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SEC Adopts Amendments to the Custody Rule under the Investment Advisers Act of 1940 in Attempt to Protect Client Assets From Fraudulent Conduct

TO: Clients and Friends¹
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I. Introduction

On December 30, 2009, the Securities and Exchange Commission (the “SEC”) published its final rule amending Rule 206(4)-2 (the “Custody Rule” or the “Rule”) under the Investment Advisers Act of 1940, as amended (the “Advisers Act”), Advisers Act Rule 204-2 (with regard to recordkeeping) and Forms ADV and ADV-E. The amendments are contained in a release entitled “Custody of Funds or Securities of Clients by Investment Advisers” (referred to herein as the “Release”) and will be effective March 12, 2010.² This follows the SEC’s earlier release in May 2009 proposing amendments to the Custody Rule and Forms ADV and ADV-E.³ The Release is intended to strengthen controls over the custody of client assets and comes amidst heightened enforcement activity by the SEC against investment advisers and broker-dealers for alleged fraudulent conduct, including misappropriation and other misuse of investor assets.

The four main features of the Custody Rule amendments are: 1) more detailed account statement delivery and related notice requirements; 2) expansion of the requirement for surprise examinations; 3) special requirements associated with physical custody of client assets; and 4) enhanced compliance and reporting obligations. As discussed below, these changes affect

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² Release No. IA-2968, available online at <http://sec.gov/rules/final/2009/ia-2968.pdf>. The SEC simultaneously issued a companion interpretive release, “Commission Guidance Regarding Independent Public Accounting Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940,” also effective March 12, 2010. Release Nos. IA-2969; FR-81 (December 30, 2009), available online at <http://www.sec.gov/rules/interp/2009/ia-2969.pdf>. The companion release provides additional guidance to accountants with respect to independent verification and internal control reports now required under the Custody Rule.

³ “Custody of Funds or Securities of Clients by Investment Advisers”; proposed rule. 74 Fed. Reg. 25354-25380 (May 27, 2009).

advisers to pooled investment vehicles such as hedge funds and other private funds in various ways.

The effective date of the amendments to Rule 206(4)-2 and Forms ADV and ADV-E is March 12, 2010. Compliance dates for various provisions of the amended Rule and the ADV forms are discussed below.

II. Background

The previous Custody Rule required investment advisers (i) registered or required to be registered with the SEC and (ii) that have custody⁴ of client funds or securities to (a) maintain client funds and securities with a “qualified custodian” (i.e., financial institutions such as banks, registered broker-dealers and futures commission merchants), (b) comply with notice requirements regarding how such assets are being maintained with the chosen custodian and (c) have a reasonable belief that the qualified custodian sends account statements directly to advisory clients. Alternatively, under the previous Rule, advisers themselves could send the account statements to clients (or investors, in the case of funds) on a quarterly basis but in such a case an independent public accountant was required to perform an annual surprise verification of such assets. There was an exception to the account statement delivery requirement for an adviser to a pooled investment vehicle if such investment vehicle were subject to an annual audit (which was not a surprise audit) and the audited annual financial statements were sent to the beneficial owners of the pool within 120 days (or in the case of funds-of-funds, 180 days) after the end of the pool’s fiscal year-end.

In addition, certain privately offered securities were exempt from being custodied with a qualified custodian and did not need to be verified by account statements (although in the case of pooled investment vehicles, this exemption was available only if the limited partnership was audited, and the audited financial statements were distributed as described above).

The recently adopted amendments to the Custody Rule changed this framework in a number of ways.

III. Scope of Amended Custody Rule

As amended, the Custody Rule continues to apply only to registered investment advisers.⁵ Investment advisers exempt from registration pursuant to Section 203(b)(3) of the Advisers Act are not impacted by these amendments. However, unregistered investment advisers should be conscious of the amendments to the Custody Rule because Congress is considering legislation that would eliminate Section 203(b)(3) and require most investment advisers, including advisers to hedge funds and other private investment funds, to register with the SEC.

⁴ In amended Rule 206(4)-2(d)(2), custody is defined as “holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them.” Custody includes possession of client funds or securities, any arrangement (including a power of attorney) under which an adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon instruction to the custodian and any capacity (such as general partner of a limited partnership or a comparable position for another type of pooled investment vehicle) that gives the adviser legal ownership of or access to client funds or securities.

