

SEC Staff Offers Guidance on Compliance with the Amended Custody Rule

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On May 20, 2010, the Staff of the U.S. Securities and Exchange Commission's (the "SEC" or "Commission") Division of Investment Management (the "Staff") published an updated list of responses to frequently asked questions raised by participants in the investment management industry regarding the recently enacted amendments to Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940 (the "Advisers Act"). The full publication, entitled "Staff Responses to Questions About the Custody Rule"¹ (the "Responses"), updates a prior list of frequently asked questions and responses initially published by the Staff on March 5, 2010.

Bernstein Shur has been actively working with the SEC Staff on behalf of investment adviser clients in seeking interpretative guidance relative to the Custody Rule amendments that became effective earlier this year. Below we have prepared a summary of several key interpretations contained in the Responses. This update does not provide a complete analysis of the Responses. To determine how the Responses affect your business, or to discuss other aspects of the Responses in greater detail, please contact our office. In addition, for a more comprehensive analysis of the Custody Rule and the amendments that became effective on March 12, 2010, please see the detailed discussion of these amendments contained in our February 18, 2010 Bernstein Shur Securities Law Update available at www.bernsteinshur.com.²

Background:

The Staff's Responses clarify several issues in the adopting release, including the amended Custody Rule's compliance dates, the definition of "custody" and the scope of the Rule, the application of U.S. GAAP to non-U.S. managers, the availability of the audited pool exemption, compliance with the requirement to use a qualified custodian for pooled investment vehicles and privately offered securities, the impact of using sub-custodians, clarifications relative to trustee relationships, the impact of using an introducing broker, the use of an affiliated transfer agent for a managed mutual fund, and offered some relief for advisers with omnibus accounts and advisers having custody of client assets as a result of inadvertent receipt of tax refunds or lawsuit settlement proceeds. Some of the key responses are summarized below.

¹ The Staff publication is available at http://www.sec.gov/divisions/investment/custody_faq_030510.htm.

² The Bernstein Shur February 18, 2010 Securities Law Update, entitled "SEC Adopts Final Amendments to the Custody Rule Under the Investment Advisers Act of 1940," is available at <http://www.bernsteinshur.com/files-publications/20100218%20BernsteinShurAdvisorySECFinalAmendments.pdf>.

Compliance Dates:

- Qualified custodians must deliver account statements directly to the adviser's clients for all periods ending on or after March 12, 2010 (the effective compliance date of the amendments to the Custody Rule). This means that quarterly account statements ending on March 31, 2010 must be sent by the qualified custodian directly to clients. However, in order to comply with the Custody Rule, this account statement is only required to cover the period from March 12, 2010 through March 31, 2010. [Question I.1]
- The surprise examination must commence on or before December 31, 2010, but does not need to be completed until 120 days after it commences. In addition, the Staff has indicated that it would not recommend enforcement action in situations where an adviser that becomes subject to the rule after the effective date has its first surprise examination commence by the later of six months after the adviser becomes subject to the Custody Rule or December 31, 2010. [Question I.3]
- Advisers must provide responses to the additional questions contained in amended Form ADV in their first annual updating amendment after January 1, 2011. Advisers who file an initial Form ADV before the updated Form ADV is available in IARD may use their first annual updating amendment to provide answers to these additional questions. [Question I.10]

Internal Control Report:

- Rule 206(4)-2(a)(6) requires that an adviser or its related person that maintains client assets as a qualified custodian must obtain (or receive from the related person) a written internal control report (e.g., Type II SAS 70 report) regarding the adviser's or its related person's custodial practices. The compliance date for obtaining an internal control report is September 12, 2010 for advisers subject to the requirement on March 12, 2010. Advisers that are newly subject to the Custody Rule (e.g., advisers that begin maintaining client assets as a qualified custodian after March 12, 2010) must obtain the internal control report within six months of becoming subject to the requirement. [Question I.7]
- The internal control report does not need to address the effectiveness of controls over custodial services that existed prior to March 12, 2010. [Question I.8]
- Qualified custodians that currently obtain custody-related SAS 70 reports prepared on an annual reporting cycle, that received such a report in 2009, and that plan to obtain such a report in 2010, are not expected to alter their reporting cycle to meet the initial September 12, 2010 compliance date. They instead may continue to follow their normal reporting cycle. [Question I.9]

