January 29, 2010

Investment Management Compliance Update: SEC Issues Amendments to Investment Adviser Custody Rule

The Custody Rule (Rule 206(4)-2 of the Investment Advisers Act of 1940, as amended (the "Advisers Act")), and certain recording-keeping requirements imposed under the Advisers Act, apply to federally-registered investment advisers that have (or are deemed to have) access to client assets. The Securities and Exchange Commission (the "SEC") has adopted amendments to the Custody Rule and those requirements and has recommended best practices in connection with the safekeeping of client assets. The amendments, which will take effect March 12, 2010, are intended to provide additional safeguards for funds and securities that are held by federally-registered investment advisers. The new requirements (and certain exceptions) set forth in the amendments are summarized below. The full text of the SEC adopting release is available at: http://www.sec.gov/rules/final/2009/ia-2968.pdf.?

While the Custody Rule and the record-keeping requirements under the Advisers Act apply directly to federally-registered investment advisers, the rule and requirements and the SEC recommendations may represent best practices for the entire investment management industry. Moreover, with the prospect on the horizon of increased registration requirements for currently exempt advisers, unregistered advisers should strongly consider adopting the new requirements and recommendations for the safekeeping of client assets. Starting in March of this year, the new requirements and recommendations may have a significant impact on many registered advisers, but will not have as much impact on (1) investment advisers that have custody of client assets solely for purposes of deducting advisory fees from client accounts and (2) many investment advisers to pooled investment vehicles (such as hedge funds and private equity funds). **Annual Surprise Examination** Unless an exception applies, investment advisers that have custody of client assets must engage an independent public accountant to conduct an annual surprise examination to verify client assets. Investment advisers that are subject to this rule are required to enter into a written agreement with an independent public accountant to conduct the annual exam.? Under the terms of such agreement, the accountant must be required to, among other things:

- Notify the SEC within one business day of any findings of material discrepancies.
- Submit a Form ADV-E and a certification to the SEC stating that the exam has been conducted and describing the nature and extent of the examination.
- Notify the SEC and submit a Form ADV-E within four business days if the accountant resigns or is dismissed by the investment adviser.

Investment advisers that have custody of client assets solely for purposes of deducting advisory fees from client accounts are not subject to the annual surprise exam requirement.

Investment advisers to pooled investment vehicles (such as hedge funds and private equity funds) are exempt from the surprise exam requirement, so long as the fund is already subject to an annual financial audit by an independent public accountant that is registered with the Public Company Accounting Oversight Board (the "PCAOB") and the independent

public accountant delivers the audited financial statements to the fund investors within 120 days of the fund's fiscal year-end (or within 180 days of the fund's fiscal year-end to investors in a fund-of-funds).

There is a limited exception for an adviser that is deemed to have custody solely as a result of a related person holding client assets. Under this exception, the adviser will not be subject to the surprise examination requirement if the related person that has custody of client assets is "operationally independent" of the adviser. The amended Custody Rule establishes a presumption that a related person is not operationally independent unless four conditions are met: (i) client assets in the custody of the related person cannot be subject to claims of the adviser's creditors; (ii) advisory personnel cannot 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; (iii) advisory personnel and personnel of the related person who have access to advisory client assets cannot be under common supervision; and (iv) advisory personnel cannot hold any position with the related person or share premises with the related person.

Delivery of Statements to Clients

The Custody Rule contemplates that, in most circumstances, the client will receive account statements on a quarterly basis from a qualified custodian. Under the current rule, an adviser using a qualified custodian may satisfy the account statement requirement by either (1) sending the statements itself and also having annual surprise audits or (2) having the qualified custodian send the statements directly to the adviser's clients. Under the amended rule, advisers will no longer have the first option (delivering quarterly statements to clients itself). Rather, the qualified custodian must send the quarterly statements directly to the adviser's clients. In addition, the adviser is required to have a reasonable belief, based on due inquiry, that the qualified custodian actually delivers the quarterly account statements directly to clients. An adviser is still permitted to send out additional account statements to clients, but a legend must be attached to the statements encouraging the clients to compare the adviser's statements to those prepared by the qualified custodian.

Investment Adviser or Related Person Custody

The amended Custody Rule imposes additional requirements on an investment adviser that maintains custody of client assets itself or with a related person rather than with an independent qualified custodian. An investment adviser that maintains custody itself or with a related person will now be required to obtain an annual written internal control report prepared by an accountant that is registered with, and subject to regular inspection by, the PCAOB. The report, commonly known as a SAS 70 report, must describe the custodian's internal controls, test the operating effectiveness of the controls and report on the results of the testing. The report must also include an opinion from the accountant. The reports must be kept in the adviser's records and must be made available to the SEC upon request.

Best Practices

The adopting release for the amendments to the Custody Rule also makes recommendations of specific policies and procedures that an investment adviser should implement in connection with the safekeeping of client assets. Specifically, the SEC recommends that investment advisers adopt the following policies: (i) conducting background checks and credit checks on employees with access to client assets; (ii) requiring authorization by more than one employee before moving, withdrawing or transferring client assets; (iii) limiting and rotating the number of employees permitted to interact with custodians; and (iv) if the investment adviser itself serves as the qualified custodian, segregating custodial duties from those of advisory personnel.

Important Compliance Dates

- The effective date of the amendments is March 12, 2010. Immediately upon the effective date, investment advisers that have custody of client assets must promptly, upon opening a custodial account on a client's behalf and following any changes to the custodial account information, send a notification to the client, including a legend urging the client to compare the account statements the client receives from the investment adviser with those the client receives from the custodian. The legend must also be included on any account statements sent by the adviser to these clients thereafter. In addition, immediately upon the effective date, investment advisers that have custody of client assets are required to have a reasonable belief, based on due inquiry (except with respect to pooled investment vehicles whose financial statements are audited by a qualifying firm and delivered to investors), that a qualified custodian sends account statements directly to clients at least quarterly.
- 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 examination will take place by December 31, 2010.
- If an investment adviser is required to obtain an internal control report, the first report must be obtained within six months of the effective date (September 12, 2010).