2009 CCOutreach Regional Seminars

Safeguarding Clients' Assets Under Management Through Asset Verification and Reconciliation*

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This document, prepared by the staff of the Office of Compliance Inspections and Examinations, is intended to suggest steps investment advisers, their Chief Compliance Officers ("CCOs"), or those acting at their direction (such as an independent accountant or a qualified compliance consultant) could take to review and assure safeguards for clients' assets under management in order to detect theft or misappropriation.

The ultimate goal of these steps is to attain a high level of confidence that the transactions and portfolio positions reported to clients by the adviser fully and fairly reflect investments and transactions made by the adviser as shown in an adviser's books and records and on custodial records.

As advisers are aware, with certain exceptions, advisory clients' assets must be held by a qualified custodian and such custodians must provide each advisory client, at least quarterly, with a statement of transactions and position balances in their custody accounts (under the Custody Rule - Rule 206(4)-2 under the Investment Advisers Act of 1940 ("Advisers Act")). Typically, custodians also provide a copy of such statements to the clients' adviser. It is also a common practice for advisers to provide their clients with periodic statements of their accounts that list transactions and end-of-period positions, along with other information. Adviser CCOs can use these documents to conduct periodic reconciliations and asset verification.

Following is a list of steps that could be performed:

1) Obtain custodian statements directly from custodian.

2) Compare custodian statements with advisory records.

3) Take additional steps to confirm assets when custody is with the adviser or an affiliate.

4) Review client account statements from the adviser.

Each of these steps is discussed in more detail below. Advisers should note that the specific procedures discussed are not required by the federal securities laws. Rather, the procedures discussed below describe a "best practices" approach to verification and reconciliation of client assets.

Performing Custody Verification and Reconciling Custodian Statements to Advisory Records to Customer Account Statements

Step One: **Obtain custodial statements from custodian.**

The first step in conducting a reconciliation and verifying client assets is to obtain copies of the statements created by the client custodians. A CCO could request that the custodian for each advisory client (or a sample of advisory clients) provide an exact copy of the most recent statement the custodian sent to each client. These statements should be sent directly to the CCO and could be transmitted electronically or on paper. As a matter of good controls, the CCO should consider obtaining such copies on a regular basis (e.g., annually).

Step Two: **Compare custodian statements with advisory records.**

Custodian records could be compared with the adviser's records with the following goals:

- *Ensure that custodian statements are being sent to clients.* CCOs could compare the names and addresses of clients as shown on these custodian statements to the names and addresses of clients as maintained by advisers. CCOs could also review clients' addresses shown on custodian statements for anomalies, such as the frequent use of post office boxes, the use of the same post office box number or street address by different clients, or the use of addresses in geographical areas not served by the adviser.

- *Ensure that the transactions and portfolio positions held by the custodian are consistent with transactions and portfolio positions in the adviser's books and records.* CCOs could compare the transactions and position balances in clients' accounts as shown on custodian statements with records of clients' transactions and positions maintained by the adviser, for all or a sample of advisory clients.

- *Review the adviser's reconciliation process to verify the consistency of internal records with custodial records.* CCOs could also review any routine reconciliation process used by the adviser and the documentation of that reconciliation (for the same period covered by the custodian statements that the CCO obtained from custodians). Custodian statements being used for reconciliations could contain the same information as the statements received directly from custodians by the CCO. Reconciliations can also be used to identify stale items, the use of "plugged" amounts to make balances reconcile, and other patterns or anomalies that may suggest the adviser's reconciliation process is being manipulated in one or more ways to cover-up inappropriate actions.