Omnibus Accounts:

- The Staff has been willing to grant additional time for compliance to investment advisers that have omnibus account arrangements with qualified custodians who currently have no client information and thus do not currently deliver client statements. Such an arrangement is no longer permissible under the amended Custody Rule. Such advisers must now have these accounts reprogrammed to allow for direct statement delivery by the qualified custodian. The Staff has indicated that it is mindful that converting these relationships to meet the requirements of the

amended Custody Rule is time intensive and requires obtaining new account documentation from clients and system reprogramming. Consequently, the Staff has indicated that it would not recommend enforcement action if an adviser modifying an omnibus arrangement as described above complies with Rule 206(4)-2(a)(3) for those accounts no later than the delivery of the account statement for the third quarter of 2010, provided that (i) the adviser sends notice to each client no later than the time of sending the account statement for the period ending March 31, 2010, clearly describing the way in which the adviser intends to change the account arrangements to comply with the amended rule and the expected timing of those changes, and (ii) the adviser undergoes a surprise examination for 2010. [Question I.2]

Definition of Custody:

- If an adviser inadvertently receives securities from a client, it may not directly forward the securities to the qualified custodian, but must instead return the securities to the sender within 3 business days or the adviser will be deemed to have custody and will be in violation of the amended Custody Rule's requirement that client securities be maintained in an account with a qualified custodian. However, the Staff has indicated that it would not recommend enforcement action in instances where an adviser inadvertently receives tax refunds from taxing authorities, or client settlement proceeds in connection with legal actions, or stock certificates, dividends, or evidence of new debt from issuers in connection with class action lawsuits involving bankruptcy or business reorganization, if it forwards these client assets within five business days of its receipt and maintains appropriate records. [Question II.1]
- Generally, where an employee of an advisory firm serves as a trustee to a firm client, the firm will be deemed to have custody. The role of the supervised person (*i.e.*, employee) as trustee is imputed to the advisory firm, thus causing the firm to have custody. However, the role of the supervised person as trustee will not be imputed to the advisory firm if the supervised person has been appointed as trustee as a result of a family or personal relationship with the grantor or beneficiary and not as a result of employment with the adviser. A similar analysis would apply where the supervised person serves as the executor to an estate as a result of a family or personal relationship with the deceased. A personal relationship does not include the relationship developed as a result of providing advisory services to a client over many years. [Question II.2]
- Pursuant to Rule 206(4)-2(d)(2)(ii), an adviser has custody if it has the authority to withdraw client assets maintained with a qualified custodian upon the adviser's instruction to the custodian. The Staff does not interpret the authority to withdraw assets to include the limited authority to transfer a client's assets between a client's accounts maintained at one or more qualified custodians if the client has authorized the adviser in writing to make such transfers and a copy of that authorization is provided to the qualified custodians, specifying the client accounts maintained with the qualified custodians. [Question II.4]
- The authority to instruct the qualified custodian maintaining a client's account to remit the funds or securities from the account to the same client at his or her address of record does not constitute having custody if (1) the client has granted such authority to the adviser in writing and a copy of that authorization is provided to the qualified custodian, and (2) the adviser has neither the authority to open an account on behalf of the client nor the authority to designate or change the client's address of record with the qualified custodian. [Question II.5]

- In instances where an adviser has a related natural person who is the owner of an account to which the adviser provides advisory services, the related person's ability to access his or her account will not compute custody to the adviser so long as the related person is a natural person and is both the legal and beneficial owner of the account (*i.e.*, he or she is not a trustee of that account). [Question II.7]
- A registered investment adviser is required to comply with the Custody Rule with respect to funds and securities of a person to whom the adviser provides investment advisory services even if the adviser receives no compensation for providing those advisory services. [Question II.9]
- In instances where an adviser has custody of a client's assets that include a swap agreement with a counterparty and the adviser posts funds or securities as collateral in connection with the swap on behalf of the client, the collateral must be maintained with a qualified custodian. [Question II.10]

