

## SEC Adopts Final Amendments to the Custody Rule Under the Investment Advisers Act of 1940

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On December 30, 2009, the U.S. Securities and Exchange Commission (the “SEC” or “Commission”) adopted and published amendments to Rule 206(4)-2 (the “Custody Rule”) under the Investment Advisers Act of 1940 (the “Advisers Act”). Implemented in the wake of several recent SEC enforcement actions against investment advisers alleging fraudulent conduct and misappropriation of investor assets, these amendments are designed to provide additional safeguards when a registered adviser (or a “related person” of the adviser) has custody of client funds or securities. As amended, the Custody Rule seeks to enhance the protection of client assets by requiring all registered advisers that have custody of client assets to:

- undergo an annual surprise examination by an independent public accountant to verify client assets;
- have a reasonable belief formed after due inquiry that the qualified custodian maintaining client assets sends account statements directly to the adviser’s clients; and
- in instances where client assets are not maintained by an independent custodian (*i.e.*, a custodian that is not the adviser itself or a “related person”), to obtain an annual written report of the internal controls relating to the custody of the client assets from an independent public accountant that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board (“PCAOB”).

The amended rules become effective on March 12, 2010 and will require registered investment advisers that have custody over client assets to take immediate action. This Legal Update reviews the new rules, as adopted (including compliance dates), and also explains the material differences between the rules that were originally proposed and the form of the rules finally adopted.

### **Background:**

Rule 206(4)-2 regulates the custody practices of investment advisers registered under the Advisers Act. Under the rule, advisers that have custody of client funds or securities (collectively, “client assets”) are required to implement controls to protect those client assets from being misused or misappropriated and are required to maintain those client assets with a “qualified custodian,” such as a broker-dealer or bank. In order to improve the safekeeping of client assets, the SEC began a comprehensive review of this rule and proposed several amendments for comment on May 20, 2009.

Although the final amendments are very similar to the proposed amendments, the final rule differs from the original proposed amendments in three material respects:

- the adopted rules provide an exception to the surprise examination requirements for certain investment advisers;
- the adopted rules require an adviser to include a legend in its notification to clients upon opening a custodial account and in any subsequent account statement urging the client to compare the account statements received from the adviser with those received from the custodian; and
- the adopted rules eliminate the prior alternative provision that allowed the adviser to deliver account statements directly to clients if it underwent annual surprise examinations by an independent public accountant.

### **The Amended Custody Rule:**

As amended, the Custody Rule contains the following provisions.

#### **1) Custody by Adviser and its Related Persons**

***Custody by Related Persons.*** Registered investment advisers that have custody of client securities or funds are subject to the Custody Rule. Under the 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. Under the current version of the rule, the SEC had established, through several staff interpretive letters, a confusing and highly fact-based analysis to determine whether or not an adviser was deemed to have custody of client assets under circumstances in which a “related person”<sup>1</sup> of the adviser had direct access to those client funds. The proposed amendments eliminated this analysis by expressly expanding the definition of custody 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. The “in connection with” limitation of the final rule prevents an adviser from being deemed to have custody of client assets held by a related person custodian in situations where the adviser does not provide advice with respect to those assets. The final rule adopted this amendment as proposed.

***Annual Custody Control Report.*** Although the SEC considered amending the Custody Rule to simply require that all client assets be held by an independent qualified custodian, it declined to do so. Instead, the Custody Rule imposes additional requirements when advisory client assets are maintained by the adviser itself or by a related person rather than with an independent custodian. As proposed, the amended rule requires that when an adviser or its related person serves as a qualified custodian, the adviser obtain or receive from its related person, no less frequently than once each calendar year, a written

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<sup>1</sup> A “related person” is defined by the final rule as any person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser. The term “control” is defined as the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise. 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.

report, which includes an opinion from an independent public accountant with respect to the adviser's or related person's controls governing the custody of client assets (the "Custody Control Report"). Pursuant to the release, a Type II SAS 70 Report is sufficient to satisfy the requirements of the Custody Control Report. Advisers are required to maintain a copy of the Custody Control Report for five years from the end of the fiscal year in which the Custody Control Report is finalized. The amended rule also requires that the accountant issuing the Custody Control Report be registered with, and subject to regular inspection by, the PCAOB.

