



Recent Amendments to the Rule 206(4)-2 under the Investment Advisers Act of 1940¹

¹ This publication has been prepared for general information of clients and friends of the firm as a brief description of recent SEC action. It is not meant to provide legal advice with respect to any specific matter.

Introduction

On December 30, 2009, the Securities and Exchange Commission (the “SEC”) adopted amendments to Rule 206(4)-2 under the Investment Advisers Act of 1940, as amended (the “Custody Rule”).² The amendments to the Custody Rule originally were proposed earlier in 2009³ largely as a response to the Ponzi scheme orchestrated by Bernard Madoff and other fraudulent investment schemes that had come to light in 2008 and early 2009. Among other features, the amendments to the Custody Rule are intended to provide additional safeguards for client funds or securities that are deemed to be in the custody of a registered investment adviser by closing certain exemptions which had previously existed under the Custody Rule.

The following is a summary of several of the key provisions of the amendments to the Custody Rule.

Delivery of Client Account Statements

Prior to the amendments to the Custody Rule, investment advisers generally were required to maintain client funds or securities with a “qualified custodian”⁴ whom the adviser reasonably believed sent an account statement to the clients of the adviser on a no-less-frequent than quarterly basis. Nonetheless, advisers previously had the option of sending statements directly to clients if the adviser agreed to undergo a surprise examination by an independent public accountant on at least an annual basis.

² *Custody of Funds or Securities of Clients by Investment Advisers*, Rel. No. IA-2968 (Dec. 30, 2009), 75 FR 1456 (Jan. 11, 2010) (the “Adopting Release”).

³ *Custody of Funds or Securities of Clients by Investment Advisers*, Rel. No. IA-2876 (May 20, 2009), 74 FR 25354 (May 27, 2009) (the “Proposing Release”).

⁴ For purposes of the Custody Rule, a “qualified custodian” is defined under Rule 206(4)-2(c) as:

- (i) A bank as defined in Section 202(a)(2) of the Advisers Act or a savings association as defined in Section 3(b)(1) of the Federal Deposit Insurance Act . . . that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act . . . ;
- (ii) A broker-dealer registered under Section 15(b)(1) of the Securities Exchange Act of 1934 holding the client assets in customer accounts;
- (iii) A futures commission merchant registered under Section 4f(a) of the Commodity Exchange Act . . . , holding the client assets in customer accounts, but only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; and
- (iv) A foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets.

Under the amended Custody Rule, advisory clients, with the exception of investors in certain “pooled investment vehicles”⁵ as explained more fully below, must now receive account statements directly from the qualified custodian. As stated in the Adopting Release, it is the view of the SEC that requiring delivery of account statements by qualified custodians will “provide greater assurance of the integrity of account statements. . .”

In addition, the adviser’s reasonable belief that the qualified custodian sends account statements directly to clients now must be formed by the adviser after “due inquiry.” In other words, advisers now have the obligation to perform some level of investigation into the processes of qualified custodians prior to relying on a custodian to deliver account statements to the clients of the adviser. The Adopting Release does not set forth a single standard for what would constitute “due inquiry.” Rather, the SEC believes that advisers should be given “the flexibility to determine how to best meet this requirement.” For example, the Adopting Release suggests that the practice of the adviser receiving duplicates of the statements sent to clients from qualified custodian(s) could satisfy the due inquiry standard under the appropriate conditions.

Pooled Investment Vehicles

As noted above, an exception to the statement delivery requirement under the Custody Rule continues to be available to certain advisers to pooled investment vehicles. Advisers that act as general partners to pooled investment vehicles would continue to be exempted from the requirement to have a qualified custodian send account statements to limited partners if the pool: 1. is audited annually; 2. distributes audited financial statements prepared in accordance with Generally Accepted Accounting Principles (“GAAP”) to the limited partners within 120 days of the end of the fiscal year of the pooled investment vehicle; and 3. upon liquidation, distributes audited financial statements, also prepared in accordance with GAAP, to the limited partners promptly after the audit’s completion.

