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a note from Tannenbaum Helpers Syracuse & Hirschtritt

Proposed Amendments to Current Custody Rules under the Investment Advisers Act of 1940¹

Summary

The Securities and Exchange Commission (the “SEC”) is proposing amendments to the existing custody rules under Rule 206(4)-2 of the Investment Advisers Act of 1940 (the “Advisers Act”).² The proposed amendments would require *registered investment advisers* that have custody of client assets (funds and securities) to maintain such assets with broker-dealers, banks, or other “qualified custodians.” The amendments also would clarify circumstances under which an adviser has custody of client assets. The amendments seek to conform the rule to modern custodial practices and enhance client protections while reducing burdens on advisers that have custody of client assets. As a consequence, the proposed amendments would reduce the costs associated with audits that independent public accountants conduct in connection with annual surprise audits and preparing balance sheets for the Form ADV and would eliminate the necessity of adopting procedures described in a series of no-action letters such as PIMS³ as a means to avoid the application of the custody rules.

Discussion

I. Custody.

The proposed definition of “custody” would provide that an adviser has custody of client assets when it holds “directly or indirectly, client funds or securities or [has] any authority to obtain possession of them.”⁴ The proposed definition of “custody” includes three examples:

- (i) Possession or control of client funds;
- (ii) Any arrangement (including a general power of attorney) under which the adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the adviser’s instruction to the custodian; and

¹ This memorandum provides general information on the subject matter described, and it should not be relied on for legal advice on any matter, which may turn on specific facts. You should seek specific legal advice before acting with regard to the subjects treated here.

² *Proposed Rule: Custody of Funds or Securities of Clients by Investment Advisers*, Release No. IA-2044 (July 18, 2002) (“Release No. IA-2044”).

³ *PIMS, Inc.*, SEC Staff Letter (Oct. 21, 1991).

⁴ Proposed Rule 206(4)-2(c)(1).

(iii) Any capacity that gives the adviser legal ownership of or access to client funds or securities.⁵

This definition includes a firm that acts as both general partner and investment adviser to a limited partnership.⁶ By virtue of its position as general partner, the adviser generally has authority to dispose of funds and securities in the limited partnership's account and thus has custody of client assets. However, amounts payable to an adviser for payment of advisory fees or similar fees due to the adviser do not represent client funds and therefore advisers would not be considered to have custody as a result of the receipt of such amounts.⁷

II. Client Asset Maintenance.

Currently, Rule 206(4)-2 requires advisers to maintain client funds with a bank but does not require that client securities be held in a securities account or with another type of financial institution.⁸ The proposed amendment requires that advisers maintain *both client funds and securities* with a qualified custodian in an account either under the client's name or under the adviser's name as agent or trustee for its client.⁹ "Qualified custodians" include financial institutions that customarily provide custodial services and are regulated and examined by regulators with respect to those services, such as banks, savings associations, registered broker-dealers, and registered futures commission merchants.¹⁰ In the case of securities (and cash and cash equivalents necessary to effect such transactions) for which the primary market is in a country other than the United States, financial institutions that customarily provide custodial services and that hold the client assets in segregated customer accounts would fall within the definition of qualified custodian.¹¹

III. Delivery of Account Statements.

The current custodian rules require advisers to send to clients quarterly account statements itemizing the funds and securities in the adviser's custody and all transactions for that account.¹² Furthermore, an independent public accountant must conduct a "surprise audit" on an annual basis.¹³ As an alternative, under the proposed rule, the

⁵ Proposed Rule 206(4)-2(c)(1)(i)-(iii).

⁶ The proposed rule also applies equally to a registered investment adviser that acts as both managing member and investment adviser of a limited liability company or holds a comparable position for another type of pooled investment vehicle, or as both trustee and investment adviser of a trust. See Release No. IA-2044, note 25.

⁷ See Release No. IA-2044, note 19.

⁸ See Rule 206(4)-2(a)(1)-(2). Client funds are to be deposited in bank accounts which contain only clients' funds. Rule 206(4)-2(a)(2)(A). However, the only requirement for securities is that they are "held in safekeeping in some place reasonably free from risk of destruction or other loss." Rule 206(4)-2(a)(1).

