SEC Proposes Amendments to Adviser Custody Rule and Related Forms

In a release dated May 20, 2009 (the "Release"), the Securities and Exchange Commission ("SEC") proposed amendments to Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940 (the "Advisers Act"), and related forms, which are designed to provide additional safeguards under the Advisers Act when an adviser has custody of client funds or securities. The amendments would, among other things, require registered investment advisers that have custody of client funds or securities to undergo an annual surprise examination by an independent public accountant to verify client funds and securities. In addition, unless client accounts are maintained by an independent qualified custodian (i.e., a custodian other than the adviser or a related person), the adviser or related person would be required to obtain a written report from an independent public accountant that includes an opinion regarding the qualified custodian’s controls relating to the custody of client assets. Finally, the amendments would provide the SEC with better information about the custodial practices of registered investment advisers. The full Release (No. IA-2876) is available at www.sec.gov/rules/proposed/2009/ia-2876.pdf. Highlights of the proposed amendments are summarized below.

Comments

Comments on the proposed amendments, suggestions for additional changes to the existing rules, and comment on other matters that might have an effect on the proposals, are due to the SEC no later than July 28, 2009. The various means for submitting comments are detailed in the Release.

Background

Presently, the Custody Rule requires advisers that have custody of client funds or securities (in many cases because they have the authority to obtain client assets, such as deducting advisory fees from client accounts or writing checks or withdrawing funds on behalf of a client) to implement controls designed to protect those client assets from being lost, misused, misappropriated or subject to the advisers'
financial hardships. As noted in the Release, there are two primary protections contained in the current Custody Rule for advisers with custody: one, the Custody Rule requires, with limited exceptions, that advisers maintain client funds or securities with a "qualified custodian"; and two, the adviser must either (i) have a reasonable belief that the qualified custodian holding the assets provides, at least quarterly, account statements directly to clients, or investors in pooled investment vehicles or (ii) deliver quarterly account statements to clients and engage an independent public accountant to verify client assets through an annual surprise examination, subject to certain additional requirements and reporting.

The SEC noted that during recent months, it has brought several enforcement actions against advisers and broker-dealers alleging fraudulent conduct, including misappropriation or other misuse of investor assets. In addition to continuing its investigation of these matters, working with criminal authorities in the prosecution of wrongdoers, and conducting examinations of broker-dealer and adviser custody practices, the SEC noted that the proposed amendments to the Custody Rule are designed to affect an improvement of the safekeeping of client assets.

Proposed Amendments

A. Annual Surprise Examination of Client Assets

1. Application to All Advisers with Custody – The SEC proposes to again require that all registered investment advisers with custody of client assets engage an independent public accountant to conduct an annual surprise examination of client assets. The Release notes that when the Custody Rule was first adopted in 1962, each adviser with custody was required to engage an independent public accountant to conduct an annual surprise examination. That requirement was dropped, when the Custody Rule was amended in 2003, with respect to client accounts for which the adviser has a reasonable belief that a "qualified custodian" provides account statements directly to clients. According to the Release, "in light of the significant enforcement actions...alleging misappropriation of client assets," the SEC has determined to revisit the 2003 rulemaking in this respect. Thus, the proposed amendments would require all registered investment advisers with custody of client assets to obtain an annual surprise examination, regardless of whether a qualified custodian directly provides account statements to clients or, in the
case of pooled investment vehicles, the pool is audited at least annually and distributes audited financial statements to its investors within 120 days of the end of its fiscal year. Of specific interest to discretionary advisors, is the SEC’s specific request for comment on whether advisers who are deemed to have custody solely because of their authority to withdraw advisory fees, should be exempted from the surprise examination requirement and whether there are alternatives that might provide similar protections.

The proposed amendments would continue to except advisers who have custody as a result of serving as a general partner (or some other capacity) of a limited partnership (or other form of pooled investment vehicle) from the requirement to have a qualified custodian send account statements, so long as the pooled investment vehicle is audited at least annually and the audited financial statements are distributed to investors within 120 days of the fiscal year end of the investment vehicle. Such advisers would not, however, be excepted from the surprise examination requirement.