In the Adopting Release, the SEC proposed having advisers to pooled investment vehicles that are subject to an annual audit also be required to undergo an annual surprise examination by an independent accountant. However, as adopted, the amended Custody Rule does not require that advisers to pooled investment vehicles undergo an annual surprise examination if they are subject to an audit by an independent certified public accountant that is subject to regular inspection by the Public Company Accounting Oversight Board (the “PCAOB”).

Funds of Funds

Pooled investment vehicles present several potential challenges under the amended Custody Rule. In the context of “funds of funds,” the Adopting Release clarifies that delivery of account

⁵ As defined in Rule 206(4)-8 of the Investment Advisers Act of 1940, as amended, a “pooled investment vehicle” means any “investment company as defined in section 3(a) of the Investment Company Act of 1940 or any company that would be an investment company under section 3(a) of that Act but for the exclusion provided from that definition by either section 3(c)(1) or section 3(c)(7) of that Act.”

statements or audited financial statements to investors in a pooled investment vehicle will not satisfy the requirements of the amended Custody Rule if all of the investors in the pooled investment vehicle are themselves pooled investment vehicles that are related persons of the advisers. Thus, account statements and audited financial statements must be delivered to the beneficial owners of the pooled investment vehicles in order to comply with the amended Custody Rule.

Special Purpose Vehicles

Similarly, special purpose vehicles (“SPVs”) that are used to facilitate investments in certain securities by pooled investment vehicles present certain challenges as well since the SPVs typically are established or controlled by the investment adviser or person related to the adviser who serves as the general partner of the pooled investment vehicle. As with funds of funds, delivery of account statements or audited financial statements to the adviser or general partner of the pooled investment vehicle could prevent the information contained in such documents from reaching those that are intended to be protected by the Custody Rule.

Therefore, under the amended Custody Rule, the adviser has two options with respect to the treatment of SPVs: 1. the adviser can treat the SPV as a separate client; or 2. the adviser can treat the SPV as being the asset of the pooled investment vehicle. If the adviser elects to treat the SPV as a separate client, the adviser will be deemed to have custody of the assets of the SPV and will have to comply separately with the audit and account statement distribution requirements of the Custody Rule. As noted above in the context of a fund of funds, the account statements and audited financial statements of the SPV should be sent to the beneficial owners of the pooled investment vehicle investing in the SPV. Alternatively, the adviser can treat the SPV as being the asset of the pooled investment vehicle and, in which case, the SPV will be examined as part of the financial statement audit or the surprise examination of the pooled investment vehicle.

Surprise Examination by Independent Certified Public Accountant

The amended Custody Rule requires advisers with custody of client funds or securities to undergo an annual surprise examination of such assets by an independent public accountant. In that regard, it is worth highlighting that advisers that maintain custody of “privately offered securities,” as such term is defined under Rule 206(4)-2(b)(2), also will be subject to the annual surprise examination requirement. Nonetheless, the amended Custody Rule provides an exception to certain advisers from annual surprise examination requirement. In particular, the following advisers generally are exempted from the surprise examination requirement:

- As noted above, advisers to pooled investment vehicles that, among other requirements, are subject to an annual financial statement audit by an independent public accountant registered with the PCAOB, and that distribute audited financial statements prepared in accordance with GAAP to the limited partners of the investment vehicle;
- Advisers that are deemed to have custody of client assets solely by virtue of their ability to deduct advisory fees from client accounts; and

- As explained more fully below, Advisers that have custody of client assets solely because a related person has custody of the funds or securities of the advisory clients; provided, however, that the adviser is deemed to be “operationally independent” of the affiliated custodian.

Custody of Client Assets by the Adviser or a Related Person

Where client funds or securities are maintained by an adviser or a related person to the adviser, the amended Custody Rule requires the adviser or related person to obtain a written report on the effectiveness of the internal controls of the party maintaining custody, such as a Type II SAS 70 report, on at least an annual basis from an independent public accountant. The report on the internal controls of the adviser or related person maintaining custody of client assets is in addition to the annual surprise examination requirement described above. In addition, where an adviser or related person serves as the qualified custodian of client assets, the internal controls report and the annual surprise examination must be performed by an independent public accountant that is registered with and subject to regular inspection by the PCAOB.