***Step Three:* Take additional steps to confirm assets when custody is with the adviser or an affiliate.**

If one or more advisory clients' assets are in custody with the adviser or an entity affiliated with the adviser, additional steps could be taken to assure that statements sent by the affiliated custodian are accurate. In these circumstances, there is no independent third party that holds customer assets and reports transactions and balances to clients. Therefore, there is increased risk that client assets may be misappropriated and/or falsified transactions or account balances may be reported to clients. As a result, when client assets are maintained by the adviser or with a custodian affiliated with the adviser, a CCO should consider doing more than requesting copies of clients' statements sent by the affiliated custodian, such as:

- *Obtain confirmations of trades or holdings higher in the custody chain.* Consider seeking confirmations from entities one or more steps higher in the custody chain that are independent of the adviser. These entities are likely to be prime brokers, depositories or counterparties of OTC derivative positions.

- *Reconcile transactions or holdings to the positions held by advisory clients with the appropriate records of an unaffiliated entity*. This process may be time consuming, as the affiliate of the adviser may maintain an omnibus account in its name at a depository and such omnibus accounts may contain transactions and positions for the firm's proprietary positions, its non-advisory client customers as well as its advisory clients.

In light of the risks associated with an affiliated custodial relationship, CCOs may want to consider undertaking this process at least on a sample basis.

***Step Four:* Review client account statements from the advisory firm.**

Advisers often create and provide periodic account statements to their clients. When client assets are maintained by an affiliate, a client may receive a single account statement. In situations where client assets are maintained by an unaffiliated custodian, clients may receive two statements covering the same period, one from the custodian and another from the adviser. In the first situation, a risk exists that the adviser could provide false information to clients about transactions or holdings. In the latter situation, a risk exists that an adviser could provide information to clients that is contrary to the custodial account statements, encourage clients to give up the ability to receive statements from the custodian, or otherwise convince clients to focus their attention only on the statements sent by the adviser. As a result, a CCO should consider periodically reviewing account statements sent to clients by the adviser to ensure that the transactions and positions reported are consistent with clients' holdings as reported by the custodian. Such steps could include:

- *Verify names and addresses on client account statements against custodian confirmations.* Similar to the review conducted against custodial statements, the

CCO could consider verifying customer account statements against the confirmations received directly from custodians, as set forth above. CCOs could pull a sample of the advisory account statements ready to be sent to clients (envelopes and statements if in paper form, electronic versions of statements and email addresses if in digital form); review the names and mailing address of clients and compare these items to information to similar information in the adviser's records as well as the addresses used for these clients on the statements sent by their custodians.

- *Ensure that the information reported to clients is consistent with information in the adviser's books and records and in custodian confirmations.* CCOs could compare the transactions, cash and portfolio positions shown in client account statements to the reconciliations prepared for these clients between the adviser's records and information reported by the clients' custodians. All transactions and positions reported by the adviser in these statements should be consistent with those reported for the same period by the custodian with due regard for reconciling items. A CCO could also review any performance information reported and determine whether the performance data appears to be consistent with the adviser's overall investment performance for that period.

- *Ask clients to contact the CCO if they notice any issue or problem.* CCOs could also consider, as a separate control mechanism, informing advisory clients that they should contact the CCO if they have any question about their account statement. For example, CCOs could include in the mailing of the client account statement a separate statement indicating that the CCO has reviewed the information in the statement and has reconciled the reported items to the adviser's records and custodian statements. The CCO's communication could also ask the client to closely review the account statement and to contact the CCO directly if any discrepancies are noted. As an added control, to ensure that the communication reaches clients, the CCO could email or mail this type of communication directly to each client.

If any irregularities are found in conducting these reviews, particularly that might indicate that clients' assets may have been misappropriated or otherwise used in ways that are inconsistent with clients' expectations, advisory personnel should discuss such matters with outside counsel to the adviser and consider bringing such matters to the attention of the local SEC inspection staff. Contact information is available on our website at www.sec.gov.

As noted above, these procedures are considered best practices, but are not required by federal securities laws. The staff believes that these additional procedures, if carried out competently and independently, could significantly enhance the security of clients' assets and the confidence that advisory clients have in the advisory firm.