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US SEC Proposes Significant Changes to Custody Rule for Registered Investment Advisers

On May 20, 2009, the US Securities and Exchange Commission (SEC) issued proposed amendments to Rule 206(4)-2 (Custody Rule) under the Investment Advisers Act of 1940 (Advisers Act) aimed at providing additional safeguards for client assets held by registered investment advisers (Proposed Amendments).[1] According to the SEC, the Proposed Amendments are intended to address the findings of several recent high-profile enforcement actions involving certain advisers' custody arrangements, particularly self-custody or custody of client assets with an affiliate, in which client assets were misappropriated or otherwise fraudulently handled.[2]

Proposed Amendments vs. Current Rule

The existing Custody Rule requires registered investment advisers with custody of client assets to maintain those client assets with a qualified custodian, either in separate accounts in each client's name, or in accounts containing client funds and securities in the adviser's name as agent or trustee. "Custody" is defined quite broadly; it includes, among other things, having substantive power to access client assets (directly or indirectly), serving as the general partner or managing member of a pooled investment vehicle, or merely having the authority to deduct advisory fees from client accounts. "Qualified custodian" is generally defined to include banks, certain broker-dealers, futures commission merchants, and certain foreign financial institutions.

The Proposed Amendments leave the definitions of these terms largely intact. However, other proposed changes to the Custody Rule would significantly alter the compliance-related responsibilities of advisers deemed to have custody.[3] Moreover, adoption of the amendments as proposed would dramatically increase the number of advisers subject to an annual surprise audit. In particular, if adopted as proposed, every adviser that automatically deducts its advisory fees from client accounts would be subject to an annual surprise audit.

ACCOUNT STATEMENTS AND SURPRISE AUDITS

Under the current rule, registered advisers with custody may avoid undergoing an annual surprise audit by having a reasonable basis for believing that any qualified custodian holding client assets independently sends to each such client a statement identifying each security and all funds held for that client at least quarterly. Advisers that provide advice to private investment funds, such as limited partnerships or limited liability companies (Private Funds), may avoid an annual surprise audit if each Private Fund is itself audited at least annually and if audited financial statements are delivered to investors within 120 days of the end of the Private Fund's fiscal year (or 180 days in the case of fund of funds).[4] If these conditions are not met, advisers are required to undergo an annual surprise audit by an independent public accountant to physically inspect all client assets.[5] The independent accountant must file a report on Form ADV-E with the SEC within 30 days of completing the surprise audit, unless a material discrepancy is found. Material discrepancies must be reported by the independent accountant to the SEC within one business day.

The Proposed Amendments would drastically alter this regime. First, the alternative for advisers with custody to avoid annual surprise audits would be eliminated, regardless of whether qualified custodians send reports directly to clients and regardless of whether the Private Funds they manage provide annual audited financial statements to their investors. Thus, every adviser with custody would have to undergo an annual surprise audit, even those whose

only form of custody is the automatic deduction of advisory fees.[6] However, preparation and delivery of audited financial statements for Private Funds would still satisfy their statement delivery obligation.

What is not clear is whether Private Funds that are fund of funds would still have 180 days to prepare their audited financials. Both the definition of the term "fund of funds" and the 180-day period for preparing fund of funds audited financial statements are absent from the proposed draft rule. It is also unclear whether advisers would be able to continue to rely on relief granted by the SEC staff in response to a request by the Investment Adviser Association in light of the failure to propose codification of the staff's response in the Proposed Amendments.[7] This no-action letter essentially excludes from the definition of "custody" inadvertent receipt by advisers of client assets if, among other things, the assets are forwarded to the client (or qualified custodian) within five days of receipt. If no longer applicable, advisers that inadvertently receive client assets (and do not return them to the *sender* within three days) would be subject to an annual surprise audit requirement even if they do not automatically deduct fees from client accounts or otherwise fall within the definition of "custody."

Second, a registered adviser that is not itself a qualified custodian would now be required to have a "reasonable basis" for believing that qualified custodians send quarterly account statements to clients: under the Proposed Amendments, advisers would be required to form this belief after "due inquiry."[8]

Third, the Proposed Amendments would modify the scope of the exception for privately offered securities. The current Custody Rule does not apply to securities that were: (i) acquired directly or indirectly from the issuer in transactions not involving any public offering; (ii) uncertificated, with ownership recorded only on the books of the issuer or its transfer agent; and (iii) transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.[9] The Proposed Amendments would except these securities only from the requirement to use a qualified custodian — as such, privately offered securities *would be* subject to an annual surprise audit if such securities are not held by a qualified custodian, or the adviser investing in such securities is otherwise deemed to have custody.