As the SEC noted in the Adopting Release, “related person custody arrangements can present higher risks to advisory clients than maintaining assets with an independent custodian.”⁶ In addition to the surprise examination, an adviser (or an operationally dependent related person) who is the qualified custodian for advisory client funds or securities will now be required to obtain an internal control report. The internal control report must include an opinion from an independent public accountant regarding the adviser’s (or the related person’s) controls to maintain custody of and safeguard client assets. We note that the requirement to conduct or obtain an internal control report also applies to pooled investment vehicles where assets are maintained with a qualified custodian that is the adviser or a related person of the adviser to the pool.

An adviser can avoid the surprise examination requirement where the adviser is deemed to have custody of client assets solely by virtue of the client assets being maintained by a related person; provided, however, that the adviser is deemed to be operationally independent of the affiliated custodian. For purposes of the amended Custody Rule, an adviser will be deemed to be operationally independent of the affiliated custodian where:

1. client assets in the custody of the related person are not subject to claims of the adviser’s creditors;
2. 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;

⁶ The Adopting Release, *supra* note 2, at 25.

3. advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision; and
4. advisory personnel do not hold any position with the related person or share premises with the related person.⁷

It is worth noting that, where the client assets of an adviser are maintained by a qualified custodian that is a related person of the adviser, the presumption under the Custody Rule is that the adviser is not operationally independent of the affiliated custodian.⁸ Therefore, advisers should carefully consider the factors listed above in determining whether or not the adviser is operationally independent of the related custodian and maintain appropriate records to support such a conclusion.

As the SEC noted in the Adopting Release, “[w]e would not consider a related person that shared management persons with the adviser, including an owner that was actively involved in the management of the two firms, to be operationally independent.”⁹ Thus, the SEC seems to be emphasizing the independence of the affiliated custodian, both in appearance and in operational fact.

SEC Reporting

Amendments to Form ADV

As part of the adoption of the amendments to the Custody Rule, the SEC also has adopted several amendments to Part 1A and Schedule D of Form ADV. In particular, Items 7 and 9 have been revised to elicit additional information regarding the custody arrangements of registered investment advisers, particularly with regard to custodians that are related persons of the adviser for purposes of the Custody Rule. Item 9 also requires advisers to pooled investment vehicles to provide certain information regarding the vehicle, including whether the pooled investment vehicle is audited and whether or not the qualified custodian of the pooled investment vehicle’s assets is responsible for sending account statements to investors.

Schedule D also has been amended to require advisers to report whether or not the adviser has overcome the presumption, described in more detail above, that it is not operationally independent of a related person serving as the qualified custodian of the assets of the adviser’s clients. In addition, Schedule D elicits information, to the extent applicable to a particular adviser, regarding the accountant chosen to perform the audit, surprise examination, or prepare

⁷ Rule 206(4)-2(d)(5) under the amended Custody Rule.

⁸ The Adopting Release, *supra* note 2, at 34.

⁹ *Id.* at note 111.

the internal control report required under the Custody Rule, including the name and address of the accountant and whether or not the accountant is registered with the PCAOB. Although the revisions to Form ADV principally affect advisers that have custody of clients assets, either directly or through related persons, it would seem prudent that all advisers, particularly advisers to pooled investment vehicles, review the content of the adviser's Form ADV to ensure that the disclosure continues to be accurate and complete in light of the amendments to the Custody Rule.

Amendments to Form ADV-E

In connection with the surprise annual examination requirement, the amended Custody Rule requires the adviser to enter into a written agreement with the independent public account conducting the surprise annual inspection. Among other provisions, the written agreement must require the accountant to notify the SEC within one business day of the finding of a material discrepancy during the course of the examination and also must require that the accountant file Form ADV-E with the SEC within 120 days of the date the surprise examination commences. In addition, such an agreement also would have to provide for the submission of Form ADV-E by the accountant within four business days following the termination of the agreement or the accountant's resignation, dismissal, or removal, accompanied by a statement detailing any problems with the examination scope or procedure that contributed to the departure.

