SEC Adopts Final Amendments to the Custody Rule under the Advisers Act

On December 30, 2009, the SEC released amendments to Rule 206(4)-2, often referred to as the "custody rule," under the Advisers Act. In conjunction with the adoption of the final rule, the SEC also released separate interpretive guidance for independent public accountants. Although the amendments contain many of the SEC's original proposals (for further information on the proposed rules, please see our May 29, 2009 alert), significant changes were made to the final rule. Consistent with the proposed rule, the final rule requires advisers with custody of client assets to undergo an annual surprise examination of client assets; however, under the final rule advisers to pooled investment vehicles that are subject to an annual audit are deemed to have satisfied the surprise examination requirement. In addition, the final rule provides limited exceptions from the surprise examination requirement (i) in circumstances when advisers are deemed to have custody solely as a result of related persons holding client assets, where the related person is "operationally independent" of the adviser, and (ii) for advisers that are deemed to have custody of client assets solely because of their ability to deduct advisory fees from client accounts.

A brief summary of portions of the final rule and related guidance from the SEC is provided below. The text of the final rule, as adopted, may be found at the SEC's website at this link. The separate interpretative guidance for independent public accountants may be found at the SEC's website at the following link.

A. Definition of Custody

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 funds or securities, or having any authority to obtain possession of them. The final rule expands the definition of custody under the current rule to provide that an adviser has custody if a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with the advisory services provided by the adviser to a client. Custody of client funds or securities includes: (i) possession of client securities or funds, (ii) arrangements authorizing an adviser to withdraw client securities or funds, or (iii) serving in a 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 advisers with custody of client assets 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 are not required to comply with the custody rule with respect to assets of registered investment companies.

B. Surprise Examination

The final rule requires registered advisers with custody of client assets to engage an independent public accountant to conduct an annual surprise examination of client assets, subject to exceptions for certain advisers described below. Advisers subject to the surprise examination must enter into a written agreement with an independent public accountant to conduct the examination. Such agreement, among other things, must require the accountant to notify the SEC within one business day of finding any material discrepancy during the course of an examination and to submit a Form ADV-E within 120 days of the surprise

examination. Form ADV-E must be filed electronically with the SEC through the Investment Adviser Registration Depository once the system begins accepting electronic filings in late 2010.

Unlike the proposed amendments, the final rule provides several limited exceptions to the surprise examination requirement (note that advisers that qualify for the exceptions below are still subject to other requirements under the rule). First, advisers to pooled investment vehicles that are subject to an annual financial statement audit by an independent public accountant are deemed to have satisfied the surprise examination requirement if the annual financial statements are prepared in accordance with generally accepted accounting principles and are distributed to investors in the pool within 120 days (or 180 days for funds of funds) of the end of the fiscal year.[1] An audit only satisfies the surprise examination requirement if the audit is performed by an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (PCAOB).

Second, an adviser that is deemed to have custody of client assets solely because a related person holds client assets in connection with the advisory services the adviser provides to clients is exempt from the surprise examination requirement if the adviser is "operationally independent" from such related person. Under the final rule, a related person is presumed not to be operationally independent unless: (i) client assets in the custody of a related person are not subject to the 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 person, or otherwise have the opportunity to misappropriate client assets; (iii) advisory personnel and personnel of the related person who have access to client assets are not under common supervision; and (iv) advisory personnel do not hold any position or share premises with the related person. An adviser that is able to satisfy these conditions and overcome the presumption that it is not operationally independent of its related person is not required to obtain a surprise examination but would be required to comply with the other provisions of the custody rule. Advisers that have custody for reasons in addition to, or other than, as a result of a related person having custody cannot rebut the presumption of non-independence contained in the final rule. Advisers whose client assets are held by a related person but do not undergo a surprise examination are required to keep a memorandum describing the relationship with the related person and an explanation of the adviser's basis for determining that it has overcome the presumption that it is not operationally independent.

Lastly, advisers deemed to have custody of client assets solely because of their ability to deduct fees from client accounts are not subject to the surprise examination requirement. The SEC concluded that the risk of client loss resulting from overcharging advisory fees in these circumstances did not warrant the cost associated with a surprise examination.

Unless an adviser qualifies for one of the exceptions described above, the final rule (consistent with the proposed rule) subjects advisers that maintain custody of privately offered securities on behalf of clients to the surprise examination requirement. The rule release and the separate release for accountants provide guidance as to how to conduct a custody examination of privately offered securities.

C. Delivery of Account Statements

The current custody rule requires advisers that have custody of client assets, with certain exceptions, to maintain client funds with a qualified custodian, and the adviser must have a reasonable basis for believing that the custodian sends account statements at least quarterly to each client for which the custodian maintains assets. As proposed, the final rule requires an adviser to form a reasonable belief after due inquiry that its qualified custodian sends such statements. The final rule does not prescribe a single method for forming this belief, but instead provides the adviser

[1] Although the final rule purports to require delivery of audited financial statements within 120 days for all advisers to private funds that wish to avail themselves of the applicable exemptions under the custody rule, the SEC confirmed in a footnote to the final rule release that the amendments to the custody rule do not affect prior guidance of the SEC staff that effectively extends the delivery period to 180 days for funds of funds.

with the flexibility to determine how best to meet the requirement. An adviser to a pooled investment vehicle that distributes timely audited financial statements to its investors is not required to have a reasonable belief that a qualified custodian delivers account statements to investors. In addition, the final rule eliminates the current alternative under the custody rule, which allows an adviser to send quarterly statements to clients if it undergoes a surprise examination by an independent public accountant at least annually.

