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Amendments to Custody Rule for SEC Registered Investment Advisers

On December 30, 2009, the SEC published the adopting release and text of new amendments to Rule 206(4)-2 (the "Custody Rule" and, as amended, the "Amended Custody Rule") and related forms and rules (including recordkeeping rules) under the Investment Advisers Act of 1940. Originally proposed in May 2009, the new amendments will be ***effective on March 12****, 2010.*

Some highlights of the Amended Custody Rule:

- Annual surprise examination required of all advisers deemed to have custody; exceptions apply
- No surprise examination requirement for private fund advisers whose funds are audited annually
- Fund audits must be conducted by independent accountants registered with the Public Company Accounting Oversight Board ("PCAOB")
- Fund audit is required upon fund's liquidation
- Fund advisers managing separate accounts are subject to surprise examinations with respect to separate account assets
- No surprise examination requirement for advisers that have custody solely for deducting advisory fees from client accounts
- Advisers that do **not** have custody but whose affiliates do will be subject to the surprise examination requirements unless they can establish "operational independence" from the affiliate that has custody
- Advisers that do not maintain custody with an independent qualified custodian must obtain from their affiliated custodian an annual internal control report (SAS 70) prepared by a PCAOB-registered accountant
- Advisers with custody must make "due inquiry" to ascertain the custodian delivers quarterly reports, regardless whether the adviser is subject to surprise examinations or sends quarterly reports

- Privately offered securities must be covered by the surprise examination

The Current Custody Rule

The current Custody Rule requires SEC registered investment advisers ("advisers") that have custody of client funds or securities to maintain those assets (with some exceptions) with a "qualified custodian"[1] which, in the adviser's reasonable belief, sends quarterly account statements to each client. In addition to having physical custody of cash or securities, an adviser that maintains custody of client assets with a qualified custodian is nevertheless deemed to have "custody" of those client assets if it has authority to (i) obtain possession of client funds or securities (such as advisers operating pursuant to a general power of attorney and/or as the general partner of an investment limited partnership) or (ii) deduct advisory fees from a client's account.

The following is a summary of the key changes to the Custody Rule and their effect on different types of advisers.

The Amended Custody Rule

Subject to notable exceptions, the Amended Custody Rule requires registered advisers deemed to have custody of clients assets to undergo an annual surprise examination by an independent accountant, which must notify the SEC within one business day of any "material discrepancies" uncovered during the examination. The independent accountant must also file with the SEC within 120 days of the surprise examination a certificate on Form ADV-E, and other information under certain circumstances (including its resignation or termination). Following is a discussion regarding the key exceptions from the surprise examination requirement and further detail about the Amended Custody Rule.

Hedge Fund and Other Private Fund Advisers

Under the current Custody Rule, advisers to private funds (i.e., investment limited partnerships and other pooled investment vehicles exempt from registration under the Investment Company Act of 1940, such as, for example, hedge funds) will satisfy the Custody Rule's requirements (i) by having a reasonable belief that the fund's qualified custodian sends quarterly account statement to investors; (ii) if they provide quarterly account statements to investors **and** undergo an annual surprise examination ("surprise exam route"); or (iii) if the funds they manage provide annual fund financial statements audited in accordance with GAAP to all fund investors within 120 days of the fund's fiscal year-end ("audit route"). Private fund advisers overwhelmingly choose the "audit route."

Fund Audit Route. Contrary to the original rule proposal, the final rule does **not** require the annual surprise examinations of advisers to private funds that provide audited financial statements in accordance with the Amended Custody Rule. However, the Amended Custody Rule requires that audited financial statements for a fund be provided by an independent accountant that is registered with and subject to regular inspection by the PCAOB, and that audit results be released to fund investors. In the case of funds whose sole investors are other funds or special purpose vehicles sponsored by the same adviser, the financial statements must be sent to the ultimate beneficial owners of the investor-funds. In addition, the Amended Custody Rule requires an audit of fund assets upon a fund's liquidation.

[1] "Qualified custodian" generally includes banks, certain broker-dealers, futures commission merchants and certain foreign financial institutions.

Separate Accounts. If a fund manager manages assets "outside" its pooled vehicles pursuant to a general power of attorney, such as a fully discretionary separately managed account, the manager must undergo a surprise examination with respect to the assets of any such account.

Adviser's Surprise Exam Route. An adviser to a private fund that does not distribute annual audited financials to fund investors must undergo an annual surprise examination **and** must reasonably believe after "due inquiry" that the fund's qualified custodian sends account statements to the investors. If an adviser chooses to send its own statements in addition to the custodian's, it must include a legend in each statement urging clients to compare account statements they receive from the custodian with those from the adviser.

If a private fund's custodian is the fund adviser's affiliate (such as an affiliated broker-dealer), the adviser will be subject to the "internal control report" requirement described under the section regarding affiliate custody below (but not the surprise examination if the fund receives annual audits).

Advisers with Authority to Deduct Fees

Another significant exception to the annual surprise examination requirement (and change from the original proposal) is that an adviser that (i) has custody of client assets **solely** based on its authority to deduct advisory fees directly from client accounts and (ii) maintains custody of client assets with an unaffiliated "qualified custodian" will **not** be deemed to have custody. Accordingly, these advisers will not be subject to a surprise examination. However, the surprise examination requirement applies if these advisers have custody for any other reasons (such as, for example, if they serve as trustees to client trust assets). Further, advisers with fee deducting authority are required under the Amended Custody Rule to implement appropriate compliance controls related to the accuracy of fee deduction calculations.

Advisers That Self- Custody or Maintain Custody with Affiliated Qualified Custodians

An adviser that maintains custody of client assets itself must, in addition to being subject to a surprise examination, obtain a written report and opinion from a PCAOB-registered independent accountant with respect to the adviser's internal controls relating to custody.

