

SEC Proposes Amendments to the Custody Rule Under the Investment Advisers Act of 1940

Scot E. Draeger & Caleb C. B. DuBois | May 28, 2009

On May 20, 2009, the U.S. Securities and Exchange Commission (the “SEC” or “Commission”) proposed for comment amendments to Rule 206(4)-2 (the “Custody Rule”) under the Investment Advisers Act of 1940 (the “Advisers Act”). These proposed amendments are designed to provide additional safeguards when an adviser has custody of client funds or securities.

Overview:

The SEC has recently brought several enforcement actions, including the case against Bernard L. Madoff, against investment advisers and broker dealers, alleging fraudulent conduct and misappropriation of investor assets. Many of these cases involve advisers who maintained “self-custody” over client assets. As a result of the behaviors brought to light by these enforcement actions, the SEC is proposing to amend the Custody Rule in order to improve the safekeeping of client assets. The proposed amendments seek to impose a number of new examination and disclosure requirements on registered investment advisers that have custody over client funds.

Background:

Rule 206(4)-2 regulates the custody practices of investment advisers registered under the Advisers Act. While investment advisers do not usually maintain physical custody of client funds or securities, they are often deemed to have custody of those funds if they have the authority to obtain client assets, such as by deducting advisory fees from a client account or by acting in a capacity, such as general partner of a limited partnership, that gives an adviser the authority to withdraw funds. Under the current rule, advisers that have custody of client funds or securities are required to implement controls to protect those client assets from being misused or misappropriated. The rule also requires advisers that are deemed to have custody of client funds to maintain those client funds with a “qualified custodian.” In order to improve the safekeeping of client assets, the SEC has proposed the following amendments to Rule 206(4)-2.

Proposed Amendments:

1) Annual Surprise Examination of Client Assets

When the Custody Rule was initially adopted in 1962, every adviser with custody of client securities or funds was required to engage an independent public accountant to conduct an annual surprise examination of the client accounts. In 2003, the SEC amended the rule to

eliminate the annual surprise examination for client accounts in which the adviser had a reasonable belief that the qualified custodian provided account statements directly to the client. The proposed amendment eliminates this 2003 exception and requires that all registered investment advisers with custody of client assets engage an independent public accountant to conduct an annual surprise examination of the client assets regardless of whether or not a qualified custodian directly provides statements to clients. Thus, the proposed rule would require all registered advisers that have custody of client assets, including advisers that are also registered as broker-dealers and thus are permitted to act as qualified custodians for their clients' assets, to obtain an annual surprise examination.

While privately offered securities are currently excluded from the requirements of the Custody Rule, the proposed amendments would make privately offered securities that investment advisers hold on behalf of their clients subject to the surprise examination requirement of the rule. The proposed amendments also modify the timeline for reporting examination information to the SEC, requiring public accountants to submit Form ADV-E to the SEC within 120 days of the surprise examination. In addition, the proposed rules would require an independent public accountant to submit Form ADV-E to the Commission within four business days of its resignation or termination.

2) Custody by Adviser and its Related Persons

Under the current Custody Rule, an adviser is deemed to have custody of client assets if it holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them. The SEC has also established that an adviser may be deemed to have custody of client assets under circumstances in which a "related person" of the adviser has access to those client funds. Through staff interpretive letters, the SEC provided guidance on the relevant factors for determining whether an adviser would be deemed to have indirect custody of client funds because of access by a related person. The proposed amendments would do away with this "indirect custody" analysis by providing 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. Thus, the proposed amendments would deem advisers whose related persons hold client assets as having custody under the rule if those assets are held by the related person in connection with the advisory services provided by the adviser to the client. The "in connection with" limitation of the proposed amendment is designed to prevent an adviser from being deemed to have custody of client assets held by a related person custodian if the adviser does not provide advice with respect to those assets. Under the amendments, a related person would be a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser. The SEC defines "control" as the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise.

In instances where the investment adviser or a related person serves as a qualified custodian of client assets in connection with the provision of advisory services, the proposed amendments would also require the adviser to obtain, or receive from the related person, no less frequently than once each calendar year, a written report (the "Custody Controls Report") from an independent public accountant, registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB"), regarding the adviser's or related person's controls for the custody of client assets. The proposed amendments would require that the Custody Controls Report include an opinion of the independent public accountant concerning the controls governing custodial services, including the safeguarding of funds and

the results of a test of operating effectiveness. The amendments would also require the adviser to maintain a copy of the Custody Controls Report for five years from the end of the fiscal year in which the internal control report is finalized.

As an alternative to imposing these conditions on advisers and their related persons that serve as custodians, the SEC is also considering amending the Custody Rule simply to require that all client assets be held by an independent qualified custodian.

3) Delivery of Account Statements and Notice to Clients

The current Custody Rule requires that quarterly account statements be delivered to clients by either (i) the qualified custodian, or (ii) the adviser so long as the adviser engages an independent public accountant to verify the client assets in a surprise examination that must occur at least once during each calendar year. The proposed amendments seek to eliminate the second delivery option under which an adviser can send reports to clients. The proposed amendments would also require registered advisers with custody of client funds or securities to have a reasonable basis for believing that the qualified custodian has sent the quarterly account statement to each client. The amendment makes it clear that advisers must form their reasonable belief that such account statements are sent through “due inquiry.” Thus, an adviser must conduct some independent diligence in order to form a reasonable belief. In addition, the amendments propose to revise the content of the notice advisers are currently required to send to clients upon opening a custodial account, requiring advisers to include a statement in the notice urging clients to compare the account statements they receive from the custodian with those they receive from the adviser.

4) Amendments to Form ADV and Form ADV-E

The SEC has also proposed several amendments to Form ADV and Form ADV-E. These amendments are designed to reflect the proposed rule amendments noted above, to provide more complete information about the custody practices of advisers registered with the SEC, and to provide the SEC with additional data to improve its ability to identify compliance risks.

The SEC is accepting public comments on these proposed rule amendments until July 28, 2009.

For further information or assistance, please contact [Scot E. Draeger](mailto:scot.draeger@bernsteinshur.com) at (207) 228-7336 or sdraeger@bernsteinshur.com; or [Caleb C. B. DuBois](mailto:caleb.dubois@bernsteinshur.com) at (207) 228-7378 or cdubois@bernsteinshur.com.