BRESSLER, AMERY & ROSS

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SECURITIES LAW ALERT

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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.

Current Requirements

Under Rule 206(4)-2, advisers generally must: (1) maintain client funds and securities with a qualified custodian, such as a bank or registered broker-dealer; (2) provide clients with notice of the name and address of such qualified custodian; and (3) have a reasonable belief that clients receive account statements at least quarterly. Under a current exemption, the client account statements may be sent by the qualified custodian or the adviser. If the adviser sends the account statements, then the adviser is required to engage an independent public accountant at least annually to verify the client assets in a surprise examination. Advisers with custody of pooled investment vehicles (*i.e.*, a hedge fund or other private investment fund) may satisfy the account statement delivery requirements by obtaining an annual audit of the investment pool and mailing it to investors within 120 days of the investment pool's fiscal year-end.

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

1 *See Custody of Funds or Securites 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.

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.

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.[3] 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.[4] The adviser must receive a copy of the related person's annual internal report.

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 as discussed below.

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

3 (*See Crocker Investment Management Corp.*, SEC Staff Letter (Apr. 14, 1978). The Adopting Release (pp. 32-33) specifically states that "in light of our amended definition of custody, our staff is withdrawing several no-action letters to the extent such letters are inconsistent with this definition, including *Crocker* and *Pictet et Cie*, SEC Staff Letter (June 22, 1980). Advisers, including those firms that have relied on these letters in the past, must comply with the amended rule." *See* Amended Rule 206(4)-2.

4 *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.

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.[5]

Annual Surprise Examination

One of the most commented upon provisions of the Amendments is the requirement that advisers with custody over client assets be subject to an annual surprise examination by an independent public accountant (or audit, if applicable, in the case of a pooled investment vehicle). Commenters noted that they were not opposed to the surprise examination requirement, but that it may be burdensome and costly for small advisers.[6] In response to these comment letters, the SEC has noted that it will evaluate the impact of the surprise examination requirement on smaller advisers and these advisers' clients, and following completion of the first round of examinations, review the findings and, if appropriate, revise the Custody Rule amendments.[7]

5 *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-2969 (December 30, 2009) ("Accounting Release"), available at: http://www.sec.gov/rules/interp/2009/ia-2969.pdf.

6 *See Comments on Proposed Rule: Custody of Funds or Securities of Clients by Investment Advisers*, available at: http://www.sec.gov/comments/s7-09-09/s70909.shtml.

7 Adopting Release at pp. 13-14.

Privately Offered Securities

The Amendments provide that privately offered securities owned by clients and held in the custody of an investment adviser will be subject to the same annual surprise examination requirements as publicly-traded securities. The Accounting Release provides guidance regarding procedures that an accountant should undertake with respect to the surprise examination of privately offered securities.

Agreement with Independent Public Accountant

Advisers subject to the Amendments are required to enter into a written agreement with an independent public accountant to conduct the surprise examination. If the qualified custodian for the client account is the adviser or a related person, an independent accountant who is registered with, and subject to regular inspection by, the PCAOB must conduct the surprise exam and enter into a written agreement with the adviser. The written agreement must require the accountant, among other things, to:

- notify the SEC within one (1) business day of finding any material discrepancy during the examination;
- submit a Form ADV-E to the SEC, accompanied by the accountant's certificate reporting on the nature and extent of the exam, within 120 days of the exam; and

Advisers subject to the Amendments are required to enter into a written agreement with an independent public accountant to conduct the surprise examination.

- file a statement regarding termination with its Form ADV-E within four (4) business days of its resignation or dismissal.

Exemptions to Surprise Exam Requirement

Certain exemptions to the surprise exam requirement under the Amendments are available for advisers:

- who are deemed to have custody solely because of their ability to deduct fees from client accounts;
- who advise pooled investment vehicles that are subject to an annual financial audit by an independent public accountant, and that distribute the audited financial statements prepared in accordance with generally accepted accounting principles ("GAAP") to the pool's investors within 120 days of the pool's fiscal year-end (the "annual audit provision"); and
- who have custody of client assets solely because a related person has custody of advisory clients' funds or securities, provided that the adviser and the related person are "operationally independent."[8]

No exemptions are provided for advisers who have custody through trustee or executor relationships.

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Delivery of Account Statements

The Amendments require that advisory clients must now receive account statements directly from the qualified custodian.

Currently, under an exemption to the Custody Rule, an adviser that underwent an annual surprise examination by an independent public accountant, rather than qualified custodian, was permitted to deliver account statements. The Amendments eliminate this exemption as of March 12, 2010. If an adviser chooses to continue to provide a client with a periodic account statement in addition to the custodian's account statement, such adviser must now include a legend in its custody notices that the client should compare the account statements they receive from the adviser with the account statements from the custodian.

"Due Inquiry" of Statement Delivery

Under the Amendments, an adviser must make "due inquiry" to form a "reasonable belief" that a custodian actually delivers client account statements to the adviser's clients at least quarterly. The adviser's receipt of duplicate statements from the qualified custodian(s) (a common industry practice) is noted as one method of "due inquiry," although advisers are not limited to this practice. The SEC noted that the accessing of advisory client statements via a website does not satisfy this "due inquiry" requirement in that the posting of statements on a website only confirms that the statements are available, not that they have been delivered.