An adviser that is deemed to have custody **solely** as a result of its "related person" (affiliate) maintaining custody of client assets (either as a qualified custodian or by having authority to obtain possession) must generally be subject to an annual surprise examination by an independent accountant. However, advisers that are operationally independent from their affiliate that has custody will be exempt from the surprise examination requirement.

The Amended Custody Rule's presumption is that an adviser is **not** operationally independent from its custodian affiliate. Therefore, the adviser itself will be treated as if it were the custodian of its clients' assets. An adviser may rebut this presumption by demonstrating (based on criteria established by the SEC) that it is sufficiently independent operationally from its affiliated custodian such that the adviser itself would not have to undergo the annual surprise examination. An adviser that is deemed to have custody for reasons other than its affiliate having custody cannot rebut the Amended Custody Rule's presumption.

All advisers whose affiliates have custody (whether or not operationally independent) will be required to obtain from the affiliate an "internal control report" (known as a 'SAS 70') at least annually regarding the affiliate's assessment of its internal controls relating to client assets, along with an opinion from an independent accountant registered with, and subject to regular inspection by, the PCAOB.

All Other Advisers

All other advisers with custody must obtain a surprise examination of client assets by an independent accountant—whether or not those assets are maintained by an independent qualified custodian. We focus on the following:

Advisers with Authority Over Client Assets Custodied by an Independent Qualified Custodian

The SEC has addressed the issue faced by smaller advisers that use an independent qualified custodian but nonetheless have authority over client assets because they (i) serve as trustees to a client trust, (ii) have a power of attorney over the client's account, or (iii) have authority to write checks on the client's account. Although these advisers are required to undergo an annual surprise examination, the SEC plans to monitor and study the impact of surprise examination costs on these advisers during the first year of the new Custody Rule's effectiveness. Depending on its findings, the SEC may revisit the issue in the future.

Other Significant Amendments

Direct Delivery of Quarterly Statements By Custodians. Advisers with custody must establish a reasonable belief based on "due inquiry" that the client's qualified custodian sends account statements to the investors. The SEC has not defined "due inquiry" – advisers will have flexibility in choosing their method of inquiry. Statements sent by the adviser alone are no longer sufficient under the Amended Custody Rule. However, if the adviser chooses to send its own statements in addition to the custodian's, those account statements must include a legend urging clients to compare account statements they receive from the custodian with those from the adviser.

Private fund advisers whose funds are audited annually are not required to make a due inquiry or have a reasonable belief regarding custodian-sent account statements. However, the SEC has noted in its release that it may revisit this issue.

Private Securities. Advisers that maintain custody of privately offered securities on behalf of clients will be subject to the surprise examination requirement, even if they have no custody of other client assets or authority to deduct fees from client accounts. However, private fund advisers with custody of private securities that otherwise conduct annual fund audits in accordance with the Custody Rule need not subject themselves to surprise examinations for the reason of maintaining custody of private securities. Further, as private securities need not be maintained by a qualified custodian, an adviser with custody of only private securities will not be subject to the internal control report and related requirements under subsection (a)(6) of the Amended Custody Rule.

Internal Controls Related to Custody. The SEC has provided guidance (in the form of multiple examples) regarding the types of policies and procedures relating to safekeeping of client assets that advisers should consider, including in their compliance manuals. Acknowledging that different controls may be appropriate for different advisers, the SEC has not suggested a single set of policies and procedures. **Please contact an attorney in the Investment Funds & Investment Management group to discuss the revised policies and procedures most appropriate for your business practices.**

Form ADV Amendments. Form ADV and ADV-E have been amended to include various custody-related items, including more detailed information regarding the adviser's custody arrangement and the service providers involved.

Recordkeeping. The recordkeeping Rule 204-2 has been amended to include requirements regarding the internal control report under the Amended Custody Rule.

SEC Reporting. Each adviser subject to surprise examinations must enter into a written agreement with an independent accountant. The agreement must require that the accountant file certain reports with the SEC, including reports regarding any findings of material discrepancies during the examination and upon the resignation or dismissal of the accountant.

Guidance for Accountants. The SEC has also issued an interpretive release updating the 1966 guidance on surprise examinations by auditors, which provides guidance regarding the internal control report required under the Amended Custody Rule.

Compliance Dates

The effective date of the Amended Custody Rule is **March 12, 2010** (the "**Effective Date**").

- **Annual Audit for Pooled Vehicles.** To be exempt from the surprise examination and certain other requirements of the Amended Custody Rule, advisers to private funds must enter into audit engagements that comply with the Amended Custody Rule for the fiscal years beginning on or after January 1, 2010.

- **Client Account Statements and Notifications.** Advisers must comply with client notification requirements pertaining to custody arrangements and have a reasonable belief that custodians send account statements to clients as of the Effective Date.

- **Surprise Examinations.**

- An adviser subject to surprise examinations as of the Effective Date must engage an independent accountant and enter into an agreement providing for the first examination to take place by December 31, 2010.

    - An adviser that becomes subject to surprise examinations after the Effective Date must enter into an agreements with an auditor providing for the first examination to take place within 6 months of becoming subject to the requirement.

    - An adviser that serves as its own qualified custodian must enter into an agreement that provides for the first surprise examination to take place no later than 6 months after it obtains the internal control report.

    - **Internal Control Reports.** Those advisers subject to the internal control report requirement must obtain or receive the report within 6 months of becoming subject to the requirement.

    - **Form ADV.** Advisers must respond to new questions in the revised Form ADV in their first annual amendment after January 1, 2011.

The SEC release is available at http://www.sec.gov/rules/final/2009/ia-2968.pdf.

For questions or additional detail on any of the above, please contact an Investment Funds & Investment Management attorney:

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