SEWARD & KISSEL LLP

October 3, 2003

Memorandum to Our Registered Investment Adviser Clients

Amendment to the Custody Rule

On September 25, 2003, the Securities and Exchange Commission (the "SEC") issued final amendments to rule 206(4)-2 (the "Rule") under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). The amendments are designed to modernize the Rule by conforming it to current custodial practices and clarify the circumstances under which a registered investment adviser ("Adviser") has custody of client assets. The Rule has changed some long standing SEC positions on "constructive custody". Under the Rule, an Adviser who, directly or through an affiliate, acts as the general partner or managing member to a limited partnership or other comparable pooled investment vehicle ("Pool"), or who deducts fees directly from a client's assets, will have custody. The Rule specifies that it would be a fraudulent, deceptive, or manipulative act, practice or course of business for an Adviser to have custody unless: (i) client assets are maintained with a "qualified custodian"; (ii) statements are sent to the client by either the Adviser or a "qualified custodian" at least quarterly; and (iii) the client is notified of the custodial arrangements, including the identity of the "qualified custodian". Quarterly statements will not be required for a client that is a Pool, provided that the Pool undergoes an annual audit (see section III(A) below).

I. Custody

The Rule defines "custody" as "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them."[1] This includes circumstances in which an Adviser's sole access to a client's assets is through fee deductions. The Rule has also clarified that if an Adviser or its affiliate serves as both the general partner and Adviser to a limited partnership, the Adviser has "custody" of the partnership's assets. In addition, if an Adviser or affiliate acts as trustee to a client's trust, the Adviser has "custody".[2]

Inadvertent receipt by an Adviser of a client's assets does not constitute custody, provided that the Adviser returns the assets to the client within three business days. Receipt by an Adviser of a check drawn on a client's account is not deemed to be custody, provided that the check is not made payable to the Adviser.

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1 The SEC has clarified that authority to trade is not considered custody.

2 The release states, however, that if a supervised person of an Adviser engages an advisory firm to advise an estate, conservatorship or personal trust for which the supervised person serves as executor, conservator or trustee, the Adviser would not be deemed to have custody solely because the supervised person had been appointed in these capacities as a result of a personal or family relationship with the decedent and not as a result of employment with the Adviser.

II. Requirements of the Rule

A. Client's assets must be maintained with a Qualified Custodian. Under the Rule, client assets must be maintained with a qualified custodian ("Qualified Custodian") which includes banks, registered broker-dealers, registered futures commissions merchants and foreign financial institutions.[3] Client assets must be held in an account under the client's name or under the Adviser's name as agent or trustee for its client. Shares of mutual funds may be held by the mutual fund's transfer agent. An Adviser with custody that is also a Qualified Custodian may maintain client assets provided that it complies with the account statement requirements discussed below, as well as any requirements which arise due to its registration as an Adviser.

B. Notice to Clients. An Adviser with custody who opens an account with a Qualified Custodian on behalf of its client is required to promptly notify the client in writing of the Qualified Custodian's name, address and manner in which the assets are maintained. Clients should be notified of changes in this information.

C. Quarterly Account Statements. The Rule requires that clients receive an account statement at least quarterly from either the Adviser with custody or the Qualified Custodian (the "Account Statement").[4] The Account Statement must state: (i) the amount of funds; (ii) each security in custody at the end of such quarter; and (iii) all transactions for the quarter, including fees deducted. The Account Statement is not required, however, to disclose the market value of the securities.

1. Qualified Custodian sends the Account Statement. If the Account Statement requirement is satisfied by the Qualified Custodian, the Adviser must have a reasonable belief that the Qualified Custodian has complied with the Rule. The Qualified Custodian is permitted to use a service provider to deliver the Account Statements provided that they are not sent through the Adviser.

2. The Adviser sends the Account Statement. If the Adviser elects to send the Account Statement to its clients, the Adviser is subject to a surprise annual audit by an independent public accountant.[5] If the Adviser is sending the Account Statement to a client that is a Pool, the Account Statement must be sent to each limited partner (or other comparable underlying owner). If a Qualified Custodian delivers the Account Statement to some, but not all of the Adviser's clients, the surprise audit of the Adviser need only verify the assets of the clients that do not receive Account Statements from the Qualified Custodian.

