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## SEC's Proposed Amendments to Custody Rule Would Require Surprise Exams and Internal Control Reports

In the wake of the Madoff scandal and numerous other enforcement actions involving misappropriation by advisers of client assets, the Securities and Exchange Commission ("SEC") has proposed new requirements for independent oversight of custody arrangements. These amendments would require:

- all registered advisers with custody of client assets to undergo an annual "surprise exam" by an independent public accountant to verify the existence of the assets; and
- all registered advisers who serve as, or whose related persons serve as, qualified custodian for client assets, to obtain, or receive from the related person, an annual Type II SAS 70 Report with respect to the controls over custody of client assets, which has been prepared by an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB").

The proposed amendments would also eliminate the option for advisers to prepare their own reports to clients and would require, instead, that they have a reasonable belief that the qualified custodian is providing clients with such reports.

The cost of the surprise audit and SAS 70 Reports would be borne by the advisers. This proposal can be expected to affect many registered hedge fund managers (and if legislation proposed by the Obama administration passes, virtually all hedge fund managers) as, by definition, they have "custody" over pools for which they serve as general partner or managing member.

A brief description of rule 206(4)-2 of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), also known as the "Custody Rule," and the proposed amendments appears below.

### THE CURRENT CUSTODY RULE

Currently, Rule 206(4)-2 imposes certain requirements on a registered investment adviser that has custody of client assets. 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 a client account, writing checks or withdrawing funds on behalf of a client or by acting in a capacity, such as general partner of a limited partnership, that gives an adviser or its supervised person the authority to withdraw funds or securities from the limited partnership's account. The Rule requires a registered investment adviser that has custody of client funds or securities to (i) maintain those client assets with a qualified custodian; (ii) send quarterly account statements to its clients; and (iii) undergo an annual surprise examination, unless the adviser has a reasonable belief that the

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qualified custodian sends account statements directly to its clients at least quarterly. In the case of an adviser to a pooled investment vehicle, the adviser does not have to obtain an annual surprise examination and deliver account statements to investors if the pooled investment vehicle is audited at least annually by an independent public accountant and distributes its audited financials to investors in the pool within 120 days of the end of the pool's fiscal year (180 days for a fund of funds) (the "Pooled Investment Vehicle Audit Requirements").

## PROPOSED AMENDMENTS TO THE CUSTODY RULE

### A. Annual Surprise Examination

#### 1. *Application to All Advisers with Custody*

The proposed amendments would 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. This is significant change from the current Custody Rule, which does not require an adviser to obtain an annual surprise examination with respect to client accounts for which the adviser has a reasonable belief that a qualified custodian provides account statements directly to clients; or in the case of an adviser to a pooled investment vehicle, that complies with the Pooled Investment Vehicle Audit Requirements.

The proposed amendments would continue to except advisers to pooled investment vehicles from the requirement to have a qualified custodian send account statements with respect to a pooled investment vehicle so long as the adviser complies with the Pooled Investment Vehicle Audit Requirements. It would not, however, except such advisers from the surprise examination requirement.<sup>1</sup>

#### 2. *Reporting to the SEC*

Under the proposed amendments, the independent public accountant conducting the surprise examination would be required to notify the SEC within one business day of finding a "material discrepancy" (a term not defined in the proposed rule), and to submit a Form ADV-E to the SEC, electronically, accompanied by a certificate within 120 days after commencement of the surprise examination.

In addition, the SEC proposes to require that the independent public accountant submit a Form ADV-E within four business days of the accountant's resignation or dismissal from, or other termination of the engagement, together with an explanation of any problems relating to the examination scope or procedure that contributed to such resignation, dismissal or other termination.

#### 3. *Privately Offered Securities*

Under the SEC proposal, privately offered securities that investment advisers hold on behalf of their clients would also be subject to the surprise examination requirement, although they still would not need to be held by a qualified custodian. Currently, privately offered securities are excluded from all aspects of the Custody Rule.

### B. Custody by Adviser or Its Related Persons

#### 1. *Custody by Related Persons*

Under the proposed amendments, a registered investment adviser would be deemed to have custody of any 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. The protection of the proposed rule would be expanded to include all clients whose funds and securities are not held by an independent custodian.

#### 2. *Internal Control Report and PCAOB Registration and Inspection*

Under the proposed amendments, if the registered investment adviser or a related person serves as the qualified custodian, the adviser would be required to obtain (or receive from the related person) once each calendar year, a written "internal control report," known as a Type II SAS 70 Report, that includes an opinion from an independent public accountant registered

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<sup>1</sup> The proposed amendments are silent on the 180-day delivery requirement for a fund of funds. We believe the omission was inadvertent and expect the issue to be raised in comments to the SEC proposal and to be addressed in any final legislation.

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with and subject to regular inspection by the PCAOB. The opinion would include a description of the adviser's or related person's controls regarding custody of client assets and of the accountant's tests of operating effectiveness of those controls. It should be noted that the proposed amendments do not require that the independent public accountant that provides the internal control report be a different accountant than the accountant that performs the surprise examination.

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

### *1. Delivery of Account Statements*

The SEC proposes to require all registered investment advisers with custody of client funds or securities to conduct "due inquiry" in order 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. An adviser could satisfy the "due inquiry" requirement if it receives from the custodian either (i) a copy of the account statement that the custodian delivers to the adviser's clients; or (ii) written confirmation that the account statements were sent to the adviser's clients. An adviser to a pooled investment vehicle that is subject to an annual audit and that distributes its financial statements to investors would remain excepted from the account statement delivery requirement with respect to assets held by the pool. The proposed amendments would eliminate the alternative, provided in the current rule, under which the adviser itself (not the custodian) can send reports directly to clients if it undergoes a surprise examination by an independent public accountant at least annually.

### *2. Notice*

The SEC proposes to require advisers to include a statement in the notice to clients upon opening a custodial account, urging clients to compare the account statements they receive from the qualified custodian with those they receive from the adviser.

## D. Liquidation Audit

Under the proposed amendments a registered investment adviser to a pooled investment vehicle that meets the Pooled Investment Vehicle Requirements would be required to conduct a final audit upon liquidation and distribute audited financial statements promptly after the pool liquidates and make final distribution payments to investors.

## E. Amendments to Form ADV

The SEC also proposes amendments to Part IA and Schedule D of Form ADV to provide more information about an adviser's custody practices. The proposed amendments would require an adviser to (i) report all related persons who are broker-dealers and to identify which, if any, serve as qualified custodians for the adviser's clients; (ii) report the amount of client assets and the number of clients for which it or its related persons have custody; and (iii) provide additional details with respect to its accountants and qualified custodians.

## REQUEST FOR COMMENTS

The SEC has requested that comments be submitted to it by July 28, 2009, with respect to, among other things, the following aspects of its proposal:

- Does it make sense to require both an internal control report and a surprise examination?
- Should all surprise examinations be conducted by independent public accountants registered with the PCAOB?
- As an alternative to the current proposal, should advisers that have custody of client assets be required to use an independent qualified custodian to maintain custody of client assets, and what would be the practical effect of such a requirement on wrap fee programs?
- Would the cost of requiring annual surprise audits or internal control reports, as described above, be unduly burdensome, in particular, for smaller advisers?

We will advise you of further developments.

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