2. **SEC Reporting** – The SEC also proposes to amend the Custody Rule to require advisers subject to the rule to enter into a written agreement with an independent public accountant to conduct the surprise examination requiring the accountant to, among other things, notify the SEC within one business day of finding material discrepancies, and to submit Form ADV-E to the SEC accompanied by a certificate within 120 days of the time chosen by the accountant for the surprise examination, stating that it has examined the funds and securities and describing the nature and extent of the examination. In addition, the proposed amendments would require that the written agreement require that the independent public accountant submit Form ADV-E to the SEC within four business days of its resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed, accompanied by a statement that includes (i) the date of such resignation, dismissal, removal, or other termination, and the name, address, and contact information of the accountant, and (ii) an explanation of any problems relating to examination scope or procedure that contributed to such resignation, dismissal, removal, or other termination. Further, Form ADV-E would be required to be filed electronically through the Investment Adviser Registration Depository ("IARD") under the proposed amendments.
3. **Privately Offered Securities** – The proposed amendments would also make privately offered securities that investment advisers hold on behalf of their clients (which are currently excluded from all aspects of the Custody Rule) subject to the surprise examination requirement.

**B. Custody by Adviser and Its Related Persons**

1. **Custody by Related Persons** – The proposed amendments would expand the Custody Rule to provide that an adviser has custody of client securities or funds that are directly or indirectly held by a "related person" in connection with advisory services provided by the adviser to its clients. For these purposes, a "related person" would be a person directly or indirectly controlling, controlled by, or under common control with, the adviser, and "control" would be defined as the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise.

2. **Internal Control Report and PCAOB Registration and Inspection** – If an independent custodian does not maintain client assets, but the adviser or a related person instead serves as a qualified custodian for client funds or securities under the rule in connection with advisory services the adviser provides to clients, the proposed amendments would require the adviser to obtain, or receive from a related person, no less frequently than once each calendar year, a written report (the "internal control report"), which includes an opinion from an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB"), with respect to the adviser's or related person's controls relating to custody of client assets. The Release notes that a report on the description of controls placed in operation and tests of operating effectiveness (commonly referred to as a "Type II SAS 70 Report"), conducted in accordance with PCAOB standards, would be sufficient for purposes of satisfying the requirements of the internal control report. These internal control reports would be required to be maintained by the adviser as part of its records, and made available to the SEC upon request. The opinion included in the internal control report would be required to be issued, in accordance with the standards of the PCAOB, with respect to the description of controls placed in operation relating to custodial services,
including the safeguarding of cash and securities held by either the adviser or a related person on behalf of the adviser’s clients, and tests of operating effectiveness.

3. **Surprise Examination and PCAOB Registration** – The proposed amendments would also require that when an adviser or a related person serves as a qualified custodian for the adviser’s clients’ funds or securities, the surprise examination discussed above be performed by an independent public accountant registered with, and subject to regular inspection by, the PCAOB, in accordance with the rules of the PCAOB.

4. **Independent Qualified Custodians** – The Release requests comments on whether, as an alternative to the proposal to impose additional conditions on advisers that serve as, or have related persons that serve as, qualified custodians for client assets, the Custody Rule should simply be amended to require that an independent qualified custodian hold client assets. The SEC noted that it is interested in “exploring the practical aspects of requiring, as an alternative to some or all of the amendments we are today proposing, an independent qualified custodian.” In particular, the SEC notes that such a requirement could preclude a broker-dealer that is subject to the Custody Rule from providing advisory services to a brokerage customer unless the customer held securities over which the adviser had discretionary authority in a brokerage account at another brokerage firm, or in a custodial account at a bank or other qualified custodian.