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[3] See §275.206(4)-2(c) of the Advisers Act for a complete list of "qualified custodians". Foreign financial institutions must keep the clients' funds and securities segregated from their own proprietary assets.

[4] A client may designate another party to receive the quarterly Account Statements. The Rule refers to such persons as "Independent Representatives". An Independent Representative is a person that (a) acts as agent for an advisory client and by law or contract is obligated to act in the best interest of the advisory client; (b) does not control, is not controlled by, and is not under common control with the Adviser; and (c) does not, and has not had within the past two years a material business relationship with the Adviser.

[5] The audit of the Adviser is required to be conducted by an independent public accountant on a date chosen by the accountant with no prior notice to the Adviser. Furthermore, the independent public accountant is required to (a) file a certificate on Form ADV-E within 30 days of completing the audit and (b) notify the SEC's Office of Compliance Inspections and Examinations within one business day of finding any material discrepancies.

III. <u>Exceptions</u>[6]

A. <u>Pools Subject to Annual Audits</u>. With respect to a Pool, an Adviser with custody is exempt from the Account Statement delivery requirement provided that: (i) the Pool is subject to an annual audit;[7] (ii) the audited financial statements are prepared in accordance with U.S. generally accepted accounting principles ("GAAP")[8]; and (iii) the audited financial statements are distributed to all underlying owners of the Pool within 120 days of the end of the Pool's fiscal year.

B. <u>Privately Offered Securities</u>. An Adviser with custody is exempt from all provisions of the Rule with respect to a client's privately offered securities, if: (i) the securities were not acquired through a public offering; (ii) ownership of the securities is recorded only on the books of the issuer or the transfer agent; (iii) ownership is in the name of the client; and (iv) transfer of ownership is subject to the prior consent of the issuer or the holders of the issuer's outstanding securities. In addition, in order for the Adviser to rely on this exemption, the Pool must have annual audited financial statements delivered to its investors as described above.

IV. Amendment to Form ADV

Item 9 of Part 1A of Form ADV requires an Adviser to specify whether it has custody of its client's assets. This item may need to be amended to reflect the application of the Rule. For example, Advisers to Pools that have elected to rely on procedures set forth in a series of SEC no-action letters (the "PIMs Procedures") will be required to indicate that they have custody of client assets. All of the SEC no action letters addressing PIMs Procedures will be withdrawn on the effective date of the Rule. In addition, the new instructions to Item 9 of Part 1A of Form ADV will specify that an Adviser with custody solely because it deducts fees from its client accounts may answer "No" to Item 9.[9] The SEC expects that it will take several months before the instructions to Form ADV are revised. In the interim, an Adviser with custody solely because it deducts fees should check "No". Finally, an Adviser with custody is no longer required to include an audited balance sheet in Part II of its Form ADV. Amendments to Item 9 are required to be filed promptly.

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6 Advisers to investment companies registered under the Investment Company Act of 1940, as amended, are exempt from complying with the Rule with respect to such companies because registered investment companies are subject to the custody rules set forth under section 17(f) of the Investment Company Act.

7 Although the Rule does not specify, the release suggests that a partnership can become obligated to undergo an annual audit by: (a) including the requirement in the partnership agreement; (b) executing an engagement letter with an independent public accountant; or (c) using its disclosure statement (i.e., the partnership's private placement memorandum) to commit to its investors that an audit will be performed annually.

8 With respect to pools that are organized outside of the United States, the financial statements can be prepared in accordance with International Accounting Standards or a similar comprehensive body of accounting standards, provided that the financial statements contain a footnote reconciling any material variations between the accounting standard used and GAAP.

9 The revised instruction pertains only to federally registered investment advisers and does not affect advisers registering with any state.

V. Effective Date

The effective date of the Rule is November 5, 2003. Advisers must be in compliance by April 1, 2004. Advisers may choose to comply with the Rule as of the effective date.

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

Seward & Kissel LLP