⁹ Proposed Rule 206(4)-2(a)(1).

¹⁰ Proposed Rule 206(4)-2(c)(3)(i)-(iii).

¹¹ Proposed Rule 206(4)-2(c)(3)(iv).

¹² See Rule 206(4)-2(a)(4).

¹³ See Rule 206(4)-2(a)(5).

adviser would be exempt from the burden of distributing quarterly account statements and the concomitant annual surprise examination if the qualified custodian sends monthly account statements directly to each advisory client.¹⁴ Moreover, to qualify for the exemption, the adviser must have a reasonable belief that the qualified custodian is delivering the monthly account statement to the adviser's clients.¹⁵

In instances when a qualified custodian does not send account statements directly to an adviser's clients because the adviser does not provide the names of its clients to the custodian due to business competition or privacy concerns, such an adviser *would continue to be required to provide quarterly account statements to each client and to undergo an annual surprise examination.*¹⁶ Moreover, the proposed amendments would require the independent public auditor to give notice to the SEC of any material discrepancies found during the surprise annual examination.¹⁷

Finally, the proposed amendments would require account statements (whether delivered directly by the adviser or by the qualified custodian) to be sent directly to the limited partners of a limited partnership (or to their independent representative) if the adviser also acts as its general partner and has custody of client assets.¹⁸ The purpose is to avoid the adviser being the sole recipient of account statements in instances when the adviser also serves as the general partner of a limited partnership.

IV. Exemptions.

The SEC proposes to exempt from Rule 206(4)-2 advisers with respect to client assets held in pooled investment vehicles such as limited partnerships or limited liability companies if the pooled investment vehicles (i) has its transactions and assets audited at least annually and (ii) distributes audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners or members within 90 days of the end of the fiscal year.¹⁹

Also, note that the SEC proposes to exempt from Rule 206(4)-2 advisers with respect to clients that are registered investment companies since registered investment companies and their advisers already have to comply with Section 17(f) of the Investment Company Act of 1940, as amended.

¹⁴ Proposed Rule 206(4)-2(a)(3)(i).

¹⁵ Proposed Rule 206(4)-2(a)(3)(i). An adviser could form a reasonable belief under the proposed rule if, for example, the qualified custodian provides the adviser with a copy of the account statement that was delivered to the client. See Release No. IA-2044, note 41. As such, as long as the reasonable belief standard is satisfied, the adviser avoids violating the rule as a result of the qualified custodian's failure to deliver an account statement to a client. See Release No. IA-2044, note 41

¹⁶ Proposed Rule 206(4)-2(a)(3)(ii)(A)-(B).

¹⁷ Proposed Rule 206(4)-2(a)(3)(ii)(C).

¹⁸ Proposed Rule 206(4)-2(a)(3)(iii). This provision would also apply to advisers with respect to other pooled investment vehicles, including limited liability companies where the adviser also acts as the managing member of the limited liability company.

¹⁹ Proposed Rule 206(4)-2(b)(2).

V. Amendments to Part II of Form ADV.

The proposed amendment eliminates the requirement that advisers with custody include a balance sheet in their client brochures.²⁰ This is because a balance sheet may provide an imperfect picture of the financial picture of the advisory firm and because Rule 206(4)-4 now requires advisers to disclose to their clients any financial condition that is reasonably likely to impair the adviser's ability to meet its contractual commitments to its clients.

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Please note that the SEC amendments are a proposal. The SEC is soliciting ruling comments through September 25, 2002. As such, the proposed amendments are subject to change.

We hope this summary has been helpful to you in conforming with the SEC's proposed amendments to the custody rule, Rule 206(4)-2. Please do not hesitate to contact us with comments or questions.

Michael G. Tannenbaum
212 508 6701
tannenbaum@tanhelp.com

Ricardo W. Davidovich
212 508 6710
davidovich@tanhelp.com

Beth Freeman
212 508 6792
freeman@tanhelp.com

Roderick J. Cruz
212 702 3149
cruz@tanhelp.com

²⁰ See Release No. IA-2044, Section II. E.