⁵ Rule 206(4)-2(a).

Once registered with the SEC, an investment adviser will be required to comply with the amended Custody Rule.

In addition, under the amended Rule, custody of client assets now can be attributed to an investment adviser if its “related person” has physical custody of or the authority to obtain possession of client assets. This attribution concept is discussed in Part V.A.3 below.

IV. Account Statement Delivery and Notice Requirements

To provide greater assurance regarding the integrity of account statements, the amended Custody Rule eliminates the ability of an investment adviser, in lieu of a qualified custodian, to send account statements to its clients. Now, the qualified custodian must send all account statements on a quarterly basis directly to an investment adviser’s clients.⁶ An adviser can still elect to send its own account statements to clients, but such statements cannot be a substitute for the statements sent by the qualified custodian and, as discussed in the following paragraph, must contain a cautionary legend. In addition, the adviser must form a reasonable belief that the qualified custodian is sending the account statements directly to clients after “due inquiry.”⁷ The Release does not prescribe a method for forming this belief, although it mentions that a popular convention is to have the qualified custodian send the adviser a copy of the same statement that is sent to clients. The Release indicates that an adviser cannot satisfy its “due inquiry” obligation merely by accessing the account statement on the custodian’s website as the statement’s presence on the website only confirms its *availability*, not that it has been sent to clients.⁸ As a result, it appears that the SEC is extending to the custodian an obligation to physically send the account statements to the adviser’s clients and not to simply make them available on a website.

The amended Custody Rule continues to require an adviser to notify its client in writing when an account with a qualified custodian is opened on behalf of an adviser’s client – either under the name of the client or under the adviser’s name as agent – and to notify its client *in writing* of the qualified custodian’s name, address, and the manner in which the funds or securities are maintained.⁹ Furthermore, advisers are still obligated to notify clients of changes in this information. Now, under the amended Custody Rule, if the adviser sends its own statements to clients (in addition to the custodian’s statements), the required notice and the statements sent by the adviser must include a legend urging the client to compare the account statements received from the custodian to those received from the adviser.¹⁰

V. Annual Surprise Examination of Client Assets

Perhaps the most significant amendment to the Custody Rule is the requirement that registered investment advisers with custody of client assets generally must undergo a surprise examination of those assets by an independent public accountant.¹¹ Commenters opposed to this proposed amendment cited the cost burden and the redundancy of having a surprise exam when client assets are already held by an independent qualified custodian. The SEC was not swayed by these arguments, citing enforcement cases brought by the SEC in which advisers were alleged

⁶ Release at p. 7.

⁷ Amended Rule 206(4)-2(a)(3).

⁸ Release at n. 21.

⁹ Amended Rule 206(4)-2(a)(2).

¹⁰ Release at p. 9; amended Rule 206(4)-2(a)(2).

¹¹ Amended Rule 206(4)-(2)(a)(4).

to have misappropriated client assets that were maintained by an independent qualified custodian.¹²

A. Exceptions to the Annual Surprise Examination Requirement

There are three exceptions from the surprise examination requirement.

1. Authority to Deduct Advisory Fees from Client Accounts

The annual surprise examination requirement does not apply to an adviser that (i) maintains client funds and securities at a qualified custodian and (ii) has custody of client assets *solely* because of the adviser's authority to deduct advisory fees from client accounts. However, the exception is not available to an adviser that has custody under the Rule for other reasons, such as serving as a trustee.

2. Pooled Investment Vehicles Subject to an Annual Audit¹³

This exception is significant for hedge fund and other private fund advisers. The surprise examination requirement will be deemed fulfilled if (i) the pooled investment vehicle is subject to an annual financial statement audit by an independent public accountant that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board ("PCAOB"), (ii) such audited financial statements are prepared in accordance with generally accepted accounting principles and (iii) the audited financial statements are distributed to the pool's investors within 120 days of the end of the fiscal year.¹⁴ In the Release, the SEC indicates that the procedures followed by accountants during an annual audit are comparable to those performed as part of a surprise examination and provide meaningful protections to investors. Specifically, the SEC points to an adviser's inability to anticipate which transactions the auditor will select and test as an adequate substitute for the "surprise" element of the examination requirement.

