Client Advisory

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Financial Services

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# SEC Adopts Custody Rule Changes for Investment Advisers

The Securities and Exchange Commission (SEC) has issued amendments to Rule 206(4)-2, the custody rule under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), and related amendments to Form ADV Part 1 and Rule 204-2 on recordkeeping.[i]

Highly publicized losses by investors with Bernard Madoff and other advisers focused public attention on the need to strengthen requirements for safekeeping of client assets. The SEC noted in adopting these rule amendments that it has recently brought a number of enforcement actions against investment advisers involving misappropriation or misuse of such assets.

The purpose of the custody rule amendments is to impose additional controls on registered advisers that have access to client funds or securities. The primary tool for this is independent verification of the assets. The form of such verification varies depending on the nature of the adviser's access to or control over the assets.

Subject to certain significant exceptions discussed below, the custody rule will now require an adviser with custody:

- to undergo an annual surprise examination by an independent public accountant to verify client assets;
- to have a reasonable belief after due inquiry that any qualified custodian maintaining client assets sends account statements directly to advisory clients; and
- if the adviser or a related person that is not "operationally independent" of the adviser acts as "qualified custodian" of client assets, to obtain or receive from the related person, a report on internal controls relating to the custody of client assets prepared by an independent PCAOB-registered public accountant and to have its own surprise examination performed by a PCAOB-registered public accountant and that is regularly inspected by the PCAOB.

All SEC-registered investment advisers are required to comply with the enhanced custody rules. The amendments were effective March 12, 2010, except in certain cases where other compliance dates are specified.

## Current Custody Rule

Currently, Advisers Act Rule 206(4)-2 imposes certain requirements on a registered investment adviser that has "custody" of client assets, as defined in the rule. A registered investment adviser may be deemed to have custody either through physical possession or by virtue of authority to obtain client assets, such as by deducting advisory fees from

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a client account, writing checks or withdrawing funds on behalf of a client or acting in a capacity, such as general partner of a limited partnership, that gives the adviser the authority to withdraw funds or securities from the client account.

Under the rule prior to amendment, a registered investment adviser with custody of client assets was required to: (i) maintain those client assets with a qualified custodian; (ii) notify the client in writing of the qualified custodian's name and address; and (iii) send quarterly account statements to its clients identifying the amount of funds and of each security in the adviser's custody and all transactions in such assets during the period, unless the adviser had a reasonable belief that the qualified custodian was sending account statements containing such information directly to its clients at least quarterly. Advisers who sent statements themselves were also required to undergo a surprise examination each year by independent public accountants. An adviser to a pooled investment vehicle did not have to obtain an annual surprise examination or deliver quarterly account statements to investors if the vehicle was audited at least annually by an independent public accountant and distributed its audited financials to investors within 120 days of the end of the pool's fiscal year (or 180 days for a fund of funds).

## Amendments to the Custody Rule

The SEC adopted the amendments largely as proposed in May 2009,[ii] but did provide certain exceptions to address concerns raised in the comment letters.

### A. Definition of Custody

The SEC has clarified that an adviser has "custody" not only if it physically possesses client funds or securities itself or has the authority to obtain possession of them, but also if a "related person" of the adviser has such authority. A "related person" means any person directly or indirectly controlling or controlled by the adviser, and any person that is under common control with the adviser.[iii]

### B. Client Reporting

The amended rule eliminates the option for advisers to deliver account statements themselves; all account statements must be delivered directly by the custodian. The rule provides that an adviser must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement (at least quarterly) directly to each client for which it maintains custody, detailing the assets and transactions in the client's account. While the SEC has not set precise requirements for what constitutes "due inquiry," it stated that the standard would be satisfied where the qualified custodian provides the adviser with a copy of the account statement that was delivered to the client.

Notices required to be sent to clients upon the opening of an account with the qualified custodian must contain a legend urging the client to compare the account statements from the custodian with any statements provided by the adviser. If the adviser elects to send its own account statements to clients in addition to those provided by the qualified custodian, the cautionary legend must be included in subsequent account statements.