Fourth, the current Custody Rule requires that, upon the opening of an account with a custodian, the adviser notify clients in writing of the name and address of the custodian and indicate how the assets are being maintained. The Proposed Amendments would also require advisers to include a statement urging clients to compare the account statements they receive from the custodian with those received from the adviser (if any).[10]

ADDITIONAL PROVISIONS FOR ADVISERS NOT USING "INDEPENDENT" QUALIFIED CUSTODIANS

The Proposed Amendments would add several provisions for advisers that maintain custody of client assets themselves (e.g., a dual-registrant broker-dealer or a foreign financial institution) or maintain custody of client assets with a qualified custodian that is a "related person" of the adviser (e.g., an affiliated bank or broker-dealer).[11]

For advisers that self-custody or use a related person to custody client assets, the proposed annual surprise audit would also require that the audit be performed by an independent public accountant registered with, *and subject to regular inspection by*, the Public Company Accounting Oversight Board (PCAOB). In addition, these advisers would be required to obtain (or receive from the related person custodian), an annual written report that includes an opinion from an independent public accountant registered with, *and subject to regular inspection by*, the PCAOB, with respect to the adviser's or related person's custody controls. This report, which describes the controls and tests their operating effectiveness, is commonly referred to in the United States as a "Type II SAS 70 Report."[12]

ADDITIONAL REPORTING BY INDEPENDENT PUBLIC ACCOUNTANTS

Upon resignation, dismissal, or other termination of the accountant's engagement, or upon removing itself or being removed from consideration for being reappointed as an adviser's independent accountant for surprise custody audits or SAS 70 Reports, the accountant would be required to submit a statement to the SEC that would include the date of the termination and an explanation of any problems relating to its examination of the adviser that contributed to such termination. Any such filing would be publicly available through the Investment Adviser Public Disclosure system (IAPD).[13]

AMENDMENTS TO FORM ADV

The Proposed Amendments would also make several notable amendments to Form ADV Part 1, including requiring advisers to disclose the following information:

Affiliated Broker-Dealers. All related broker-dealers, specifically identifying any that serve as qualified custodians with respect to any of the adviser's clients' assets;

Assets Under Custody. The number of clients, and the US dollar value of client assets, over which the adviser, or a related person, has custody, and the month in which the adviser's last surprise examination commenced;

Private Fund Audit Status. With respect to Private Funds: (i) whether a qualified custodian sends account statements to investors in Private Funds it advises; (ii) whether the Private Fund's financial statements are audited; (iii) whether the adviser's clients' assets are subject to a surprise examination; and (iv) whether an independent public accountant registered with and subject to regular inspection by the PCAOB prepares an internal control report; and

Accountant Information. Any accountant that performs audits and surprise examinations, or prepares control reports (as applicable) with address and PCAOB registration and inspection status, type of engagement; and whether the accountant's report was unqualified.

Other Considerations

The Proposed Amendments seek comment on a number of issues crucial to the Custody Rule, including:

- Whether to except from the surprise audit requirement those advisers that have custody solely because of their authority to withdraw advisory fees from client accounts;
- Whether to except from the surprise audit requirement assets of Private Funds that are themselves audited annually;
- Whether to require accountants conducting surprise audits to test advisers' valuation methods, including valuations of privately offered securities; and
- Whether to require that all advisers maintain client assets with an "independent" qualified custodian.

Concluding Observations

During the SEC open meeting at which the Proposed Amendments were approved for issuance, SEC Commissioners Paredes and Casey expressed concern over the additional costs the Proposed Amendments might impose on smaller advisers, echoing concerns initially raised by Commissioner Aguilar in an earlier speech.[14] These comments seem to suggest that the SEC may be sensitive to the new burdens that the amendments would impose, and that they might be receptive to feedback detailing whether the Proposed Amendments meet the stated policy goals in a cost-effective way, or whether other alternatives should be considered.