8 *See* Amended Rule 206(4)-2(d)(5).

Internal Control Report; Custody by a Related Person

Repeatedly throughout the Adopting Release, the SEC "encourages" the use of independent custodians but does not require such. The Amendments provide additional requirements when an adviser or related person serves as qualified custodian for client funds or securities. As discussed above, the adviser must undergo an annual surprise examination and obtain, or receive annually from its related person, an internal control report, such as a Type II SAS 70 report, with respect to custody controls. The internal control report, like the surprise examination, must be prepared by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB, and must include an opinion from such regarding the adviser's or the related person's controls to maintain custody of and safeguard client assets.

The Accounting Release provides guidance for accountants on how to verify that the client funds and securities are reconciled to a custodian other than the adviser or its related person.

Additional Requirements for Advisers to Pooled Investment Vehicles

As discussed above, an adviser to a pooled investment vehicle that avails itself of the annual audit provision is deemed to have satisfied the annual surprise examination requirement. However, in the Adopting Release, the SEC noted that because an adviser to a pooled investment employing the annual audit provision is not required to have a "reasonable belief" that a qualified custodian delivers account statements to investors, the investors in such pooled investment vehicles, in turn, do not have the benefit of regularly receiving reports that the assets underlying their investments are properly held. The SEC stated that it is "concerned that the current protections of the rule may be insufficient," and has directed its staff to "explore ways [to] remedy this potential shortcoming while respecting the confidential nature of proprietary information."[9]

The Amendments impose the following additional requirements on advisers to pooled investment vehicles.

Internal Control Report

Where assets are maintained with a qualified custodian that is the adviser or a related person of the adviser to the pool, the adviser must conduct or obtain an internal control report.

Liquidation Audit

If an adviser relies on the annual audit provision, in addition to obtaining an annual audit, such adviser must obtain a final audit of the pool's financial statements upon liquidation of the pool when the liquidation occurs prior to the pool's year end, and distribute the financial statements to pool investors promptly after completion of the audit.

9 Adopting Release, pp. 17-18.

...an adviser to a pooled investment vehicle that avails itself of the annual audit provision is deemed to have satisfied the annual surprise examination requirement.

Responses to the revised Form ADV will be required in the first annual amendment after January 1, 2011.

Special Purpose Vehicles

In situations where all the investors in a pooled investment vehicle to which account statements are sent are pooled investment vehicles that are related persons of the adviser (*i.e.*, "Special Purpose Vehicles" or "SPVs"), the SEC has proscribed that the investment adviser could either treat the SPV as a separate client, in which case the adviser will have custody of the SPV's assets, or treat the SPV's assets as assets of the pooled investment vehicles of which it has custody indirectly. If the adviser treats the SPV as a separate client, the adviser must distribute the audited financial statements or account statements of the SPV to the beneficial owners of the pooled investment vehicles. If the adviser treats the SPV's assets as assets of the pooled investment vehicles of which it has custody indirectly, such assets must be considered within the scope of the pooled investment vehicle's financial statement audit or surprise examination.[10]

Form ADV Amendments

The Amendments to Form ADV mirror the Amendments to the Custody Rule. The Amendments amend Form ADV as follows:

- Item 7. Advisers must report all related persons who are broker-dealers and identify which, if any, serve as qualified custodians with respect to the adviser's clients' funds or securities;
- Item 9. Advisers must report: (1) the total number of clients and amount of client assets in the adviser's (or a related person's) custody; (2) if the adviser, or a related person, acts as an adviser to a pooled investment vehicle, whether the pool is audited and whether the qualified custodians send account statements to investors; (3) whether an independent public accountant conducts an annual surprise examination; (4) whether an independent public accountant prepares an internal control report for the adviser or a related person; and (5) whether the adviser or a related person serves as qualified custodian for the adviser's clients;
- Schedule D. Advisers must: (1) identify and provide certain information about the accountants that perform audits and surprise examinations and that prepare internal control reports; and (2) identify related persons that serve as qualified custodians for client funds or securities not otherwise disclosed in Item 7; and
- Section 7.A. of Schedule D. An adviser must report whether it has overcome the presumption that it is not "operationally independent" from a related person broker-dealer qualified custodian, and, therefore, is not required to obtain a surprise examination for the clients' assets maintained at that custodian.

Responses to the revised Form ADV will be required in the first annual amendment after January 1, 2011. The IARD system for the upcoming March 2010 Form ADV annual updates will not reflect these Amendments.

10 *Id.* at pp. 41-42.

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. Such recommendations include, among other things, conducting background and credit checks on the adviser's employees who will have access (or could acquire access) to client assets, requiring the authorization of more than one employee to move funds from client accounts and to change account ownership information, limiting the number of employees interacting with client custodians and rotating them periodically, and, if the adviser also serves as qualified custodian, segregating the duties of advisory and custodial personnel to make it difficult for any one person to misuse client assets without being detected.

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

To discuss how the Custody Rule Amendments impact your business, please contact Brian Amery or Frances Grabish.

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

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