### C. Annual Surprise Examinations

Despite some controversy, the SEC adopted a requirement that registered advisers with custody of client assets undergo an annual surprise examination of those assets by an independent public accountant. As discussed more fully below, these requirements do not apply to advisers who have custody solely because they are authorized to deduct fees from client accounts. Nor is the annual surprise examination required of advisers to pooled investment vehicles that provide audited financial statements to investors or advisers who have custody solely because they use as qualified custodians related persons that are "operationally independent" of the adviser, both of which circumstances are subject to other controls discussed more fully below under "Exceptions".

Any adviser that is subject to the surprise audit requirement must enter into a written agreement with the accountant requiring it to: (i) file a certificate on Form ADV-E within 120 days of the date of the examination describing the nature and scope of the examination; (ii) notify the SEC within one business day of any finding of material discrepancies during the course of the

examination; and (iii) file Form ADV-E within four business days of its resignation or dismissal from the engagement or upon a voluntary or involuntary removal from consideration for reappointment, along with a narrative statement providing contact information and an explanation of any problems encountered that may have contributed to such termination.

Following the completion of the first round of surprise examinations, the SEC will review the impact of the surprise examination requirement on smaller advisers.

***Compliance Date.*** The first surprise examination must take place no later than December 31, 2010, or for advisers that become subject to the rule after the effective date, within six months of becoming subject to the rule. If the adviser itself (and not a related person) acts as qualified custodian, the first examination must take place no later than six months after obtaining an internal control report, as discussed below.

Exceptions. As mentioned, there are three significant exceptions to the annual surprise examination requirement:

***1. Advisers with Custody Due Solely to Fee Deduction***

An investment adviser that has custody of client assets solely because of its authority to deduct advisory fees is not required to obtain annual surprise examinations as detailed above. This is a departure from the proposed amendments, which the SEC said were made in response to comments that (i) the risk involved—deduction of a fee to which the adviser is not entitled under its advisory contract—would not be addressed in an annual examination designed to verify the existence of client assets, and (ii) such risks may be identified by the client by reviewing account statements sent directly to the client by the qualified custodian.

***2. Pooled Investment Vehicles Subject to Audit***

An investment adviser to a pooled investment vehicle that is subject to an annual financial statement audit and distributes the audited financial statements (prepared in accordance with U.S. GAAP) to the pool's investors is deemed to have satisfied the annual surprise examination requirement. The audit must be performed by an independent PCAOB-registered and inspected accountant and the financial statements must be distributed to investors within 120 days of the end of the pooled investment vehicle's fiscal year end (or 180 days for a fund of funds). In addition, if a pooled investment vehicle is liquidated, it must be audited upon liquidation and the audited financial statements distributed to all investors "promptly" after completion of the audit.

The SEC noted that, for pooled investment vehicles that deliver audited financial statements to investors, separate statements from the qualified custodian to investors are not required. The SEC has directed its staff to explore ways in which additional protections may be afforded to investors in such vehicles.

***3. Custody through "Operationally Independent" Related Person***

An investment adviser that (i) is deemed to have custody solely because a related person holds or has authority to obtain possession of clients' assets and (ii) is "operationally independent" of the related person is not required to obtain an annual surprise examination. A related person is presumed not to be "operationally independent" unless: (i) client assets in the custody of the related person are not subject to claims of the adviser's creditors; (ii) advisory personnel do not have access to client assets (or the power to control the disposition of such assets to third parties for the benefit of the adviser or its related persons) of which the related person has custody; (iii) advisory personnel and personnel of the related person who have access to client assets are not under common supervision; and (iv) advisory personnel do not hold any positions with the related person or share premises with the related person.