D. Advisers or Related Persons Serving as Qualified Custodian

As proposed, the final rule requires that if an adviser or a related person serves as a qualified custodian for client funds or securities, such adviser must obtain, or receive from its related person, an internal control report, which includes an opinion from an independent public accountant with respect to its or its related person's custodial controls relating to client assets. The independent public accountant issuing the internal control report must be registered with the PCAOB and must verify that client funds and securities are reconciled to a custodian other than the adviser or its related person.

In its proposed rule release, the SEC requested comments on whether advisers should be prohibited from advising clients whose assets are maintained with the adviser or a related person. The final rule was not amended to require the use of independent custodians because the SEC was concerned that such a requirement could make unavailable many advisory accounts popular with smaller investors (such as wrap fee accounts), but in the final rule release the SEC encouraged advisers to use independent custodians as a "best practice" whenever feasible.

E. Interpretative Guidance for Independent Public Accountants

In conjunction with the final rule, the SEC released interpretive guidance for independent public accountants conducting surprise examinations and preparing internal control reports. In order to conduct a proper surprise examination, an accountant should perform the following procedures, among others: (i) obtain records from the adviser regarding client assets of which the advisor has custody; (ii) confirm client assets with the qualified custodian and confirm that client assets are held in either a separate account under the client's name or in accounts under the name of the adviser as agent or trustee for a client; (iii) confirm with the client assets held in the account, and contributions and withdrawals of assets from the account; and (iv) reconcile confirmations received and other evidence obtained from the adviser's records. Verification procedures with respect to privately offered securities should include confirmation by the accountant with the issuer of or counterparty to the security, and where replies are not received, alternative procedures.

Under the final rule release, a Type II SAS 70 Report, or a report issued in connection with an examination of internal control conducted in accordance with the standards of the American Institute of Certified Public Accountants, are sufficient to satisfy the requirements of the internal control report. For an internal control report to meet the rule's requirements, an accountant must verify that client assets are reconciled to an unaffiliated custodian (e.g., the Depository Trust Company) either through direct confirmation or other procedures designed to verify that data used in reconciliation is obtained from unaffiliated custodians and is unaltered.

F. Guidance on Custody Policies and Procedures

Under Rule 206(4)-7, registered investment advisers are required to adopt written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules adopted thereunder. Although the final custody rule does not itself address compliance policies, in the rule release, the SEC provided extensive guidance regarding the types of policies and procedures relating to the safekeeping of client assets that advisers should consider including in their compliance programs, including among other things: (i) conducting background and credit checks on employees who have access to client assets; (ii) requiring the authorization of more than one employee prior to the movement of assets within, and withdrawals or transfers from, client accounts; (iii) limiting the number of employees who are permitted to interact with custodians with respect to client assets and rotating

such employees on a periodic basis; and (iv) segregating duties of the adviser's advisory personnel from those of its custodial personnel if an adviser serves as a qualified custodian for client assets.

Further, as custody of client assets presents elevated compliance risk, the SEC recommended that advisers consider developing procedures that periodically test their internal controls regarding the safekeeping of client assets. The SEC acknowledged that different controls may be appropriate for different advisers and encouraged advisers to tailor their custody policies and procedures to fit their size and particular business model. In light of the final rule and the SEC guidance set forth in the final rule release, registered advisers should review their existing policies on custody of client assets and update such policies as appropriate.

G. Amendments to Form ADV

The SEC also adopted amendments to Part IA and Schedule D of Form ADV in the final rule. Item 7 and Section 7.A. of Schedule D now require advisers to report all related persons who are broker-dealers and to identify which, if any, serve as qualified custodians for client assets. Under the prior rule, reporting of the names of related person broker-dealers was optional. In addition, the amendments require advisers to report certain additional information regarding custody of client assets under Item 9, add clarifying instructions to Item 9, and amend Schedule D to require an adviser to report whether it has overcome the presumption that it is not operationally independent from a related person that holds client assets.

H. Effective Date

The final rule takes effect on March 12, 2010, and advisers must comply with the amended rules on and after such date, except as stated below. Advisers required to obtain a surprise examination must enter into a written agreement with an independent public accountant that provides for such an examination to take place by December 31, 2010, or for advisers that become subject to the rule after the effective date, within six months of becoming subject to the requirement. However, if an adviser maintains client assets as qualified custodian, the agreement must provide for the first surprise examination to occur no later than six months after obtaining the internal control report. Advisers required to obtain or receive an internal control report must obtain or receive an internal control report within six months of becoming subject to the requirement. Advisers must provide responses to revised Form ADV in their first annual amendment after January 1, 2011. The adopting release provides that advisers to pooled investment vehicles may rely on the annual audit provision if the adviser or a related person becomes contractually obligated to obtain an audit for fiscal years beginning on or after January 1, 2010, by an independent public accountant registered with, and subject to regular inspection by, the PCAOB. SEC staff has confirmed to us verbally that the SEC would regard this condition as satisfied as long as each pooled investment vehicle to which the exception relates has engaged a qualified accountant by the end of 2010.

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