

May 27, 2009

Memorandum to Our Registered Investment Adviser Clients and Friends

**SEC Proposes New Custody Rule Requirements for
Registered Investment Advisers**

I. Introduction

On May 20, 2009, the Securities and Exchange Commission (the “SEC”) issued proposed amendments (the “Proposed Amendments”) to Rule 206(4)-2 (the “Custody Rule”) under the Investment Advisers Act of 1940, as amended (the “Advisers Act”), in response to the recent enforcement actions brought against investment advisers and broker-dealers alleging fraudulent conduct.¹ The Proposed Amendments would significantly affect registered investment advisers with custody, including those advisers that serve as the general partner or managing member to a limited partnership or other comparable Hedge Fund investment vehicle (“Hedge Fund Advisers”), as follows:

- All advisers with custody would be required to undergo an annual “surprise examination” by an independent public accountant.² For a Hedge Fund Adviser, this requirement would apply regardless of whether the pooled investment vehicle it manages undergoes an annual audit and distributes audited financial statements to its underlying investors.
- Privately offered securities that a Hedge Fund Adviser or its related person holds on behalf of the Hedge Fund Adviser’s clients would be subject to the surprise examination requirement and possibly a more exhaustive internal control report (the “ICR”) as discussed below.
- Hedge Fund Advisers would be subject to enhanced disclosure regarding their custodial arrangements on Form ADV.

¹ *Custody of Funds or Securities of Clients by Investment Advisers*, Advisers Act Release No. 2876 (May 20, 2009).

² The Custody Rule defines “custody” as holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. The Proposed Amendments would 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.

II. Proposed Amendments

A. Annual Surprise Examination of Client Assets

The Proposed Amendments would require all advisers with custody of client assets (including Hedge Fund Advisers and those advisers that debit fees from client accounts or act as a trustee to a client's trust) to enter into a written agreement with an independent public accountant to conduct an annual "surprise examination" of client assets.³ The surprise examination would be mandatory regardless of whether a qualified custodian provides account statements directly to clients or, with respect to pooled investment vehicles, the pool undergoes an annual audit and distributes audited financial statements to its underlying investors.⁴ The SEC believes that an independent public accountant may identify misuse of assets that may go unnoticed by clients, resulting in earlier detection of fraud and a reduction in client losses.

The independent public accountant conducting the surprise examination would be required by the written agreement with the adviser to notify the SEC within one business day of finding any "material discrepancies" during the examination and to electronically 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. In addition, the independent public accountant would 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.⁵

Although privately offered securities that advisers hold on behalf of their clients are not currently subject to any provisions of the Custody Rule, in furtherance of the goals of the Custody Rule, the Proposed Amendments would subject privately offered securities to the surprise examination requirement.⁶

³ Under the Proposed Amendments, an "independent public accountant" is one that meets the independence standards described in Rule 2-01(b) and (c) of Regulation S-X.

⁴ In addition to the surprise examination, if the adviser or its 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 Proposed Amendments would require the adviser to obtain, or receive from its related person, a written ICR at least annually from an independent public accountant registered with and regularly inspected by the Public Company Accounting Oversight Board (the "PCAOB"). The ICR would include the PCAOB-registered accountant's opinion with respect to controls relating to custodial services, tests of operating effectiveness and the general control framework.

⁵ Under the Proposed Amendments, the "termination statement" would include: (i) the date of resignation, dismissal, or other termination; (ii) the name, address and other contact information of the independent public accountant; and (iii) an explanation of any problems relating to the scope of the examination or procedures that contributed to such resignation, dismissal or other termination.

⁶ The Custody Rules defines "privately offered securities" as securities: (i) that are acquired from the issuer in a transaction not involving any public offering; (ii) whose ownership is recorded only on the books of the issuer or the transfer agent; and (iii) that are transferable only with the

B. Account Statements and Notice to Clients

Pursuant to the Proposed Amendments, a Hedge Fund Adviser whose pooled investment vehicle is subject to an annual audit and that distributes its financial statements to the pool's underlying investors would continue to be exempt from the account statement delivery requirement with respect to assets held by the pool, i.e., that clients receive an account statement at least quarterly from either the adviser with custody or the qualified custodian. However, for those Hedge Fund Advisers whose pooled investment vehicle is not subject to an annual audit, the Proposed Amendments would eliminate the adviser's option to send account statements to clients, and would further require that the adviser must have a "reasonable basis" for believing that the qualified custodian sends a quarterly account statement directly to each client for which the custodian maintains assets.⁷ Furthermore, the Proposed Amendments would clarify that a Hedge Fund Adviser relying on such annual audit exemption to the account statement delivery requirement would be required to obtain a final audit and promptly distribute audited financial statements to investors in the pool if the pool liquidates at a time other than the end of its fiscal year.

The Proposed Amendments would also require an adviser, when notifying clients upon opening a custodial account on their behalf, to urge clients to compare account statements they receive from the custodian with those received from the adviser so as to increase clients' awareness of possible misappropriation or fraud.

C. Enhanced Form ADV Disclosure

The Proposed Amendments would amend 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 pools.

* * * * *

Comments on the Proposed Amendments may be submitted to the SEC by July 28, 2009. All comment submissions will be available for public viewing after submission. If you have any questions concerning the Proposed Amendments or are interested in commenting thereon, please contact an attorney in the Investment Management Group at Seward & Kissel.

Seward & Kissel LLP

SK 99269 0020 999124 v3

prior consent of the issuer. The Proposed Amendments imply that privately offered securities maintained by an adviser or its related person would also be subject to the ICR requirement.

⁷ Advisers must form their reasonable belief that account statements are sent to clients directly by qualified custodians after "due inquiry." "Due inquiry" would include obtaining a copy of the account statement delivered by the qualified custodian to the adviser's clients or obtaining a signed confirmation from the qualified custodian that it has sent account statements to the adviser's clients.