Overview

On May 14, 2009, the Securities and Exchange Commission ("SEC") proposed amendments to Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940 (the "Advisers Act") which governs custody arrangements for registered investment advisers. These amendments are intended to provide additional safeguards under the Advisers Act when an adviser has custody of client funds or securities. The proposals come in the aftermath of several high profile enforcement actions brought by the SEC against registered investment advisers and broker-dealers alleging misappropriation and other misuse of investor assets. While the Custody Rule currently requires advisers that have custody of client funds or securities to implement controls designed to safeguard those client assets from being lost, misused, and misappropriated or subject to the adviser's bankruptcy, these recent enforcement actions have led the SEC to conclude that additional safeguards relating to custody of clients assets are appropriate. The rule amendments do not apply to registered investment company accounts managed by an adviser.

The proposed amendments would require that:

- all registered investment advisers that have custody of client assets or securities must undergo an annual surprise examination by an independent public accountant to verify client assets and securities;
- advisers maintaining funds with a qualified custodian that is a "related person", such as a broker-dealer or bank that is under common control with the adviser must obtain a written report from an independent public accountant that includes an opinion regarding the qualified custodian’s controls relating to custody of client assets;
- qualified custodians must always deliver client financial statements at least quarterly -- advisers will no longer be able to send clients financial statements as an alternative.

The proposed amendments also include certain technical revisions to Form ADV. Comments to these proposals are due on or before July 28, 2009.

Annual Surprise Examination of Client Assets

The SEC proposal would extend the annual surprise examination requirement to all registered investment advisers who are deemed to have custody of client assets. The amendment therefore would eliminate the current
exemptions under the Custody Rule from the surprise audit requirements for advisers that use qualified custodians that directly provide statements to clients, advisers that only hold privately offered securities and advisers to pooled investment vehicles where the pool is audited annually and which distributes its audited financial statements to its investors within 120 days of the end of its fiscal year.

The proposed amendments would require advisers subject to the rule to enter into a written agreement with an independent public accountant to conduct the surprise examination. The written agreement would require the accountant, among other things, to notify the SEC within one business day of finding material discrepancies. It also would require the accountant to submit Form ADV-E to the SEC accompanied by a 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.

In addition, the written agreement would require the accountant to submit Form ADV-E to the SEC within four business days of its resignation, dismissal, removal or other termination of the engagement, accompanied by a statement relating to the circumstances under which the accountant was terminated. This statement will be compared to the adviser’s description of why the accountant’s engagement was terminated.

**Custody by Adviser, Internal Control Report and PCAOB Registration**

The proposed amendments would make explicit prior staff positions that provide that advisers have custody of any client securities or funds when those assets are held by a “related person” in connection with advisory services provided by the adviser to its clients. 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 Release explains that the “in connection with the advisory services” limitation is designed to prevent an adviser from being deemed to have custody of client assets held by a related person broker-dealer (or other qualified custodian) with respect to which the adviser does not provide advice.

The proposals also would require that when an adviser or related person serves as qualified custodian for client funds or securities in connection with advisory services provided by the adviser to its clients, the adviser must obtain, or receive from the related person, at least annually, a written internal control report which includes an opinion from an independent public accountant registered with, and subject to inspection by, the Public Company Accounting Oversight Board (“PCAOB”), with respect to the description of controls relating to custodial services, including the safeguarding of cash and securities and tests of operating effectiveness. The Release notes that this amendment is being proposed because there are additional risks to client assets when they are maintained by the adviser or its related person instead of with an independent custodian. This requirement would be in addition to the surprise examination described above.

The written internal control report would be issued in accordance with standards of the PCAOB with respect to the description of controls placed in operation relating to custodial services, including the safeguarding of cash and securities held by either the adviser or its related person on behalf of the adviser’s clients, and tests of operating effectiveness. In addition, the amendments would require that when an adviser or its related person acts as qualified custodian for the adviser’s clients’ assets or securities, the surprise examination discussed above must be done by an independent public accountant registered with the PCAOB.

As an alternative, the Release asks for comments on whether or not the Custody Rule should require that only an independent qualified custodian can hold an adviser’s clients’ assets.
and securities. The Release notes that this alternative could preclude a broker-dealer that is also an investment adviser from providing advisory services to a brokerage client, unless those particular assets, for which the adviser is providing advisory services, are moved to another independent qualified custodian.

**Delivery of Account Statements**

The proposed amendments would eliminate the current alternative that allows advisers to send account statements to clients, instead of the qualified custodian, provided that the adviser is subject to an annual surprise examination. The Release states that the SEC had allowed this alternative because some advisers were disinclined to disclose the names of their clients to custodians for competitive reasons or for privacy concerns. The SEC now believes that having account statements sent directly from the custodian in all cases provides greater assurance against fraud and that privacy and confidentiality concerns can be addressed through the custodial contracts.

In addition, with respect to the Custody Rule’s requirement that an adviser form a reasonable belief that a custodian actually delivers client account statements to clients at least quarterly, the proposed amendment would require that advisers must make “due inquiry” before making any such determination. Advisers to limited partnerships and limited liability companies would continue to be exempt from sending account statements if investors in those entities receive audited financial statements. However, the proposal does note that in addition to the annual audit, these entities must be audited upon liquidation.

**Amendments to Form ADV**

The SEC is also proposing changes to Form ADV to ensure that registered investment advisers report their compliance with the custody rule in addition to the Form ADV-E that the independent public accountant must file.

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*If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:*

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2 This requirement would be in addition to the existing requirements under the Custody Rule that the adviser have a reasonable belief that qualified custodians deliver account statements directly to clients.

3 Currently, privately offered securities are excluded from all aspects of the Custody Rule.