## **2) Delivery of Account Statements and Notice to Clients**

***Delivery of Quarterly Account Statements.*** The current version of the Custody Rule allows quarterly account statements to be delivered to clients by either: (i) the qualified custodian, or (ii) the adviser if the adviser engaged an independent public accountant to verify the client assets in an annual surprise examination. The rule, as adopted, eliminates the second delivery option as a method for satisfying the rule. Consequently, while the SEC still encourages advisers to deliver account statements to each client, the Custody Rule now requires the qualified custodian to deliver quarterly account statements. This change is intended to provide clients with the ability to compare statements received from the qualified custodian against statements received from the adviser and to discover discrepancies. In addition, the final rule requires that registered advisers with custody of client assets have a reasonable basis formed after "due inquiry" to believe that the qualified custodian has sent the quarterly account statement to each client. An adviser must conduct some inquiry in order to meet this standard.

***Inclusion of Legend in Client Notices.*** The current version of the Custody Rule requires that advisers notify clients promptly upon opening a custodial account on the client's behalf, as well as when changes are made to the information required in the notification. As amended, the final rule also requires advisers to include in that notice a legend that urges clients to compare the account statements they receive from the custodian with those they receive from the adviser. Additionally, advisers are required to include the same legend in any account statements that advisers send to these clients after they are required to send the notification discussed above. However, this cautionary legend is only required to be included in the account statements if the adviser elects to send its own account statements to clients.

## **3) Annual Surprise Examination of Client Assets**

***Applicability of Annual Surprise Examination.*** When the Custody Rule was initially adopted in 1962, every adviser with custody of client assets 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 was designed to eliminate this 2003 exception and once again require 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. While the final rule extends almost that far, unlike the proposed amendments, the final rule provides three limited exceptions to the surprise examination requirement.

***Exceptions to the Surprise Examination Requirement.*** Three types of advisers are excluded from the surprise examination requirement. Despite qualifying for the exceptions from annual surprise examination, these advisers are still required to comply with the other requirements of the rule, including notifying the client where the assets are maintained, forming a reasonable belief after due inquiry that the qualified custodian sends the client account statements, and obtaining a Custody Control Report from a related person that is a qualified custodian.

a) Advisers Deemed to Have Custody Solely Due to Fee Deduction:

Advisers that are 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. In arriving at this exception, the SEC concluded that the cost of holding an exam far outweighed the benefit for this type of adviser since clients could easily monitor the amount of advisory fees deducted by reviewing account statements provided by the qualified custodian.

b) Advisers of Pooled Investment Vehicles Subject to an Annual Financial Statement Audit:

Advisers of a pooled investment vehicle are deemed to have satisfied the annual surprise examination requirement if the pooled investment vehicle: (i) is subject to an annual financial statement audit by an independent public accountant, and (ii) distributes the audited financial statements prepared in accordance with generally accepted accounting principles to the pool's investors within 120 days of the pool's fiscal year-end. If the pooled investment vehicle does not distribute audited financial statements to its investors, the adviser must obtain an annual surprise examination and must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement of the pooled investment vehicle to its investors in order to comply with the custody rule. The SEC arrived at this exception, reasoning that a financial statement audit provides meaningful protections to investors and that a surprise examination would be largely duplicative of an annual financial statement audit. The SEC also adopted a new provision of the rule that would preclude advisers from using layers of pooled investment vehicles to avoid meaningful application of the protections of the rule. Thus, the rule provides that sending an account statement or distributing audited financial statements will not meet the rules requirements if all of the investors in a pooled investment vehicle are themselves pooled investment vehicles that are related persons of the adviser.

c) Advisers Deemed to Have Custody Solely Because the Custodian is a Related Person and the Adviser is "Operationally Independent" from the Custodian:

Advisers that are deemed to have custody solely as a result of a related person holding client assets are not required to undergo surprise examinations if the advisers are "operationally independent" of the related person. Under the rule, a related person is presumed not to be operationally independent of the adviser unless each of the following conditions is met *and* no other circumstances exist that can reasonably be expected to compromise the operational independence of the related person: (i) client assets in the custody of the related person are not subject to 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 persons, or otherwise have the opportunity to misappropriate such client assets; (iii) advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision; and (iv) advisory personnel do not hold any position with the related person or share premises with the related person. In order to avail itself of the rule, an adviser must make and keep a memorandum that describes the relationship with the related person in connection with advisory services the adviser provides to clients and that includes an explanation of the adviser's basis for determining that it has overcome the presumption that it is not operationally independent of the related person with respect to the related person's custody of client assets. This memorandum must be kept for five years from the end of the fiscal year in which the memorandum is finalized. We have already counseled a number of clients seeking advice on whether an affiliate who maintains custody of client securities is "operationally independent" from the adviser and we expect this to be an area where factual and legal analysis is required.