Account Statements:

- Account statements may be delivered electronically if: (1) the client has given informed consent to receiving the information electronically; (2) the client can effectively access the electronically delivered information; and (3) there is evidence that delivery occurred, such as an email return-receipt or other confirmation that the information was accessed. The adviser may satisfy its requirement to form a reasonable belief after due inquiry that the clients are receiving those electronic statements by being copied on the email notifications of account statement postings sent to clients in addition to having access to client statements on the custodian's website. [Question IV.1]
- Advisers may voluntarily send their own quarterly account statements to clients in addition to statements sent directly from the qualified custodian so long as the adviser inserts the legend required under paragraph (a)(2) of the Custody Rule, urging the client to compare the information provided by the adviser against the information provided by the custodian. [Question IV.2]

Pooled Investment Vehicles:

- If an independent public accountant performing an annual audit on a pooled investment vehicle in lieu of the required annual surprise examination is not currently registered with, and subject to, regular inspection by the Public Company Accounting Oversight Board ("PCAOB") as required by Rule 206(4)-2(b)(4), the adviser may still satisfy the requirement for exemption from the surprise examination if the accountant becomes subject to regular inspection by the PCAOB before the issuance of the audited financial statements for the pooled investment vehicle's 2010 fiscal year. [Question I.6]
- In instances where an investment adviser to a pooled investment vehicle does not utilize the "audit provision" under the Custody Rule by ensuring that the financial statements of the pooled investment vehicle are audited and distributed to investors in accordance with paragraph (b)(4) of the rule, the exceptions provided in that paragraph will not be available to the adviser. In order to comply with the Custody Rule in that instance, the adviser, among other things, must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends quarterly account statements to each investor in the pool and must obtain an annual surprise examination

with respect to the pool's assets. Moreover, because the privately offered securities exception provided in paragraph (b)(2) of the Custody Rule is not available with respect to assets of an unaudited pool, the adviser must maintain privately offered securities owned by the pool with a qualified custodian. [Question VI.1]

- Account statements sent by the qualified custodian to investors in a pooled investment vehicle should list a statement of funds and securities held by the pool and transactions entered into by the pool as opposed to merely a statement of the investor's ownership interest in the pool. [Question VI.2]
- When an accountant performs a surprise examination for a pooled investment vehicle its confirmation procedures should include obtaining confirmation from investors of (i) funds and securities held by the pooled investment vehicle as of the date of the examination and (ii) contributions and withdrawals of funds and securities to and from the pooled investment vehicle by the investors since the date of the last examination. [Question VI.3]
- When using the "audit approach" under the Custody Rule, financial statements for pooled investment vehicles must be prepared in accordance with U.S. GAAP in order to meet the requirements of the rule, with some exceptions for non-U.S. funds and non-U.S. advisers. Pooled vehicles organized outside of the United States, or having a general partner or other manager with a principal place of business outside the United States, may have their financial statements prepared in accordance with accounting standards other than U.S. GAAP so long as they contain information substantially similar to statements prepared in accordance with U.S. GAAP. Any material differences with U.S. GAAP must be reconciled. The Staff has indicated that it would not recommend enforcement action if that reconciliation is included only in the financial statements delivered to U.S. persons. The required audit of those financial statements must be by an independent public accountant and meet with requirements of U.S. generally accepted auditing standards ("U.S. GAAS"). In addition, offshore advisers registered with the SEC are not subject to the custody rule, with respect to offshore funds. [Question VI.5]
- An adviser may not rely on the "audit provision" of the Custody Rule if the audit does not meet U.S. GAAS. [Question VI.6]
- The audit approach is not available in instances where the client is not a pooled investment vehicle (i.e., when a client is not a pooled investment vehicle, account statements must be sent directly to the client by a qualified custodian). [Question X.1]
- Although an adviser relying on the Custody Rule is required to distribute audited financials to investors within 120 days of its fiscal year end, the Staff has indicated that it would not recommend enforcement if an adviser relying on the "audit provision" for a fund of funds distributes the audited financials to investors within 180 days from the end of the fund of funds' fiscal year. A fund of funds is a pooled investment vehicle that invests 10 percent or more of its total assets in other pooled investment vehicles that are not, and are not advised by, a related person of the pool, its general partner, or its adviser. A "related person" of an adviser includes officers, partners, directors, most employees, and anyone controlled by, controlling or under common control with the adviser. [Question VI.7]

