement.

Solicit updates from them on how they are managing their accountability to Custody Rule Compliance.

i.e. recording custody scenarios, obtaining proper approvals for accepting custody, supervision of their department's activities

CONTROL PROCESSES

Provide guidance on best practices to the functional departments that perform activities associated with the Custody Rule.

Laser focus should be on processes that support regulatory exam readiness

- What systems can be used to track, record, and report custody scenarios to Compliance in real time?
- What codified/formalized workflows can be put in place to achieve;
 - Segregation of duties including cash controls, and documentation of authorization to accept custody scenarios
 - Supervisory reviews including Reconciliations and Exception Reviews/Reporting

CONTROL PROCESSES

Practice Tip

Guide functional teams to tag or code accounts and scenarios for custody in existing business platforms as they arise

Identify all data points that you need to prepare for exam, audit, and filing production.

- **Type of access**
 - **Standing Letter of Authorization**
 - **Trustee or Other Agency Role on Client Account**
 - **Asset movement**
 - **Client credential**
 - **Third party check**
 - **Sponsored Private Fund**
- **Date access acquired**
- **Date removed**
- **Account number**
- **Account name**
- **Authorized signers**
- **Account values**

Ideally leverage performance, billing, or CRM platforms that have account values native to their data i.e. Addepar, Salesforce, Custodial Platforms, etc.

Create custom attributes or fields or repurpose existing attributes or fields.

Also a tracker can be created in Excel.



PROCEDURAL BEST PRACTICES

The primary objective of each procedure is to, *on the daily*, identify and record custody scenarios and supervise departmental activities

- **Mail Processing**

- a. Ensure persons designated to handle mail are Compliance trained
- b. A good mail processing procedure revolves around segregation of duties relating to secure handling of incoming checks.
- c. Proper analysis of mail for third party checks, security certificates, and unauthorized use of the Firm's address is critical.
- d. Checks and exceptions are logged and tracked to ensure proper handling in accordance with firm policies.

- **Account onboarding**

- a. Processes should identify, prior to onboarding, the type of access required to perform services. If the type of access required entitles a covered person to move funds or securities, then the accounts should be included in an account control log.
 - i. i.e. date access granted, date access removed, account numbers, custodial names, type of access etc. must be recorded on an account control log.

- **Trustee or other agency role assignments on client accounts**

- a. A workflow approving an employee to act as trustee etc, and recording the type of role, and account access is required.
- b. Additionally, if the employee acts as a trustee on accounts that include private investments, a review of whether the investments distribute audited financial statements is required. If they do not remember to facilitate safekeeping
- c. Record scenario in appropriate system to extract client, account, and account value data for filing

PROCEDURAL BEST PRACTICES

The primary objective of each procedure is to, *on the daily*, identify and record custody scenarios and supervise departmental activities

- **Distribution of Audited Financials for Sponsored Funds**

- Ensure financial statements are completed within required time frames
- Verify investor lists
- Review e-mail records to confirm delivery

- **SLOAs**

- Identify first or third-party scenario
- Record scenario in appropriate system to extract client, account, and account value data for filing

- **Compliance Oversight and Testing**

- Require departments to provide quarterly reporting of custody account control logs
- Require departments to provide evidence of platform reconciliations (i.e. bank platform to account control log)
- Conduct independent reviews and testing of department procedures
 - Have all accounts and scenarios been updated in appropriate systems on a timely basis
 - Are proper authorizations in place from the client
 - Are departments documenting supervision of processes and activities

Summary

This Webinar provided the following:

1. Background and Key Requirements of the Custody Rule
2. The Custody Rule as it applies to Private Funds and Privately Offered Securities
3. Best Practices for Complying with the Custody Rule
4. A Panel Discussion on the Custody Rule



Resources

- Custody Rule (adopting release containing the latest amendments)
 - <https://www.sec.gov/rules/final/2009/ia-2968.pdf>
- Staff Responses to Questions About the Custody Rule
 - [SEC.gov | Staff Responses to Questions About the Custody Rule](#)
- Various Risk Alerts
 - <https://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf>
 - <https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf>
- The Top 3 Custody Rule Pitfalls We've [the Kreischer Miller IIG] Observed
 - [The Top 3 Custody Rule Pitfalls We've Observed \(kmiig.com\)](#)



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The logo for Kreischer Miller, featuring the name in a serif font. The 'K' is large and stylized, with the 'M' and 'Miller' stacked to its right.

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