

SECURITIES LAW ALERT

MARCH 2010

SEC Adopts Amendments To The Advisers Act Custody Rule

The Securities Exchange Commission (“SEC”) has adopted amendments to Rule 206(4)-2 (the “Custody Rule”) under the Investment Advisers Act of 1940 (the “Advisers Act”).¹

In response to several highly publicized scandals and notable enforcement actions in the investment industry, the SEC proposed amendments to the Custody Rule and related forms originally in May 2009 and adopted such amendments, revised per industry comments, on December 30, 2009. The Custody Rule amendments (the “Amendments”) are designed to provide additional safeguards under the Advisers Act when a registered investment adviser has custody of client funds or securities and to provide the SEC with better information about the custodial practices of investment advisers. The Amendments do not apply to registered investment company accounts managed by an investment adviser.

Expanded Definition of Custody under Amendments

The Amendments expand the definition of “custody” and will impact not only an adviser with actual custody over client assets, but those advisers whose related persons have custody of client assets, *i.e.*, constructive custody. The Amendments will impact those advisers who are dually-registered as broker-dealers. Advisers who act as trustees or executors or have general authority to withdraw client assets

from clients’ accounts will be subject to the new requirements under the Amendments. Advisers to pooled investment vehicles and privately offered securities will also be impacted. Advisers who automatically deduct advisory fees from client accounts will need to comply with certain aspects of the Amendments.

Under the Amendments, a “related person” is defined as a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser.² The Adopting Release notes that for advisers who are part of multi-service financial organizations, such related person custodians may include broker-dealers and banks. Prior to these Amendments, there was no presumption that an adviser’s affiliate’s custody was imputed to the adviser. Rather, the adviser was deemed to have custody only if the affiliate held funds or securities of the adviser’s clients under conditions where the adviser had access to these client assets or securities through the affiliate. An adviser whose related person acts as a qualified custodian for client assets is presumed to have custody and must report custody on its Form ADV and must submit to an annual surprise exam, unless the adviser claims operational independence from its affiliate and does not otherwise have custody over client assets.³ The adviser must receive a copy of the related person’s annual internal report.

² See Amended Custody Rule 206(4)-2(d)(2) and (7).

³ See Amended Rule 206(4)-2(d)(5) (defining “operationally independent”). Note: The adviser is required to maintain a memorandum describing its relationship with the related person and the adviser’s basis for its “operationally independent” determination.

¹ See *Custody of Funds or Securities of Clients by Investment Advisers*, SEC Release No. IA-2968 (December 30, 2009) (“Adopting Release”), available at: <http://www.sec.gov/rules/final/2009/ia-2968.pdf>.

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New Requirements

The Amendments require, among other things, that advisers who have custody of client funds or securities:

- undergo an annual surprise examination by an independent public accountant to verify client assets;
- have the qualified custodian maintaining client funds and securities send account statements directly to the advisory clients and form a “reasonable belief” based upon “due inquiry” that the custodian has actually done so; and
- unless client assets are maintained by an independent custodian (*i.e.*, a custodian that is not the adviser itself or a related person), obtain or receive from the related person a report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board (“PCAOB”).

The Amendments also include certain technical revisions to the Form ADV that require advisers to report current information about custodial relationships.

The SEC published a companion Release to provide guidance to accountants with respect to the annual surprise examination and internal control report required under the Amendments.⁴

⁴ See *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*, Release No. IA-

Compliance Policies and Procedures

The Adopting Release provides guidance to advisers regarding the types of policies and procedures they should adopt to satisfy their obligations under Rule 206(4)-7 with respect to the Custody Rule.

Effective Date

The effective date of the Amendments is March 12, 2010. An investment adviser required to obtain a surprise examination must enter into a written agreement with an independent public accountant that provides that the first such examination will take place by December 31, 2010. An investment adviser also required to obtain or receive an internal control report because it or a related person maintains client assets as a qualified custodian must obtain or receive an internal control report within six (6) months of the effective date.

Additional Information

For a more comprehensive explanation of how the Custody Rule Amendments impact your business, please contact Brian Amery or Frances Grabish.

- Frances C. Grabish, Esq.

2969 (December 30, 2009), available at: <http://www.sec.gov/rules/interp/2009/ia-2969.pdf>.

For more information about any of the topics covered in this issue of the Securities Law Alert, please contact:

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