If an adviser complies with the annual audit exemption, it is not required to have a custodian send quarterly account statements to investors. Accordingly, the quarterly account statement delivery requirement and surprise examination requirement applies only if the adviser cannot satisfy the audit procedures described above. It is important to note, as the SEC does in the Release, that fund investors do not have the benefit of regularly receiving custodial reports when the adviser chooses to comply with the audit requirement. The SEC identifies this in the Release as a concern and implies that more regulation of fund advisers may be forthcoming to remedy this gap.

¹² Release at n. 35.

¹³ Amended Rule 206(4)-2(b)(4).

¹⁴ Amended Rule 206(4)-2(b)(4)(i)-(ii). Advisers to funds of funds may still distribute audited financial statements within 180 days of the end of the fiscal year in accordance with the no-action position taken by the SEC in *ABA Committee on Private Investment Entities*, SEC Staff Letter (Aug. 10, 2006). Release at n. 45.

3. Custody Attributed to Adviser Through an “Operationally Independent” Related Person

Under the amended Custody Rule, custody of client assets will be attributed to an investment adviser if a “related person” directly or indirectly has custody of any client securities or funds in connection with advisory services provided by the adviser to its clients.¹⁵ However, the surprise examination requirement is waived if the adviser is deemed to have custody of client assets *solely* because a related person is holding the assets and the related person custodian is “operationally independent” of the adviser.

The term “related” in this case means a person directly or indirectly “controlling or controlled by” the adviser and any person under common control with the adviser.¹⁶ Thus, in the case of advisers that are part of multi-service financial organizations, related person custodians may include broker-dealers and banks.¹⁷ Now, where a related person of an adviser holds or has authority to obtain possession of advisory client assets, the SEC presumes the adviser and the related person are not operationally independent of each other, thereby attributing custody of those assets to the adviser and subjecting the adviser to the surprise examination requirement. It is important to note, however, that the presumption is rebuttable, meaning that the surprise examination requirement will not apply if the adviser can successfully rebut it.

The adviser may rebut this presumption if the following conditions contained in amended Rule 206(4)-2(d)(5) apply to the related person: 1) client assets in the custody of the related person are not subject to claims of the adviser’s creditors; 2) advisory personnel do not have custody or possession of, or direct or indirect access to client assets of which the related person has custody, or the power to control the disposition of such client assets to third parties for the benefit of the adviser or its related persons, or otherwise have the opportunity to misappropriate such client assets; 3) advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision; and 4) advisory personnel do not hold any position with the related person or share premises with the related person. Furthermore, the adviser must prepare and retain in its records a memorandum describing how it has overcome the presumption that it is not operationally independent of the related person with respect to the related person’s custody of client assets.

Even if the adviser does not have to obtain a surprise examination of the client assets held by a related person because it has rebutted the presumption, it still has to comply with other provisions of the amended Custody Rule (unless another exemption is available) because it is deemed to have custody of those assets. Such requirements include notifying the client where the assets are maintained, forming a reasonable belief after due inquiry that the qualified

¹⁵ Amended Rule 206(4)-2(d)(2). This is a departure from the SEC’s practice of not attributing custody of client assets held by a related person to an adviser even if the related person was operationally separate. Accordingly, the SEC is withdrawing *Crocker Investment Management Corp.*, SEC Staff Letter (Apr. 14, 1978), *Pictet et Cie*, SEC Staff Letter (June 22, 1980) and other related no-action letters. Firms that have relied on these letters must now comply with the amended Rule.

¹⁶ Amended Rule 206(4)-2(d)(7). “Control” is defined in amended Rule 206(4)-2(d)(1) to mean the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract or otherwise and includes, for example, (i) the right to vote or the power to sell or direct the sale of 25% or more of a class of a corporation’s voting securities and (ii) in the case of a partnership, the right of a person to receive upon dissolution, or such person’s contribution of, 25% or more of the capital of such partnership.

¹⁷ Release at n. 102.

custodian sends the client account statements, and obtaining an internal control report from a related person that is a qualified custodian.