**C. Delivery of Account Statements and Notice to Clients**

The proposed amendments would require registered advisers with custody of client funds or securities to have a reasonable basis for believing that the qualified custodian sends an account statement, at least quarterly, to each client for which the qualified custodian maintains funds or securities. Thus, the proposed amendments would eliminate the alternative, presently available under the Custody Rule, under which and adviser can sent reports to clients if it undergoes a surprise examination by an independent public accountant at least annually. The proposed amendments would also require that this “reasonable belief” be formed after “due inquiry.” The SEC notes that there are a number of ways that an adviser could satisfy the “due inquiry” requirement, including (i) requiring the custodian to provide to the adviser, a copy of the account statement that was delivered to the
client, or (ii) obtaining a quarterly written confirmation from the custodian that it has sent account statements to the adviser's clients. Additionally, the proposed amendments would modify the notice that advisers must currently send to clients upon opening a custodial account on their behalf, to include a statement urging clients to compare the account statements that they receive from the custodian with those that they receive from the adviser.

**D. Liquidation Audit**

The proposed amendments would also clarify the provisions of the Custody Rule that exempt advisers from the account statement provisions with respect to those limited partnerships or other pooled investment vehicles that are subject to an annual audit and that distribute financial statements to investors, to more clearly articulate the availability of the annual audit exception to pooled investment vehicles that liquidate and make final distributions other than at year end.

**E. Amendments to Form ADV**

The Release also contains proposed amendments to Form ADV. Specifically, it is proposed that Item 7 be amended to require an adviser to report all related persons who are broker-dealers and to identify which, if any, serve as qualified custodians with respect to the adviser's clients' funds or securities. Presently, that Item requires an adviser to identify each related person that is an investment adviser and permits advisers to report the names of related person broker-dealers. Additionally, it is proposed that Item 9 be amended to require that advisers that have custody, or whose related persons have custody, of client funds or securities, provide additional information regarding their custodial practices, including (i) reporting the amount in U.S. dollars of client assets and number of clients of which it or its related person has custody, and (ii) whether it or its related person serves as qualified custodian with respect to the adviser's clients' funds or securities. Further, a new section would be added that would require an adviser with custody to report (A) whether a qualified custodian sends quarterly account statements to investors in pooled investment vehicles the adviser manages, (B) whether the financial statements of the pooled investment vehicles the adviser manages are audited, (C) whether the adviser's clients' funds or securities are subject to a surprise examination, and (D) whether an independent public accountant registered with, and subject to regular inspection by, the PCAOB prepares an internal control report with respect to the adviser or its related persons' custodial services when acting as a qualified custodian for advisory client funds or securities. In addition, it is proposed that Item 9 be further amended to require advisers that are subject to the surprise examination requirement, report the month in which the last examination
commenced. General Instruction number 4 would be amended to make conforming changes.

Finally, it is proposed that Schedule D of Form ADV be amended by adding items to require additional details relevant to an adviser's response to the proposed amendments to Item 9. These amendments would require advisers to, (I) with respect to accountants, (A) identify the accountants that perform audits or surprise examinations and that prepare internal control reports, (B) provide information about the accountants, including address and PCAOB registration and inspection status, (C) indicate the type of engagement (audit, surprise examination, internal control report), and (D) indicate whether the accountant's report was unqualified, and (II) with respect to qualified custodians, identify any related person that serves as a qualified custodian for its clients by reporting the related person's name and address and indicate whether the related person qualified custodian is a bank, futures commission merchant or foreign financial institution.

F. Amendments to Form ADV-E

Form ADV-E is proposed to be amended as follows. First, it is proposed that the instructions be amended to require that the form and the accountant's examination certificate that accompanies it be filed electronically with the SEC. Second, it is proposed that the instructions be amended to reflect the proposed requirement that the form and the examination certificate be filed within 120 days of the time chosen by the accountant for the surprise examination. Finally, it is proposed that an instruction be added that would implement the proposed rule change regarding the accountant's obligation under the written agreement with the adviser to file Form ADV-E, accompanied by the termination statement, within four business days of the accountant's resignation, dismissal, or removal.

G. Required Records

Finally, the release proposes amendments to Rule 204-2 under the Adviser's Act to require the adviser to maintain a copy of the internal control report, referred to above, for a period of five years from the end of the fiscal year in which it is finalized.
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