JACKO LAW GROUP, PC

Legal Risk Management Tip
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SEC Releases Significant Amendments to the Custody Rule (Rule 206(4)-2)

On December 30, 2009, the Securities and Exchange Commission ("SEC" or "Commission") released amendments to its rules governing the custodial practices applicable to SEC registered investment advisers deemed to have custody of client funds or securities (the "Amended Rule").[1] Section 206(4) of the Investment Advisers Act of 1940 (the "Advisers Act") gives the Commission broad rulemaking authority to prevent fraudulent or deceptive conduct by investment advisers registered with it.[2] It is under this authority that the SEC adopted the amendments, which are designed to strengthen controls over the custody of client assets held by registered investment advisers by eliminating certain exemptions in the current rule and encouraging the use of independent custodians. The revisions come as part of a comprehensive review by the SEC of the rules regarding the safekeeping of investor assets.[3]

Expanded Definition of "Custody"

Although the amendments do not significantly change the definition of custody set forth in Rule 206(4)-2 (the "Custody Rule"), the Amended Rule expands upon the former definition to provide that advisers will be deemed to have custody of client assets that are held directly or indirectly by a related person in connection with advisory services provided by the adviser to its clients.[4] A related person is defined as "any person, directly or indirectly, controlling or controlled by [the adviser], and any person under common control with [the adviser]."[5] Significantly, such an adviser will only be deemed to have custody of those assets held by the related person with respect to which the adviser provides investment advice.

Additional Safeguards Under the Amended Rule

The amendments to Rule 206(4)-2 impose certain additional requirements on advisers with custody in order to strengthen the controls over such advisers and provide a more robust set of rules designed to prevent client assets from being lost, misused, misappropriated, or adversely affected by the adviser's financial hardships. These additional safeguards include: (i) requiring all qualified custodians to send account statements directly to the clients; (ii) requiring certain advisers to undergo an annual surprise examination; and (iii) unless client assets are maintained by an independent custodian, requiring the adviser to obtain a report from the custodian of the internal controls from an independent public accountant.[6]

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[1] Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2968 (Dec. 30, 2009) *available at* http://www.sec.gov/rules/final/2009/ia-2968.pdf [hereinafter Adopting Release].
[2] Investment Advisers Act of 1940 § 206(4), 15 U.S.C. § 80b-6(4).
[3] Adopting Release, *supra* note 1, at 3-4.
[4] Amended Rule 206(4)-2(d)(2).
[5] *Id.*
[6] *See* Adopting Release, *supra* note 1, at 1.

A. Direct Delivery of Account Statements by Custodian

Rule 206(4)-3 requires advisers deemed to have custody of client assets, in most cases, to maintain such assets with a "qualified custodian," and to have a reasonable belief that the custodian sends account statements directly to advisory clients.[7] The current rule permits advisers to send account statements instead of the custodian if the adviser is subject to an annual surprise verification of client assets. The Amended Rule effectively eliminates this alternative and requires direct delivery of account statements by the qualified custodian regardless of whether the adviser undergoes a surprise verification.[8] Such practices are intended to provide greater assurance of the integrity of account statements and enhance protections afforded to clients. The Amended Rule further retains the requirement that an adviser must have a reasonable belief that the custodian sends statements directly to clients, but further provides that the reasonable belief must be formed after "due inquiry,"[9] which may be accomplished by having the qualified custodian provide the adviser with a copy of the account statement delivered to the client. The Amended Rule also provides that if an adviser chooses to send its own statements in addition to those sent directly by the custodian, the adviser must include a cautionary legend urging clients to compare the statements received from the adviser with those received from the custodian.[10]

B. Annual Surprise Examination

In order to provide "another set of eyes" on client assets, the SEC has amended the Custody Rule to require that all advisers with custody obtain an annual surprise examination of client assets by an independent public accountant. Such a requirement is intended to deter fraudulent conduct and help identify problems that may not otherwise come to clients' attention. Additionally, the scope of the surprise examination has been expanded to provide that privately offered securities are subject to verification. Thus, although such securities are not required to be maintained by a qualified custodian, accountants conducting annual verifications of client assets are no longer permitted to forego examining privately offered securities, as defined in the rule. Consequently, advisers that maintain custody of privately offered securities on behalf of their clients are subject to the surprise examination requirement under the Amended Rule.[11]

Advisers required to obtain a surprise examination under the Amended Rule must enter into a written agreement with an independent public accountant that provides for the first examination to take place by December 31, 2010. The agreement must require the accountant to notify the Commission within one business day of finding any material discrepancy during the examination.

