GAO Highlights

Highlights of GAO-13-569, a report to congressional committees

July 2013

INVESTMENT ADVISERS

Requirements and Costs Associated with the Custody Rule

Why GAO Did This Study

Investment advisers provide a wide range of services and collectively manage around $54 trillion in assets for around 24 million clients. Unlike banks and broker-dealers, investment advisers typically do not maintain physical custody of client assets. However, under federal securities regulations, advisers may be deemed to have custody because of their authority to access client assets, for example, by deducting advisory fees from a client account. High-profile fraud cases in recent years highlighted the risks faced by investors when an adviser has custody of their assets. In response, SEC amended its custody rule in 2009 to require a broader range of advisers to undergo annual surprise examinations by independent accountants. At the same time, SEC provided relief from this requirement to certain advisers, including those deemed to have custody solely because of their use of related but “operationally independent” custodians. The Dodd-Frank Wall Street Reform and Consumer Protection Act mandates GAO to study the costs associated with the custody rule. This report describes (1) the requirements of and costs associated with the custody rule and (2) SEC’s rationale for not requiring advisers using related but operationally independent custodians to undergo surprise examinations.

To address the objectives, GAO reviewed federal securities laws and related rules, analyzed data on advisers, and met with SEC, advisers, accounting firms, and industry and other associations.

View GAO-13-569. For more information, contact A. Nicole Clowers at (202) 512-8678 or clowersa@gao.gov.

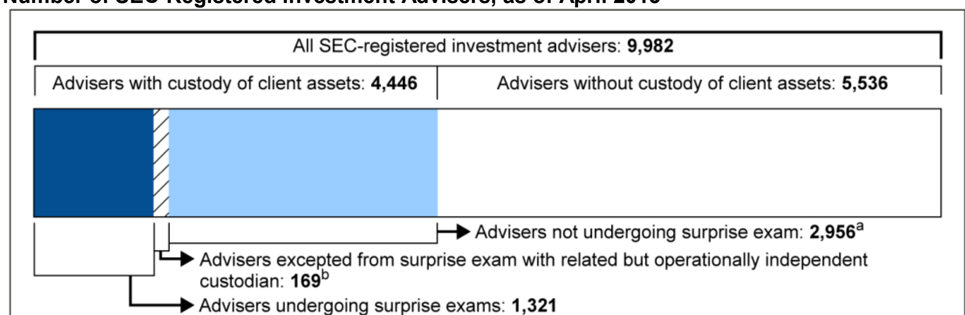
What GAO Found

Designed to safeguard client assets, the Securities and Exchange Commission’s (SEC) rule governing advisers’ custody of client assets (custody rule) imposes various requirements and, in turn, costs on investment advisers. To protect investors, the rule requires advisers that have custody to (1) use qualified custodians (e.g., banks or broker-dealers) to hold client assets and (2) have a reasonable basis for believing that the custodian sends account statements directly to clients.

The rule also requires advisers with custody, unless they qualify for an exception, to hire an independent public accountant to conduct annually a surprise examination to verify custody of client assets. According to accountants that GAO interviewed, examination cost depends on an adviser’s number of clients under custody and other factors. These factors vary widely across advisers that currently report undergoing surprise examinations: for example, their reported number of clients under custody ranged from 1 client to over 1 million clients as of April 2013. Thus, the cost of the examinations varies widely across the advisers. The rule also requires advisers maintaining client assets or using a qualified custodian that is a related person to obtain an internal control report to assess the suitability and effectiveness of controls in place. The cost of these reports varies across custodians based on their size and services.

SEC provided an exception from the surprise examination requirement to, among others, advisers deemed to have custody solely because of their use of related but “operationally independent” custodians. According to SEC, an adviser and custodian under common ownership but having operationally independent management pose relatively lower client custodial risks, because the misuse of client assets would tend to require collusion between the firms’ employees. To be considered operationally independent, an adviser and its related custodian must not be under common supervision, not share premises, and meet other conditions. About 2 percent of the SEC-registered advisers qualify for this exception for at least some of their clients. If the exception were eliminated, the cost of the surprise examination would vary across the advisers because the factors that affect examination cost vary widely across the advisers.

Number of SEC-Registered Investment Advisers, as of April 2013



Source: GAO analysis of Form ADV data as of April 1, 2013.

[a]These advisers may undergo an annual financial statement audit in lieu of a surprise examination.

[b]Of the 169 SEC-registered investment advisers excepted from the surprise examination requirement, 41 of them qualified for an exception from the surprise examination requirement for some of their clients under custody but underwent a surprise examination for other clients under custody.