SEC Proposes Amendments to the Custody Rule under the Advisers Act

On May 20, 2009, expressly in response to several recent instances of alleged misappropriation of client assets, including the Madoff and Stanford International matters, the Securities and Exchange Commission (SEC) published proposed amendments to Rule 206(4)-2, often referred to as the "custody rule," under the Advisers Act. The SEC's proposed amendments to the custody rule would, among other things: (i) require all registered investment advisers with custody of client assets to undergo an annual "surprise" examination; (ii) where a registered investment adviser or related person serves as qualified custodian of client assets, require the adviser to obtain a written report on custody controls from an independent public accountant at least yearly; and (iii) subject to exemption with respect to certain pooled investment vehicles, require a registered investment adviser with custody of client assets to have a reasonable basis for believing that a qualified custodian sends an accounting statement, at least quarterly, to each client for which it maintains such assets.

A summary of the custody rule and the SEC's proposed amendments appears below.

The Custody Rule

Investment advisers registered under the Advisers Act that have custody of client securities or funds are subject to the custody rule. For purposes of the rule, "custody" means holding, directly or indirectly, client securities or funds, or having any authority to obtain possession of them. Custody of client funds or securities includes possession of client securities or funds, arrangements authorizing the adviser to withdraw client securities or funds, or legal capacity that provides ownership or access to client funds or securities, such as serving as the general partner of an investment fund organized as a limited partnership. The custody rule generally requires registered advisers to maintain client funds or securities with a "qualified custodian" (such as a bank, registered broker-dealer or registered futures commission merchant), and mandates certain reporting to clients and the SEC. Advisers to registered investment companies are not required to comply with the custody rule.

Surprise Examination

The SEC's proposed amendments would require all registered investment advisers with custody of client assets to engage an independent public accountant to conduct an annual surprise examination of client assets. Under the current custody rule, registered investment advisers are not subject to a surprise examination if a qualified custodian provides account statements directly to clients, or with respect to pooled investment vehicles, the pool is audited at least annually and distributes its financial statements to its investors within 120 days (or 180 days for funds of funds) of the end of its fiscal year. However, the proposed amendments would eliminate these exceptions. Independent public accountants conducting examinations would be required to notify the SEC immediately of material discrepancies and to submit a Form ADV-E electronically reporting on the examination within 120 days after commencement of the examination.

The proposed amendments would also subject certain privately offered securities (such as hedge fund and private equity fund interests) held by an adviser on behalf of clients to the annual surprise examination, although advisers would not be required

to maintain such interests with a qualified custodian. The existing custody rule exempts privately offered securities from all aspects of the rule.

Advisers or Related Persons Serving as Qualified Custodians

The proposed amendments would apply two special rules to any registered investment adviser where the adviser or a related person of the adviser, rather than an independent party, serves as qualified custodian of client assets. First, the proposal would require such an adviser to retain an independent public accountant registered with, and subject to inspection by, the Public Company Accounting Oversight Board (PCAOB) to conduct the annual surprise examination of client assets described above. Second, the proposal would require such an adviser to obtain, or receive from its related person, at least once per year, a written report with respect to the adviser's or related person's controls relating to the custody of client assets. The written control report would be required to include an opinion from an independent public accountant registered with and subject to inspection by PCAOB, and the adviser would be required to keep a copy of the report for five years from the end of the fiscal year in which the report was finalized. Under the proposed rules, a "related person" includes a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser. Related persons would have custody under the rule if client assets were held in connection with advisory services provided by the adviser.

In the proposed rule release, the SEC also solicited comments on a more radical proposal: that the custody rule be amended to require an independent qualified custodian to hold all client assets. This alternative is not a part of the proposed rule, and the SEC acknowledged in the release that adopting such a requirement could have a significant impact on existing arrangements that combine advisory and brokerage services.

Delivery of Account Statements

The SEC proposal would also require registered investment advisers with custody of client assets to have a reasonable basis for believing that a qualified custodian sends an account statement, at least quarterly, to each client for which the custodian maintains assets. Under the proposed rule, advisers relying on a qualified custodian to send statements would be required to form a reasonable belief after due inquiry that quarterly statements were being sent. An adviser to a limited partnership or other pooled investment vehicle that is subject to an annual audit and distributes financial statements to investors within 120 days of the end of its fiscal year would remain excepted from the account statement delivery requirement with respect to assets held by the pool.[1] The proposal would eliminate the current custody rule alternative, which allows an adviser to send quarterly statements directly to clients if the adviser undergoes a surprise examination.

Form ADV Amendments

In addition to the amendments to the custody rule, the SEC also proposed corresponding amendments to Part 1A and Schedule D of Form ADV, to require more detailed reporting to the SEC regarding an adviser's custody practices.

The SEC has requested comments from the public with respect to the proposed amendments. Comments must be submitted on or before June 28, 2009.

If you would like to learn more about the issues raised in this update, please contact your usual Ropes & Gray adviser.

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[1] The proposed amendment would not restore to the text of the custody rule the special 180-day delivery period for audited financial statements of funds of funds that was originally adopted as part of the hedge fund adviser registration rule and was subsequently vacated, in the SEC's view, by the D.C. Circuit Court of Appeals in *Goldstein v. SEC* (2006). However, SEC staff has confirmed by telephone that they intend the no-action relief for funds of funds set forth in the *Goldstein v. SEC* no action letter (August 10, 2006), which effectively restored the 180-day delivery period for funds of funds in the wake of *Goldstein*, to continue to apply following adoption of the proposed rule.

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