

January 11, 2010

SEC Adopts New Custody Rule Requirements for Registered Investment Advisers

Memorandum to Our Investment Management Clients and Friends

I. Introduction

On December 16, 2009, the Securities and Exchange Commission (the "SEC") adopted amendments to Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). [1] The Custody Rule governs a registered adviser's custody of client funds and securities ("client assets"). The SEC indicated in the Release that the amended Custody Rule (the "Amended Custody Rule") is designed to strengthen the existing custodial controls imposed by the Custody Rule and to expand the protections afforded advisory clients.

In light of the likely passage of legislation this year requiring many private fund advisers to become registered with the SEC, the Custody Rule and these new requirements will have broader application.

The effective date of the Amended Custody Rule is March 12, 2010, although certain requirements will not be phased in until later dates (see "Effective and Compliance Dates" below for additional information).

II. Amendments

A. Quarterly Account Statements and Notice to Clients

The Custody Rule currently requires SEC-registered advisers that have custody of client assets ("Advisers"), with certain limited exceptions, to maintain client assets with a "qualified custodian." The Adviser must 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 client assets. The Amended Custody Rule eliminates the alternative currently available under the Custody Rule which permits an Adviser to send quarterly account statements directly to clients provided the Adviser undergoes an annual surprise examination by an independent public accountant. The Amended Custody Rule also specifies that only after "due inquiry" will an Adviser be able to form a reasonable belief that the qualified custodian sends quarterly account statements directly to each client for which the custodian maintains assets. [2]

If an Adviser elects to send account statements directly to clients in addition to those sent by the qualified custodian, the Adviser will be required to include a legend or other

disclosure when notifying clients upon opening a custodial account, following any changes to the information required in that notification and in any subsequent quarterly account statements delivered to clients, urging clients to compare quarterly account statements they receive from the custodian with those received from the Adviser.

B. Annual Surprise Examination of Client Assets

With limited exceptions, the Amended Custody Rule will require Advisers to undergo an annual surprise examination of client assets for which the Adviser has custody. [3] Advisers subject to the annual surprise examination must enter into a written agreement meeting the requirements of the Amended Custody Rule with a qualifying public accountant to conduct the annual surprise examination. [4] The first surprise examination must take place by December 31, 2010. The following Advisers are not subject to the surprise examination requirement:

- An Adviser (or related person of the Adviser) ("Private Fund Adviser") that serves as the general partner or managing member to a private investment vehicle (a "Pooled Vehicle"), if such Pooled Vehicle is subject to an annual audit in accordance with the Amended Custody Rule, because the audit will be deemed to have satisfied the annual surprise examination requirement. [5]
- An Adviser that has custody of client assets solely as a consequence of its authority to deduct advisory fees from client accounts.
- An Adviser that is deemed to have custody solely as a result of certain of its related persons holding client assets and that is "operationally independent" of the affiliated custodian. [6]

The Amended Custody Rule will require that a surprise examination include privately offered securities that were previously excluded from the annual verification of client assets. [7]

C. Private Fund Advisers

A Private Fund Adviser to a Pooled Vehicle that meets the annual audit provision remains exempt from the account statement delivery requirement with respect to assets held by the Pooled Vehicle. However, the Amended Custody Rule will affect Private Fund Advisers with custody in the following manner:

- A Private Fund Adviser to a Pooled Vehicle will be deemed to have satisfied the annual surprise examination requirement through the annual audit only if the annual audit is conducted by an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (the "PCAOB").
- The Amended Custody Rule will require that if a Private Fund Adviser is relying on the annual audit provision, the Pooled Vehicle must obtain a final audit and promptly distribute audited financial statements to investors in the Pooled Vehicle, if the Pooled Vehicle liquidates at a time other than the end of its fiscal year.
- Sending quarterly account statements or annual audited financial statements will not meet the requirements of the Amended Custody Rule, if all of the investors in the Pooled Vehicle are themselves Pooled Vehicles that are related persons of the Adviser (an "SPV").

The Adviser must either (i) comply separately with the Amended Custody Rule with respect to the SPV, or (ii) treat the SPVs' assets as assets of the Pooled Vehicles of which it has custody indirectly and include such assets in the scope of its compliance with the Amended Custody Rule. [8]

D. Internal Control Reports

If an Adviser or a related person, rather than an independent custodian, serves as the qualified custodian of client assets in connection with advisory services provided by the Adviser, the Amended Custody Rule will require that, in addition to the surprise examination, the Adviser obtain, or receive from its related person, a written internal control report (the "ICR"), such as a Type II SAS 70 report, at least annually from an independent public accountant registered with and regularly inspected by the PCAOB. The ICR must demonstrate that the Adviser, or its related person, has established appropriate custodial controls. The Adviser must maintain the ICR in its records and make it available to the SEC staff upon request.