Note that the presumption cannot be rebutted if the adviser has custody for other reasons in addition to a related person having custody (such as the adviser acting as trustee with respect to assets held in an account at a related broker-dealer). Such adviser would be subject to the surprise examination requirement and would have to receive an internal control report from the related person qualified custodian (which report is further discussed in Part VI).

B. Engaging Accountants to Perform the Surprise Examination; SEC Reporting

By agreement with an independent public accountant, the first surprise examination must take place by December 31, 2010 or, for advisers that become subject to the Rule after the effective date, within six months of becoming subject to the requirement. The agreement must also require the accountant to file a certificate on Form ADV-E with the SEC within 120 days of the time chosen by the accountant to perform the examination stating that it has examined the funds and securities and describing the nature and extent of the examination. If the accountant finds material discrepancies during the course of the examination, the SEC must be notified of the finding within one business day. If the accountant resigns, or is dismissed from, the engagement to perform surprise examinations, the accountant must file Form ADV-E within four business days accompanied by a statement that includes an explanation of any problems that contributed to such resignation, dismissal or other termination. Despite objections from several commenters, the SEC now requires that the Form ADV-E be made available to the public. As indicated in the Release, the SEC believes that clients and potential clients need to be able to assess for themselves the reasons for the termination of an accountant's engagement.

VI. Physical Custody of Client Assets by Adviser and Related Persons; Internal Control Report

An adviser or a "related person" of the adviser (as defined herein) serving as a qualified custodian for advisory client funds or securities (instead of maintaining such assets at an independent qualified custodian) is subject to the surprise examination discussed above *and* must obtain or receive from the related person a written "internal control report" prepared by an independent public accountant with respect to the adviser's or related person's custody of client assets. The report can be in the form of a Type II SAS 70 report, although other types of reports can also satisfy this requirement. The accountant issuing the internal control report also must be registered with and subject to regular inspection by the PCAOB. The adviser can retain the same accountant to perform both the surprise examination and the internal control report.¹⁸ **The adviser must obtain or receive the initial internal control report within six months of becoming subject to the requirement.**¹⁹

As discussed above, custody of client assets can be attributed to an adviser if its related person holds the client's assets, but the surprise examination requirement can be waived if this is the only reason why the adviser is deemed to have custody and if the related person is operationally independent. However, if the adviser has custody for other reasons (such as acting

¹⁸ Release at n. 73.

¹⁹ The elements of the internal control report are contained in the companion interpretive release cited at n. 2, *supra*.

as trustee with respect to client assets held in a related person broker-dealer's account), the adviser cannot overcome the presumption that it is not operationally independent from the related person; that adviser would become subject to the surprise examination requirement *and* would have to receive an internal control report from the related person with respect to those assets.

VII. Amended Custody Rule's Application to Pooled Investment Vehicle Advisers

As discussed above, an investment adviser to an investment pool such as a hedge fund is deemed to have fulfilled the surprise examination requirement if it distributes to the beneficial owners of the pool audited financial statements prepared by a PCAOB-registered and inspected accounting firm within 120 days (or 180 days for funds of funds) of the pool's fiscal year-end.

Additionally, advisers relying on the audit provision to comply with the Custody Rule and intending to liquidate the pool must obtain a final audit of the pool's financial statements and distribute the financial statements to pool investors promptly after the completion of the audit.²⁰

If the adviser to a private fund does not rely on the annual audit exemption, it must obtain an annual surprise examination and form a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement of the fund to the fund's investors. In either case, if the pooled vehicle's assets are maintained with a qualified custodian that is either the adviser to the pool or a related person of the adviser, the adviser would have to obtain, or receive from the related person, an internal control report (since the adviser would have fulfilled the surprise examination requirement but is still deemed to have physical control of client assets). Furthermore, amended Rule 206(4)-2(c) further provides that distribution of account statements or audited financial statements to beneficial owners that are themselves pooled investment vehicles that are related persons of the adviser will not satisfy the Rule. This provision is intended to preclude advisers from using layers of pooled investment vehicles to avoid application of the Rule's protections; note that it does not preclude advisers from distributing the account statements/audited financial statements to beneficial owners that are unrelated pooled investment vehicles.

