

Securities Attorneys

1-21-10

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SEC AMENDS CUSTODY RULES FOR REGISTERED INVESTMENT ADVISERS

On December 30, 2009, the Securities and Exchange Commission (SEC) adopted amendments to its custody rule for investment advisers to increase the compliance requirements applicable to investment advisers who have custody of client funds or securities. The amendments are effective March 12, 2010. 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. An investment adviser also required to obtain an internal control report must receive that report by December 12, 2010.

Custody Rule

Rule 206(4)-2 regulates the custody practices of investment advisers registered with the SEC under the Investment Advisers Act of 1940 (the Advisers Act). This rule defines custody to include not only maintaining physical custody of client funds or securities but also the authority to obtain client funds or securities, such as the authority to deduct advisory fees from a client account, write checks or withdraw funds on behalf of a client or act in a capacity, such as a general partner of a limited partnership or other pooled investment vehicle, that gives the adviser or its supervised persons the authority to withdraw funds or securities from the limited partnership's account. In fact, the SEC in its release proposing the new rules (Release No. IA-2876) noted that most investment advisers are subject to the custody rules not because they maintain physical custody of client assets but because of authority to access client assets.¹

Rule 206(4)-2 requires advisers that have custody, with certain limited exceptions, to maintain client funds or securities with a "qualified custodian" which is generally a bank or registered broker-dealer. The rule also requires that an adviser with custody of client assets have a reasonable belief that the qualified custodian holding the assets provides account statements directly to clients, or investors in pooled investment vehicles, at least quarterly. Under the prior rule, in lieu of the qualified custodian providing account statements directly to the clients, an investment adviser could itself deliver the account statements. However, in such case, the investment adviser was required to engage an independent public accountant to verify the client assets in a surprise examination that must occur at least once each year.

Amendments to Custody Rule

The SEC's amendments to the custody rule include the following:

- *Annual Surprise Examination of Client Assets.* The final amendments to Rule 206(4)-2 require that a registered investment adviser with custody of client

¹ The SEC has provided guidance that an investment adviser does not have custody of client assets where a client instructs the custodian to debit the client's account for advisory fees. See Staff Responses to Questions About Amended Custody Rule, Question III.3 (January 10, 2005). The adopting release (Release No. IA-2968) for the amendments to the custody rule do not state that this SEC position has changed.

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assets must engage an independent public accountant² to conduct an annual surprise examination of client assets. Given recent frauds involving investment advisers (the SEC in the proposing release cited as examples the well-known recent cases of Bernard L. Madoff and Stanford International Bank) the SEC believes that an examination by an independent public accountant will provide "another set of eyes" to protect against the misuse of client assets. However, in a change from the SEC's original proposal, the final amendments provide an exception from the surprise examination requirement when the adviser has custody of client assets solely because of its authority to deduct advisory fees from client accounts.

Privately offered securities held by an investment adviser on behalf of its clients are also subject to the audit. Previously, privately offered securities were excluded from all aspects of the custody rule.

- *Self-Custody or Custody by an Affiliated Custodian.* The amendments apply additional requirements with respect to client assets held by a registered investment adviser or held by a related person (in either case the adviser or related person must still be a qualified custodian). A related person is defined as a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser. For such cases of self-custody or custody by a related person, the surprise audit must be conducted by an independent public accountant that is registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (PCAOB). In addition, the adviser must obtain, not less than annually, a written report with respect to the adviser's or related person's controls relating to the custody of client assets. This internal control report must include an opinion from an independent public accountant that is registered with, and subject to regular inspection by, PCAOB.

The amendments also add an exception to the application of the custody rule where a registered investment adviser has custody solely as a result of custody by a related person if the related person is operated independently of the adviser. The SEC's adopting release contains guidance regarding the criteria for operating independently.

- *Delivery of Account Statements by the Custodian.* The amendments require all registered investment advisers with custody of client funds or securities to have a reasonable basis to believe that the qualified custodian sends a quarterly account statement to clients. This eliminates the alternative that had allowed an adviser to send out the account statements itself if it undergoes a surprise examination by an independent accountant at least quarterly since all advisers with custody must undergo an annual surprise audit examination in any event. The amendments provide that the adviser's reasonable belief that such account statements are sent must be based on due inquiry.
- *SEC Reporting.* The amendments require registered investment advisers subject to the surprise examination requirement to enter into a written agreement with the independent public accountant to conduct the surprise examination. This agreement must require, among other things, that the accountant agree to notify the SEC within one business day of finding any material discrepancies and 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 audit. In addition, the accountant must

² The amendments define an independent public accountant as a public accountant that meets the standards for independence described in Rule 2-01(b) and (c) of Regulation S-X, the rule that addresses independence of accountants who audit financial statements filed with the SEC for public companies.

agree to submit Form ADV-E to the SEC within four business days of its resignation, dismissal from or other termination of the engagement or upon removing itself or being removed from consideration for being reappointed. The SEC amended Form ADV to require disclosure by advisers of additional information regarding custodial practices, including the amount of client assets and number of clients of which it or its related person has custody and disclosure regarding compliance with the new rules.

- *Pooled Investment Vehicles.* The rule amendments have a number of special provisions addressing pooled investment vehicles. First, an adviser to a pooled investment vehicle may satisfy the surprise examination requirement by delivering audited financial statements to the pool investors within 120 days after the pool's fiscal year end, provided that the audit is conducted by an accounting firm registered with, and subject to regular inspection by, PCAOB. If the pool does not distribute such audited financial statements, then the adviser must obtain an annual surprise examination and have a reasonable basis, after due inquiry, to believe that the qualified custodian sends an account statement to the investors. Regardless of whether the adviser satisfies the verification requirements through a surprise examination or delivery of audited financial statements, if the pool's assets are maintained with a qualified custodian that is either the adviser to the pool or a related person, the pool would have to obtain an internal control report. Finally, the amended rule requires advisers to pools that comply with the custody rule by delivering audited financial statements to obtain an audit upon liquidation of the pool.
- *Guidance for Accountants.* Concurrent with the adoption of the final amendments to the custody rule, the SEC also issued an interpretative release (Release No. IA-2969) providing guidance to accountants regarding the scope of surprise examinations and the internal control report.
- *Compliance Policies and Procedures.* Rule 206(4)-7 requires registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules. In the adopting release, the SEC provided guidance on controls with respect to custody of client assets. Suggested controls include background and credit checks on employees who will have access to client assets, requiring authorization from more than one employee for access to client assets, limiting the number of employees who interact with custodians and rotating them on a periodic basis, and requirements for reporting problems or suspicious activities. Clients who have custody as a result of the right to deduct fees should consider periodic testing on a sample basis of fee calculations and testing aggregate fees that have been deducted over a period of time against aggregate assets under management during that period.

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