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PHILLIPS NIZER LLP

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# SECURITIES LAW ALERT

## U.S. SECURITIES & EXCHANGE COMMISSION AMENDS CUSTODY RULE

On December 30, 2009, the SEC adopted its long awaited amendments to Rule 206(4)-2 under the Investment Advisers Act of 1940, as amended (the "Custody Rule"),[1] which become effective on March 12, 2010. As previously, an adviser with custody of client assets must maintain those assets with a qualified custodian and inform the client in writing of the name and address of such custodian. The Custody Rule has been amended, *inter alia*, to require SEC-registered investment advisers to undergo an annual surprise examination by an independent public accountant registered with the Public Accounting Oversight Board (the "PCAOB") to verify assets under such investment adviser's custody. The annual surprise examination requirement does not apply to: (i) advisers who have custody of client assets solely because they are authorized to deduct fees from client accounts; (ii) advisers to pooled investment vehicles who deliver audited financial statements to pool participants; and (iii) advisers who have custody because they maintain client assets with a related person that is "operationally independent" of such adviser.

Annual Surprise Examination

As noted above, all SEC-registered investment advisers with custody of client assets must undergo an annual surprise examination of such assets by an independent accountant registered with the PCAOB. The Custody Rule makes it clear that an adviser has custody if it or a "related person" (essentially an affiliate of such adviser) physically possesses client funds or securities or has the authority to obtain possession thereof.

The Custody Rule requires that client account statements be delivered directly to the adviser's clients by the "qualified custodian."[2] Advisers will no longer have the option of complying with the rule by delivering such statements themselves. Advisers must have a reasonable basis, after due inquiry, for believing that the qualified custodian has sent an account statement, at least quarterly, to each client for which it maintains custody. Generally speaking, the account statement shall set forth the assets and transactions in the account as reflected in the custodian's records. In this regard, the SEC has indicated that an adviser will be deemed to have satisfied this requirement where the qualified custodian provides it with a copy of the account statement that was delivered to the client.

The Custody Rule requires that a notice be sent to each client upon the opening of a custodial account with a qualified custodian which contains a legend stating that the client should compare the custodian-provided account statement with any account statement provided by the client's adviser. For advisers who choose to send such account statements in addition to those sent by the qualified custodian, the cautionary legend must be included in any subsequent adviser-provided account statements that are delivered to clients after the initial notice during the conduct of the account so as to minimize any confusion. The SEC believes such regular notice will serve to more effectively remind clients to take steps to protect their assets.

An adviser subject to the surprise examination requirement must enter into a written agreement with the accountant that provides for the first examination to take place by December 31, 2010. Such written agreements must also require the accountant to: (i) file a certificate on Form ADV-E within 120 days of the time chosen by the accountant for the surprise

***(Please see reverse for more information.)***

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examination, stating that the accountant has examined the funds and securities and describing the nature and scope of the examination; (ii) notify the SEC within one business day if it finds any material discrepancies during the examination; and (iii) file a Form ADV-E within four business days of its resignation or dismissal from the engagement or if it is removed from consideration from reappointment, either voluntarily or involuntarily, which shall include a narrative statement setting forth any problems encountered by the accountant which may have contributed to the termination. Accountants will file the Form ADV-E electronically through the Investment Adviser Registration Depository ("IARD").[3]

For advisers becoming subject to the rule after the effective date, such advisers must have a surprise examination within six months after becoming subject to the rule. If the adviser itself (and not a related person) acts a qualified custodian, the first surprise examination must take place within six months after obtaining an internal control report, which is discussed below.

Exemptions

(a) Advisers with Custody Solely Due to Fee Deduction

An adviser who has custody solely because it has authority to deduct fees from client accounts is not required to undergo an annual surprise examination. This is no doubt a response to the criticisms of the proposed rule made during the comment period.

(b) Advisers to Pooled Investment Vehicles Subject to Audit

Advisers to pooled investment vehicles whose financial statements are audited annually in accordance with U.S. GAAP by a PCAOB-registered independent accountant and delivered to pool participants within 120 days after the end of the fiscal year (180 days in the case of a fund of funds) are not subject to the surprise examination requirement.[4] This exemption will not apply if all of the pool participants are themselves pooled investment vehicles which are related persons of the adviser. This has been done to prevent an adviser from avoiding compliance with the rule by setting up a tier of funds to receive financial statements. Also, if a pooled investment vehicle uses special purpose vehicles ("SPVs"), the adviser to such pooled investment vehicle must either include the assets of such SPVs in the scope of the audit or treat each SPV as an individual client (requiring it to comply separately with the Custody Rule's audit distribution or account statement/surprise examination requirements).

