
GAO: Most SEC-registered Advisers Not Subject to Surprise Exams.

Most of the investment advisers registered with the Securities and Exchange Commission who maintain custody of their clients' investment funds are not subject to surprise annual examinations, according to a new federal report.

A study released on Monday by the Government Accountability Office. found that 4,446 of the 9,982 SEC-registered advisers had control over client money as of April 1, amounting to more than $14 trillion in client assets.

Of those who had custody, 1,321 are subject to annual surprise examinations by independent public accountants. A total of 2,956 advisers with custody do not have to undergo surprise exams.

Advisers can be exempted from surprise inspections if they have custody of client assets only to deduct fees from client accounts or are "operationally independent" of the custodian.

There are 169 advisers who have possession of client funds but don't have to undergo annual surprise audits because they are "operationally independent" from their custodian, even though the adviser and custodian are owned by the same entity. In these cases, the adviser and the custodian cannot have common supervision or share the same premises.

The GAO conducted a performance audit of 12 investment advisers from September through July to determine the costs of the inspections. It found that the firms paid anywhere from $3,500 to $31,000 for the surprise examinations.

The charge for the audits is based on a number of factors, including the number of clients and the amount of assets in custody. The advisers reviewed had between one and more than 1 million clients under custody.

Internal control reporting requirements cost between $25,000 and $500,000, according to accounting firms the GAO interviewed.

The GAO custody study was mandated by the Dodd-Frank financial reform law.

Most investment advisers house their clients' assets with a third-party custodian such as Charles Schwab & Co. Inc. or TD Ameritrade Inc.

In 2009, the SEC amended the custody rule to expand surprise inspections in response to the Ponzi scheme perpetrated by Bernard Madoff that bilked investors of more than $50 billion. The scheme revolved in part around the fact that Mr. Madoff's firm had custody of his clients' money.

In a March investor alert, the SEC said that roughly one-third of advisory firms examined last year — about 140 — were flagged for problems with how they held or had access to their clients' assets.

The SEC exams found that many advisers didn't know that they had inadvertently become custodians. The designation can be triggered by actions such as serving as a trustee for a client, signing checks on clients' behalf or withdrawing funds from client accounts to pay bills.

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