Client ALERT

August 2002

Proposed Amendments to SEC Rule Regarding Investment Advisers' Custody of Funds or Securities of Clients

By Lawrence J. Hass and Bethany Cheever

The Securities and Exchange Commission ("SEC") has issued proposed amendments to Rule 206(4)-2 under the Investment Advisers Act of 1940 ("Advisers Act") that reflect modern custodial practices and clarify the circumstances under which an investment adviser is deemed to have custody of client assets. Rule 206(4)-2 requires investment advisers that have custody of client funds or securities to deposit the funds in bank accounts and segregate and hold the securities in a safe place. The SEC believes the proposed amendments will provide greater protection for advisory clients and remove unnecessary regulatory requirements.

The proposed amendments clarify that an adviser will be considered to have custody of client assets if the investment adviser (i) holds or has authority to obtain possession of client funds or securities, (ii) has authority to withdraw client assets held by a custodian upon instruction to the custodian, or (iii) has legal ownership of or access to client assets by reason of an arrangement such as being the general partner of a limited partnership, the managing member of a limited liability company or a trustee of a trust.

Further, the proposed amendments require a "qualified custodian" to maintain the client funds and securities, which must be held in a separate account for each client or in accounts containing only the assets of a single adviser under the adviser's name. Qualified custodians include banks, savings associations, registered broker-dealers and futures commission merchants.

The proposed amendments also remove the requirement that the adviser send quarterly account statements to clients and submit to an examination each year by an independent public accountant without notice to the adviser, if the adviser has reason to believe that the qualified custodian sends monthly statements to clients identifying the amount of funds and each security in the clients' accounts and describing each transaction during that period.

A pooled investment vehicle that has its transactions and assets audited annually and distributes the audited financial statements to all limited partners, members or beneficial owners, as appropriate, within ninety days of the end of its fiscal year, will not have to comply with Rule 206(4)-2.

Finally, the proposed amendments would eliminate the exemption from the custody requirements for advisers that are also registered broker-dealers.

If you wish to receive a copy of the text of the proposed amendment, or if you have any questions regarding it, please do not hesitate to contact any of the members of our ERISA - Investment Management team.

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