- As permitted by Rule 12d1-1 under the Investment Company Act of 1940, some registered fund families have organized unregistered money market funds for investment exclusively by their registered investment companies. In these instances, the financial statements of the unregistered money market funds are audited, but are delivered to the registered investment companies, which may be related persons of the adviser. Under Rule 206(4)-2(c), sending audited financial statements solely to pooled investment vehicle investors that are themselves pooled investment vehicles and related persons of the adviser does not satisfy the financial statement delivery requirement under Rule 206(4)-2(b)(4). The Staff has indicated that it would not recommend enforcement action under the Custody Rule if the audited financial statements of the unregistered money market funds are not delivered to the shareholders of the registered investment companies, so long as that the financial statements are delivered to each registered investment company's chief compliance officer, audit committee members and the members of the board of directors who are not interested persons of the adviser. [Question VI.10]

Independent Representatives:

- In instances where an accounting firm acts as independent auditor or independent surprise examiner, it is not likely that the accounting firm may also act as the independent representative for the limited partners of or investors in a pooled investment vehicle run by the adviser. In such a situation, it would be unlikely that the accounting firm would meet the definition of "independent representative" in the Custody Rule. [Questions VIII.2 and VIII.3]
- One who is an advisory client of an adviser may act as an independent representative for other clients of the adviser if it meets the test for independence set out in the Custody Rule; however, if the client relationship is a material business relationship (or the person has another material business relationship) with the advisory firm, the person will not meet the independence test. [Question VIII.5]

Participant-Directed Defined Contribution Plans:

- The Staff has address the circumstances under which a related person of an investment adviser may act as the trustee of a participant-directed defined contribution plan established for the benefit of the adviser's employees. The Staff has indicated that it will not recommend enforcement action against an investment adviser that does not treat the assets of a participant-directed defined contribution plan established for the benefit of the adviser's employees as those of a client of which it has custody solely because a related person of the adviser (*e.g.*, an officer or director of the advisor) is trustee which may select service providers and investment options for the plan, provided that (i) neither the investment adviser nor a related person otherwise acts as an investment adviser to the plan or any investment option available under the plan and (ii) the investment adviser and the related person trustee are in compliance with the Employee Retirement Income Security Act of 1974 ("ERISA") with respect to the plan. [Question XII.1]

Co-Trustees:

- Under certain trust arrangements, a co-trustee is not able to withdraw client assets without the prior written consent of the other co-trustee(s). When an adviser acts as a trustee in this sort of an arrangement, the Staff is of the opinion that the adviser does not have custody if (i) the trust

has a co-trustee that is a bank or a trust company that meets the definition of a qualified custodian under Rule 206(4)-2(d)(6) and is not a related person of the adviser, (ii) the qualified custodian delivers account statements directly to each co-trustee that is not itself the custodian, and (iii) under the trust instrument or by law the withdrawal of any assets of the trust by the adviser requires the prior written consent of all of its co-trustee(s). [Question XII.2]

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The foregoing summary is merely an overview of the material Responses. Additional frequently asked questions and the Staff's responses are available on the SEC's website. The Staff has indicated that it will update the Responses from time to time to modify any previous responses as necessary and to add additional responses to new questions.

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