Implications to Rule 206(4)-7 Compliance Programs

Each adviser should consider the degree to which the amendments to the Custody Rule may impact the written compliance policies and procedures the adviser has adopted pursuant to Rule 206(4)-7 under the Advisers Act. Although Rule 206(4)-7 generally does not specify policies and procedures that should be adopted by an adviser, it is worth noting that the release adopting Rule 206(4)-7 identified the "[s]afeguarding of client assets from conversion or inappropriate use by advisory personnel" as one of the key issues that should be addressed by each adviser's compliance policies and procedures.¹⁰ Thus, an adviser should not underestimate the importance that the SEC places on ensuring that assets of clients of an adviser are properly protected. As the SEC observed in the Adopting Release, "[w]e believe that an adviser's maintenance of strong policies and procedures, . . . [in addition to the amendments to the Custody Rule], is an essential component of a comprehensive approach to addressing the potential risks raised by an adviser's custody of client assets."¹¹

To that end, the Adopting Release contains examples of several policies and procedures that Advisers should consider implementing as part of their compliance programs depending, in part, on whether or not the adviser is deemed to have custody of client assets for purposes of the Custody Rule and the factual setting behind such a determination. With regard to advisers that

¹⁰ *Compliance Programs of Investment Companies and Investment Advisers*, Rel. No. IA-2204 at 4 (Dec. 17, 2003), 68 FR 74714 (Dec. 24, 2003).

¹¹ The Adopting Release, *supra* note 2 at 42.

are deemed to have custody of client assets generally, the Adopting Release recommends that the adviser consider the following policies and procedures:

- conducting background and credit checks on employees of the investment adviser who will have access (or could acquire access) to client assets to determine whether it would be appropriate for those employees to have such access;
- requiring the authorization of more than one employee before the movement of assets within, and withdrawals or transfers from, a client's account, as well as before changes to account ownership information;
- limiting the number of employees who are permitted to interact with custodians with respect to client assets and rotating them on a periodic basis; and
- if the adviser also serves as a qualified custodian for client assets, segregating the duties of its advisory personnel from those of custodial personnel to make it difficult for any one person to misuse client assets without being detected.¹²

Regardless of whether or not an adviser elects to adopt the suggested policies and procedures, the Adopting Release indicates that each adviser should recognize the elevated risks associated with the custody of client assets and design their compliance program accordingly. In that regard, the adviser should consider the implementation of procedures to periodically test the effectiveness of the policies of the adviser related to the safekeeping of client assets.¹³

An adviser that is deemed to have custody of client assets by virtue of the ability of the adviser to deduct advisory fees directly from client accounts maintained at a qualified custodian also should adopt procedures that are reasonably designed to mitigate the risks associated with such an arrangement. In particular, the Adopting Release suggests that such advisers consider the following policies and procedures:

- periodic testing on a sample basis of fee calculations for client accounts to determine their accuracy;
- testing of the overall reasonableness of the amount of fees deducted from all client accounts for a period of time based on the adviser's aggregate assets under management; and
- segregating duties between those personnel responsible for processing billing invoices or listings of fees due from clients that are provided to

¹² *Id.* at 43-44.

¹³ *Id.* at 45.

and used by custodians to deduct fees from clients' accounts and those personnel responsible for reviewing the invoices and listings for accuracy, as well as the employees responsible for reconciling those invoices and listings with deposits of advisory fees by the custodians into the adviser's proprietary bank account to confirm that accurate fee amounts were deducted.¹⁴

Given that Rule 206(4)-7 requires that advisers review their written compliance policies and procedures on at least an annual basis, the adoption of the amended Custody Rule would seem an appropriate time for advisers to conduct such a review. It is reasonable to anticipate that custody arrangements of advisers will be a topic of review during routine examinations by the staff of the SEC.

Key Compliance Dates

The amended Custody Rule becomes effective on March 12, 2010. Advisers that are subject to the annual surprise examination requirement of the amended Custody Rule must enter into a written agreement with an independent public accountant that requires the first examination to take place prior to December 31, 2010. Those advisers that are required to obtain an internal control report because either the adviser or a related person maintains client assets as a qualified custodian must obtain the internal control report within six months of the effective date of the amendments to the Custody Rule.

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¹⁴ *Id.* at 46.

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