One additional point to keep in mind is the potential for the Proposed Amendments to have a drastically increased reach in the event that any of the legislation currently percolating in Congress forces registration of advisers of Private Funds, thereby subjecting them to the requirements of the Custody Rule.[15] The public comment period closes July 28, 2009.

Endnotes

1 Investment Advisers Act Release No. 2,876 (May 20, 2009), 74 FR 25354 (May 27, 2009), available at http://www.sec.gov/rules/proposed/2009/ia-2876.pdf.

2 *See generally* Proposed Amendments at n. 11.

3 As proposed, the definition of "custody" would be modified to include an explanation that custody would result from maintaining client assets with a "related person" or authorizing such person to obtain possession of client assets. At the same time, the Proposed Amendments add the newly defined term "related person," which includes any person controlling, controlled by or under common control with the adviser. *See* Proposed Amendments, text of revised Custody Rule at 206(4)-2(c)(6).

4 Audited Private Fund financials must be prepared in accordance with US generally accepted accounting principles (GAAP). See Rule 206(4)-2(b)(3).

5 "Surprise" audits must occur without prior notice to the adviser, and may not take place on the same day each year. The independent accountant is required to (i) confirm all cash and securities held by the custodian, (ii) reconcile the adviser's client account records with all transactions since the last audit, and (iii) confirm with clients, on a test basis, funds that have been returned from accounts closed since the last audit.

6 However, the time given to the independent public accountant to file Form ADV-E with the SEC would be extended from the current 30 days to 120 days.

7 Investment Adviser Association, SEC No-Action Letter (Sept. 20, 2007), available at http://www.sec.gov/divisions/investment/noaction/2007/iaa092007.pdf.

[8] The Proposed Amendments suggest that there are many ways an adviser could satisfy this due inquiry requirement, such as, receiving written confirmation from the custodian *each quarter*, confirming that account statements have been sent to the adviser's clients.

[9] Under the current Custody Rule, Private Funds may only use this exception if audited financial statements are annually prepared and distributed to investors.

[10] We note that advisers have no obligation under the Advisers Act to deliver account statements to clients.

[11] The Proposed Amendments define "related person" as any person directly or indirectly controlling or controlled by the adviser, and any person under common control with the adviser. The Proposed Amendments would use the same definition of "control" as is currently used on Form ADV Part 1, which includes, among other things, the power to vote more than 25% of a corporation's securities or being manager of an LLC.

[12] The adviser would be required to retain this additional report under the books and records rule for a period of at least five years, and would be required to make it available to the SEC or its staff upon request.

[13] http://www.adviserinfo.sec.gov/.

[14] Luis A. Aguilar, Commissioner, SEC, SEC's Oversight of the Adviser Industry Bolsters Investor Protection, Address Before the Investment Adviser Association Annual Conference (May 7, 2009), available at http://www.sec.gov/news/speech/2009/spch050709laa.htm.

[15] *See, e.g.*, The Hedge Fund Transparency Act, S. 344, 111th Cong. (2009) (available at http://thomas.loc.gov/cgi-bin/query/z?c111:S.344:), The Private Fund Transparency Act of 2009, S. 1276, 111th Cong. (2009) (available at http://thomas.loc.gov/cgi-bin/query/z?c111:S.1276:). *See also* Mayer Brown Client Update "Proposed Law Would Require SEC Registration and Filings, and Anti-Money Laundering Procedures for Certain Private Investment Funds (and Possibly SEC Registration for their Advisers)" available at http://www.mayerbrown.com/publications/article.asp?id=6110&nid=6.

If you have questions regarding the Proposed Amendments or the Custody Rule in general, please contact the Mayer Brown attorney with whom you normally communicate or any of the attorneys below.

Michael R. Butowsky
+1 212 506 2512
mbutowsky@mayerbrown.com

Marc R. Cohen
+1 202 263 3206
mcohen@mayerbrown.com

Michele L. Gibbons
+1 212 506 2180
mgibbons@mayerbrown.com

Elizabeth M. Knoblock
+1 202 263 3263
eknoblock@mayerbrown.com

Stephanie M. Monaco
+1 202 263 3379
smonaco@mayerbrown.com

Jerome J. Roche
+1 202 263 3773
jroche@mayerbrown.com