(c) Advisers with Custody Through "Operationally Independent" Related Persons

An investment adviser who has custody solely because it utilizes a related person as the qualified custodian is not subject to undergoing an annual surprise examination if such related person is "operationally independent." A related person will not be operationally independent unless: (i) client assets are not subject to the claims of the adviser's creditors; (ii) the adviser's personnel do not have access to the client's assets or the power to control the disposition of such assets for the benefit of the adviser or its related persons; (iii) personnel of the adviser and the related person who have access to client assets are not under common supervision; and (iv) the personnel of the adviser do not hold any positions or share space with the related person.

Internal Control Report

Where an adviser or its related person is acting as the qualified custodian (as opposed to using an "independent" qualified custodian), in addition to undergoing a surprise examination,[5] such adviser or related person must obtain an annual internal control report with respect to its controls over custody of client assets prepared by an independent PCAOB-registered accountant. This is to address the custodial risks associated with an affiliated custodial relationship. The SEC indicated that the surprise examination requirement alone would not adequately address such risks as the accountant seeking to verify client assets would rely, in part, on custodial reports issued by the adviser or the related person. The internal control report must include the accountant's opinion as to whether the qualified custodian's internal controls are suitably designed and are operating effectively to meet control objectives related to custodial services, including the safeguarding of fund and securities of advisory clients during the year, among other things. If the qualified custodian is the adviser to a pooled investment vehicle or a related person of the adviser, the adviser to the pool would have to obtain, or receive from the related person, an internal control report.

Other Matters

(a) Form ADV Part 1A and Schedule D have been amended to require more detailed disclosure of advisor custody practices and to update such information. In addition, the identity and certain other information must be disclosed regarding accountants performing audits, surprise examinations and internal control reviews as well as the identity of any related person that acts as qualified custodian for client assets.

(b) "Privately offered securities", as defined by the Custody Rule, may no longer be omitted from the purview of the annual surprise examination.

(c) A companion release[6] provides accountants with guidance addressing the scope of the surprise examination and the internal control report, as well as the relationship between them.

(d) The amended Custody Rule requires advisers to pooled investment vehicles that follow the rule's annual audit provision to also obtain a final audit of the pool's financial statements upon liquidation of the pool and distribute them to pool investors promptly after the completion of such audit.

(e) The SEC has provided guidance regarding compliance polices and procedures to be considered as controls over the safekeeping of client assets. These include:

- background and credit checks on employees with access to client assets;
- dual authorization for: (i) moving assets within a client account; (ii) withdrawing assets from a client account; or (iii) changing account ownership information;
- limiting employee contact with custodians and, where the adviser serves as the qualified custodian, segregating the duties of advisory personnel from custodial personnel;
- establishing the basis for reasonable belief that qualified custodians send account statements to clients on at least a quarterly basis;
- ensuring that the adviser remain "operationally independent" from related persons acting as qualified custodians; and
- testing the adviser's controls over the safekeeping of client assets on a periodic basis, including comparing adviser prepared account statements with those prepared by the custodian, testing the computation of advisory fees deducted from client accounts and monitoring client addresses.

(f) Advisers shall be required to maintain: (i) a copy of the internal control report that such adviser is required to obtain or receive from its related person; and (ii) the memorandum describing the basis upon which the adviser determined that the presumption that any related person is not operationally independent has been overcome for a period of five years from the end of the fiscal year in which such items were finalized.

**Notes:**

1 Investment Advisers Act Release No. 2968 (December 30, 2009).

2 The term "qualified custodian" is defined in Rule 206(4)-2(a)(1) and generally includes the types of financial institutions to which clients and advisers customarily turn for custodial services, such as banks, registered broker-dealers, and registered futures commission merchants.

3 The SEC anticipates that IARD will be able to accept Form ADV-E filings electronically in late 2010. In the meantime, advisers shall continue with paper filings of the form to the SEC.

4 Nor are such advisers required to have a reasonable belief that a qualified custodian is delivering account statements directly to investors, no doubt a recognition of the lack of privity between custodians and pool participants. The SEC has directed its staff to investigate ways in which such investors may obtain additional protections.

5 Although related persons that are "operationally independent" are exempt from the surprise audit requirement, they remain subject to the annual internal control report requirement.

6 Investment Advisers Act Release No. 2969 (December 30, 2009).

We are available to provide counsel and guidance concerning similar Securities Law issues, as well as others not discussed in this Alert. Please contact us or visit our Securities Practice description on our Website.


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