Finally, the Release contains interesting guidance with respect to the formation of special purpose vehicles (each, an "SPV") by advisers to pooled investment vehicles. The SEC advises that an SPV can be treated as a separate client with the adviser having custody of the SPV's assets, or the assets of the SPV can be treated as the fund's assets. In the first case, the adviser would have to comply separately with the quarterly custodial account statement distribution and surprise examination requirements or with the audit exception with respect to the SPV. Alternatively, if the assets of the SPV are treated as the fund's assets, such assets would have to be included in the audited financial statements of the fund or be included with the fund's assets when subject to the surprise examination. In either case, the beneficial owners of the pooled investment vehicle will receive the account statements or the audited financial statements of the SPV.

VIII. Other Considerations

A. Privately Offered Securities

²⁰ Amended Rule 206(4)-2(b)(4).

A registered investment adviser is not required to maintain “privately issued securities” with a qualified custodian, but such securities are still subject to the surprise examination under the amended Custody Rule.²¹ For securities to be deemed privately issued, they must satisfy the following elements:

- The securities were acquired in a private offering;
- The securities are uncertificated, and ownership of the securities is recorded only on books of the issuer or its transfer agent in the name of the client; and
- The securities are transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.

Although a registered investment adviser need not maintain privately offered securities with a qualified custodian, the accountant conducting the surprise annual verification of client assets will not be able to forego examining such securities. Furthermore, the adviser may maintain custody of privately offered securities without having to obtain the internal control report required under amended Rule 206(4)-2(a)(6) unless it also acts as qualified custodian with respect to other client funds or securities.²²

B. Recommended Compliance Policies and Recordkeeping

The Release recommends that advisers with custody of client assets institute the following policies and procedures as part of their compliance programs:

- conducting background and credit checks on employees of the investment adviser who will have access to client assets;
- requiring the authorization of two or more employees to transfer assets in and out of a client’s account, as well as before changes are made to account ownership information;
- limiting the number of employees who are permitted to interact with custodians with respect to client assets and rotating such employees on a periodic basis; and
- if the adviser also serves as a qualified custodian for client assets, segregating the duties of its advisory personnel from those of custodial personnel to make it difficult for any one person to misuse client assets without being detected.

Additional prudent policies would include (i) policies establishing the basis for an adviser’s reasonable belief that qualified custodians have sent account statements to clients and (ii) policies for documenting the basis upon which the adviser rebuts the presumption that its related person is not operationally independent (thereby exempting the adviser from the surprise examination requirement). The Release also suggests that firms establish policies that would prevent the adviser from inadvertently being deemed to have custody of client assets, for example, by prohibiting employees from becoming trustees for client assets or obtaining powers of attorney for clients.

With respect to recordkeeping, the SEC has adopted amendments to Advisers Act Rule 204-2 requiring an adviser to maintain for five years a copy of (i) the internal control report if

²¹ This exception is available with respect to privately issued securities held for the account of a limited partnership or other type of pooled investment vehicle only if the pool is audited and the audited financial statements are distributed to the pool’s beneficial owners.

²² Release at n. 65.

one is obtained or received, and (ii) the memorandum describing the basis upon which the adviser rebuts the presumption that its related person is not operationally independent.

IX. Amendments to Form ADV

The SEC has amended Part 1A and Schedule D of Form ADV to require registered advisers to report more detailed information about their custody practices, to identify the accountants that perform audits or surprise examinations and that prepare internal reports and to identify related persons that serve as qualified custodians.²³ An adviser must also report whether it has determined that it has overcome the presumption that it is not operationally independent from a related person qualified custodian and thus is not subject to a surprise examination. The SEC anticipates that the IARD will reflect the changes to Form ADV and accept electronic filing of Form ADV-E in the fourth quarter of 2010. Registered investment advisers can expect to provide responses to the revised Form ADV in their first annual amendment after January 1, 2011. Accountants performing surprise audit examinations will continue to file paper copies of Form ADV-E until the IARD system is upgraded to accept electronic filings.

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Please feel free to contact us if you have any questions about the Custody Rule or if you would like us to review and assist in amending your compliance manual in light of the guidance contained in the Release.

²³ Release at pp. 120-125.