***Written Agreement with Independent Public Accountant.*** The final rule adopted other aspects of the surprise examination process as proposed. For example, under the final rule each investment adviser subject to the surprise examination requirement must enter into a written agreement with an independent public accountant to conduct the surprise examination. This agreement must: (i) provide that the first examination will take place by December 31, 2010, (ii) require the accountant to, among other things, notify the Commission within one business day of finding any material discrepancy during the course of the examination, and (iii) require the accountant to submit Form ADV-E to the Commission accompanied by the accountant's certificate within 120 days of the time chosen by the accountant for the surprise examination, stating that the accountant has examined the funds and securities and describing the nature and extent of the examination. The agreement also must provide that, upon resignation or dismissal, the accountant must file within four business days a statement regarding the termination along with Form ADV-E.

***Privately Offered Securities.*** In addition, under the final rule, privately offered securities that investment advisers hold on behalf of their clients are now subject to the surprise examination requirement. Thus, the rule as adopted no longer permits the accountant conducting the annual verification of client assets to forego examining privately offered securities.

#### **4) PCAOB Registration and Inspection**

Under the final rule, the surprise examination and Custody Control Report must be performed or prepared by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB.

#### **5) Guidance Regarding Compliance Policies and Procedures**

The adopting release also provides guidance regarding the types of policies and procedures advisers should consider including in their compliance programs related to the safeguarding of client assets from conversion or inappropriate use by advisory personnel. These policies should be designed to prevent misappropriation or misuse of client assets,

assure prompt detection of misuse, and take appropriate action if any misuse occurs. For example, the SEC urged that advisers with custody of client assets should consider instituting the following policies and procedures, among others, as part of their compliance programs:

- conducting background and credit checks on employees who will have access to client assets;
- requiring the authorization of more than one employee before withdrawals from a client's account can occur and before changes to account ownership information can occur;
- limiting the number of employees who are permitted to interact with custodians with respect to client assets and rotating them on a periodic basis;
- segregating the duties of advisory personnel from custodial personnel (if the adviser also serves as a qualified custodian);
- requiring that any custodial problems be brought to the immediate attention of the adviser's management; and
- developing procedures to allow the CCO to periodically test the effectiveness of the firm's controls of the safekeeping of client assets and the reconciliation of account statements prepared by advisers against those prepared by qualified custodians.

#### **6) Companion Release for Independent Public Accountants**

In conjunction with the final rule release, the SEC also published a companion release to provide interpretive guidance for independent public accountants that addresses the surprise examination and the Custody Control Report required under the amendments and the relationship between the two. This companion release also sets forth the requirements of the Custody Control Report, providing that it must include the accountant's opinion as to whether the qualified custodian's internal controls have been placed in operation as of a specific date, and are suitably designed, and are operating effectively to meet control objectives related to custodial services, including the safeguarding of funds and securities of advisory clients during the year. For the Custody Control Report to meet the rule's requirements, the accountant must verify that client assets are reconciled to an unaffiliated custodian.

#### **7) Amendments to Form ADV and Form ADV-E**

The SEC also adopted several amendments to Form ADV and Form ADV-E in the final rule. These amendments are designed to reflect the proposed rule changes 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. Advisers will be required to provide responses to revised Form ADV in their first annual amendment after January 1, 2011.

## 8) Compliance Dates

**Effective Dates.** The final amendments become effective on March 12, 2010. Within 60 days of the effective date (May 11, 2010), advisers will be expected to comply with at least three (3) requirements. First, advisers that have custody of client assets must promptly upon opening a custodial account on a client's behalf, and following any changes to the custodial account, send a notification to the client, including a legend urging the client to compare the account statements the client receives from the custodian with those the client receives from the adviser. Second, advisers that have custody of client assets will also be required to include such legend in any future account statements that the adviser sends to these clients. Third, advisers that have custody of client assets must take appropriate actions to form a reasonable belief that a qualified custodian sends quarterly account statements directly to clients.

**Surprise Examinations.** In addition, an investment adviser required to obtain a surprise examination must enter into a written agreement with an independent public accountant that provides that the first examination will take place by December 31, 2010. Advisers that become subject to the rule after the effective date are required to have their first examination take place within six months of becoming subject to the rule. In instances where the adviser itself maintains client assets as a qualified custodian, the agreement with the independent public accountant must provide for the first surprise examination to take place no later than six months after obtaining the Custody Control Report.

**Custody Control Reports.** An investment adviser that is required to obtain or receive a Custody Control Report because it or a related person maintains client assets as a qualified custodian must obtain or receive the Custody Control Report within six months of becoming subject to the requirement (September 11, 2010 for advisers subject to the rule on its effective date) . As noted above, an adviser obtaining a Custody Control Report because it (rather than a related person) also serves as a qualified custodian of its clients' assets (e.g., a broker-dealer) need not undergo a surprise examination until six months after obtaining the Custody Control Report.

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