Advisers with Custody Solely Because of Authority to Deduct Advisory Fees. Persuaded by comments received relating to the surprise examination requirement set forth in the proposed amendments,[12] the SEC has included an exception from the surprise examination requirement for advisers with limited custody *solely* because of their authority to deduct advisory fees from client account.[13]

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[7] 17 C.F.R. § 275.206(4)-2(a)(1). Under the Custody Rule, "qualified custodians" include banks, registered broker-dealers, and registered futures commission merchants. *Id.* § 275.206(4)-2(d)(6).
[8] Adopting Release, *supra* note 1, at 7.
[9] Amended Rule 206(4)-2(a)(3).
[10] Amended Rule 206(4)-2(a)(2); *see also* Adopting Release, *supra* note 1, at 9.
[11] Adopting Release, *supra* note 1, at 21.
[12] *See* Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2876 (proposed May 20, 2009), *available at* http://www.sec.gov/rules/proposed/2009/ia-2876.pdf [hereinafter Proposing Release].
[13] Amended Rule 206(4)-2(b)(3).

The rationale for this exception is that the risk of the adviser deducting fees to which it is not entitled is adequately addressed in the Amended Rule through the requirement that custodians send statements directly to clients, permitting clients to monitor the amount of fees deducted for their accounts.[14]

Advisers to a Pooled Investment Vehicle that is Subject to Annual Financial Statement Audit. In another departure from the proposed amendments, the SEC's final amendments provide that registered advisers to pooled investment vehicles subject to an annual financial statement audit may be deemed to have satisfied the surprise examination requirement if certain requirements are met. Specifically, the audit must be conducted by an independent public accountant registered with and subject to inspection by the Public Company Accounting Oversight Board ("PCAOB"). Additionally, the audited financial statements must be prepared in accordance with generally accepted accounting principles and distributed to the pool's investors.[15]

Advisers "Operationally Independent" of a Related Person with Custody of Client Assets. As mentioned above, the definition of custody has been expanded to include advisers with client assets held by a related person in connection with the adviser's advisory services. Such advisers will not be subject to the annual surprise examination if: (i) the sole reason the adviser is deemed to have custody is because client assets are held by a related person; and (ii) the adviser is "operationally independent" of the custodian.[16] Under the Amended Rule, a related custodian will be presumed not to be operationally independent unless the adviser can meet certain conditions set forth in the Rule and no other circumstances exist that may compromise its operational independence.

C. Internal Control Report

Concerned with increased risks posed by affiliated custodial arrangements, the SEC considered, but stopped short of, requiring the use of custodians independent of the adviser.[17] Rather, the SEC stated that encourages the use of independent custodians wherever feasible, but amended the Rule to provide an additional safeguard applicable to Related Person custody arrangements by requiring advisers that maintain client assets with a custodian that is under common control with the adviser must obtain from the custodian an internal control report demonstrating the custodial controls of the affiliated custodian. The report must include an opinion from an independent public accountant that sets forth whether appropriate custodial controls have been established and whether they are operating effectively.[18]

Amendments to Form ADV

In connection with the amendments to the Custody Rule, the SEC adopted several amendments to Form ADV, which require more detailed disclosure of the adviser's custody practices. Specifically, Item 7 of Part 1A requires advisers to report all related persons who are broker-dealers and to identify which, if any, serve as qualified custodians with respect to client assets.[19] Item 9 of Part 1A requires advisers with custody to report amount of those assets and the number of clients for which it has custody.

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[14] Adopting Release, *supra* note 1, at 14-15.

[15] *See* Adopting Release, *supra* note 1, at 17.
[16] Amended Rule 206(4)-2(b)(6).
[17] Adopting Release, *supra* note 1, at 25-27.
[18] Amended Rule 206(4)-2(a)(6)(ii).
[19] Adopting Release, *supra* note 1, at 47-49.

Advisers must provide responses to such Items of Form ADV in their first annual amendment after January 1, 2011.[20]

As a result of the amendments to the Custody Rule, advisers should review, and if necessary revise, their written policies and procedures relating to the safekeeping of client assets. Such procedures will vary based on the extent of each adviser's custody arrangements, but in any event should be reasonably designed to prevent violations of the Amended Rule. For any questions on the amendments to the Custody Rule or this article, or for guidance with implementing necessary revisions to your written policies and procedures, please contact us at (619) 298-2880.

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[20] *Id.* at 54.