E. Compliance Policies and Procedures

Compliance with Rule 206(4)-7 under the Advisers Act requires registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules. The Release provides guidance on the types of policies and procedures relating to safekeeping of client assets that an Adviser should consider including in its compliance program in light of the Amended Custody Rule.

F. Enhanced Form ADV Disclosure

The SEC also adopted amendments to Parts 1A and Schedule D of Form ADV to require an Adviser to provide the SEC with detailed information regarding its financial industry affiliations and custodial practices, including information regarding the audits and financial statements of Pooled Vehicles. Advisers must provide responses to the revised Form ADV in their first annual amendment after January 1, 2011.

III. Effective and Compliance Dates

The effective date of the Amended Custody Rule is March 12, 2010. An Adviser's first surprise examination must take place by December 31, 2010 or with respect to Advisers that become subject to the rule after the effective date, within six months of becoming subject to the requirement. An Adviser required to obtain or receive an ICR because it or a related person maintains client assets as a qualified custodian must obtain or receive an internal control report within six months of becoming subject to the requirement. If an Adviser itself maintains client assets as a qualified custodian, the first surprise examination must take place within six months of obtaining the first ICR.

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If you have any questions concerning the Amended Custody Rule, please contact an attorney in the Investment Management Group at Seward & Kissel.

[1] *Custody of Funds or Securities of Clients by Investment Advisers*, Advisers Act Release No. 2968 (December 30, 2009) (the "Release"). The SEC proposed amendments to the Custody Rule on May 14, 2009. *Custody of Funds or Securities of Clients by Investment Advisers*, Advisers Act Release No. 2876 (May 20, 2009). In addition to the Release, the SEC also provided guidance for accountants in a companion release published on December 30, 2009. *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*, Advisers Act Release No. 2969 (December 30, 2009). The SEC also adopted amendments to Rule 204-2 and Form ADV to conform those items to the Amended Custody Rule.

[2] The SEC did not establish one manner in which Advisers would be required to develop a reasonable basis or standard for "due inquiry". The Release provides examples of due inquiry, including obtaining a copy of the account statement delivered by the qualified custodian to the Adviser's clients.

[3] The Custody Rule currently defines "custody" as holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. The Amended Custody Rule will clarify this definition to provide that an Adviser has 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. A "related person" is defined as a person directly or indirectly controlling, controlled by or under common control with the Adviser.

[4] Among other things, the independent public accountant conducting the surprise examination will be required by the written agreement with the Adviser to submit Form ADV-E with a certificate, describing the nature and extent of the examination, within 120 days of the time chosen by the accountant for the surprise examination and to notify the SEC within one business day of finding any "material discrepancy" during the course of the examination. In addition, the independent public accountant will be required by the written agreement to submit Form ADV-E and a "termination statement" to the SEC within four business days of its resignation, dismissal from or other termination of its engagement with the Adviser. This information will be filed electronically and as a result the information will be available to the public.

[5] A condition of the annual audit provision is that the audited financial statements be distributed within 120 days of the end of the Pooled Vehicle's fiscal year. We note that the Amended Custody Rule will not contain a reference to the expanded audit delivery time period from 120 days to 180 days for fund of funds. Accordingly, an Adviser to a fund of funds will be relying on the SEC staff's guidance that permitted the 180 day expanded time period.

[6] A related person is presumed not to be "operationally independent" unless each of the following conditions is met: (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 custody or possession of, or direct or indirect access to client assets of which the related person has custody, or the power to control the disposition of such client assets to third parties for the benefit of the Adviser or its related persons, or otherwise have the opportunity to misappropriate such client assets; (iii) advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision; and (iv) advisory personnel do not hold any position with the related person or share premises with the related person.

[7] The SEC determined that an Adviser may maintain custody of privately offered securities without being subject to the ICR (as defined herein) requirement unless the Adviser holding the privately offered securities also has custody of other client funds or securities as qualified custodian, in which case the Adviser is subject to the ICR requirements.

[8] Advisers who comply separately with respect to the SPV will be required to distribute the audited financial statements or account statements of the SPV to the beneficial owners of the pooled investment vehicles.