**D. Investment Advisers Acting as Qualified Custodians**

If an adviser or its non-operationally independent related person acts as qualified custodian, the adviser must, in addition to the annual surprise examination described above, obtain (or receive from its related person) an annual internal control report, such as a Type II SAS 70 Report, with respect to its controls over custody of client assets. The report must be

prepared by an independent PCAOB-registered and inspected accountant. In order for the internal control report to satisfy the rule's requirements, the accountant preparing the report must verify that the client funds and securities are reconciled to a custodian other than the adviser (or its related persons).

***Compliance Date.*** An adviser must obtain its first internal control report within six months of becoming subject to the requirement and, as indicated above, must have a surprise examination within six months thereafter.

**E. Other Significant Items**

1. ***Guidance for Accountants.*** In a companion release, the SEC has provided updated guidance for accountants that addresses the scope of the surprise examination and the internal control report and the relationship between them.[iv]

2. ***Delivery to Related Persons.*** The custody rule has been amended to provide that sending an account statement or distributing audited financial statements will not satisfy the requirements of the rule if all of the investors in a pooled investment vehicle to which the statements are sent are themselves pooled vehicles that are related persons of the adviser. The rule is an explicit prohibition to prevent an adviser from avoiding compliance with the rule by setting up a tier of funds to receive financial statements.

3. ***Privately Offered Securities.*** The amended custody rule no longer permits the accountant performing the annual surprise examination to forego examining certain "privately offered securities" (as defined in the rule). Advisers that maintain custody of privately offered securities on behalf of clients are subject to the surprise examination requirement described above.

4. ***Amendments to Form ADV.*** The SEC has amended Form ADV Part 1A and Schedule D to require that advisers disclose more detailed information regarding their custody practices.

In addition, advisers must report (i) the identity of and certain other information concerning the accountants that perform audits, surprise examinations, and/or internal control reviews, and (ii) the identity of any related persons such as banks and broker-dealers that act as qualified custodians.

5. ***Compliance Policies and Procedures.*** The SEC has provided guidance regarding the types of policies and procedures it believes would be prudent for an adviser to consider as controls over safekeeping of client assets. Such policies and procedures might include:

   - conducting background and credit checks on employees of the adviser with access to client assets;
   - requiring dual authorization for movement of assets within, and withdrawals and transfers from, a client's account, and changes to account ownership information;
   - limiting the number of employees permitted to interact with custodians;
   - segregating the duties of advisory personnel from those of custodial personnel (where the adviser also serves as the qualified custodian);
   - establishing a basis for the adviser's reasonable belief that qualified custodians send account statements directly to clients at least quarterly;
   - ensuring that the adviser continues to satisfy the requirements necessary to rebut the presumption that it is not "operationally independent," if applicable;
   - testing periodically the adviser's controls over safekeeping of client assets, including reconciling account statements prepared by the adviser with account statements as reported by qualified custodians and comparing client addresses on file with the qualified custodians to client addresses maintained by the adviser (looking for inconsistencies or patterns suggesting possible manipulation/concealment); and
   - reconciling advisory fees billed with assets under management as reported on account statements of the client's qualified custodian and testing fee calculations for accuracy and overall reasonableness (where the adviser has custody as a result of its authority to deduct advisory fees directly from client accounts).

The amendments to Rule 206(4)-2 are complex, have significant associated costs and should be carefully considered when structuring advisory relationships and pooled investment vehicles. Some advisers may wish to reevaluate their safekeeping arrangements for client assets to avoid or mitigate such costs.

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[i] Investment Advisers Act Release No. 2968 (December 30, 2009), http://www.sec.gov/rules/final/2009/ia-2968.pdf.

[ii] Investment Advisers Act Release No. 2876 (May 20, 2009), http://www.sec.gov/rules/proposed/2009/ia-2876.pdf.

[iii] "Control" means the power, directly or indirectly, to direct the management or policies of a person. A presumption of control exists where a person has a 25 percent or greater capital (or voting) interest in an entity.

[iv] Investment Advisers Act Release No. 2969 (December 30, 2009), http://sec.gov/rules/interp/2009/ia-2969.pdf.