

# LOWENSTEIN SANDLER PC CLIENT ALERT

## INVESTMENT MANAGEMENT

ATTORNEY ADVERTISING

### SEC RELEASES FINAL RULES TO STRENGTHEN CUSTODY CONTROLS OF INVESTMENT ADVISERS

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February 11, 2010

**On December 30, 2009, the Securities and Exchange Commission (the "SEC") released final amendments to Rule 206(4)-2 (the "Rule"), promulgated pursuant to Section 206(4) of the Investment Advisers Act of 1940, as amended (the "Advisers Act").<sup>1</sup> The revisions to the Rule followed a period of commentary on a proposed rule release that was put forth by the SEC in May 2009.<sup>2</sup> The following information summarizes and analyzes the existing Rule, the new amendments to the Rule, which will become effective on March 12, 2010, and certain related matters.**

#### The Existing Rule

Pursuant to the Rule, as currently in effect, investment advisers registered (or required to be registered) under the Advisers Act are required to fulfill certain obligations if such advisers are deemed to have custody of client assets. For purposes of the Rule, custody includes possession of client funds or securities, as well as the ability to obtain possession of client funds or securities (such as, for example, the ability to withdraw client funds or securities maintained with a qualified custodian or serving as the

general partner of a limited partnership). If deemed to have custody of client assets, investment advisers registered (or required to be registered) under the Advisers Act must, among other obligations, maintain accounts with "qualified custodians" (e.g., registered broker-dealers) and, with certain exceptions, reasonably believe that the qualified custodian sends quarterly account statements to each advisory client. Certain privately offered securities need not be held by a qualified custodian (including privately offered securities held by a pooled investment vehicle, if the pooled investment vehicle is audited annually and the audited financial statements are distributed to all investors in such pooled investment vehicle). In addition, the adviser itself may send quarterly account statements to clients rather than the qualified custodian if the adviser also engages an independent public accountant to verify client assets in an annual surprise examination. Pooled investment vehicles subject to an annual audit that distribute audited financial statements to investors within designated time frames are exempt from the quarterly account statement distribution requirement (including the associated surprise examination if the adviser distributes the quarterly statements itself).

#### Amendments to the Rule

The amendments to the Rule require all federally registered investment advisers (or those investment advisers required to be federally registered) with custody of client assets to:

- (i) maintain client funds and securities with a qualified custodian in a separate account for each client under that client's name or in an account that contains only client funds and securities with the adviser listed as agent or trustee for the clients<sup>3</sup>;
- (ii) have a reasonable basis, formed after "due inquiry," for believing that the qualified custodian holding client funds or securities sends an account statement to each advisory client at least quarterly. Investment advisers may no longer, as an alternative to having the qualified custodian deliver these accounts statements, send account statements directly to clients if they undergo a surprise examination at least annually<sup>4</sup>;
- (iii) provide a notice to clients upon opening any new custodial account

on behalf of the client (or changes to any such account) and include a legend in such notice urging the clients to compare custodial account statements with any statements received from the adviser (if the adviser elects to send any such statements directly)<sup>5</sup>;

- (iv) undergo an annual surprise examination conducted by an independent public accountant pursuant to a written agreement.<sup>6</sup> Certain “privately offered securities” are now subject to the surprise examination requirement<sup>7</sup>;
- (v) for those investment advisers that either directly or indirectly (i.e., through “related persons”), maintain control of advisory client assets as a qualified custodian, obtain annually an “internal control report” issued by certain independent public accountants that are registered with the Public Company Accounting Oversight Board (the “PCAOB”). The “internal control reports” are intended to assess the quality of the investment adviser’s (or its related person’s) custody controls. In addition, for those investment advisers that either directly or indirectly maintain control of advisory client assets as a qualified custodian, the surprise examination mentioned in (iii) above must also be conducted by an accountant registered with the PCAOB for such investment advisers;
- (vi) make additional custody related disclosures on Part 1A of Form ADV and Schedule D thereto; and
- (vii) for investment advisers to pooled investment vehicles that distribute the pool’s audited financial statements to investors, obtain a final audit of the pool’s financial statements upon

liquidation of the pool and distribute the financial statements to pool investors promptly after the completion of the audit.

Certain requirements of the amended Rule are discussed in more detail below.

#### **Annual Surprise Examinations and Written Agreement with Accountant**

Except as discussed below, the amended Rule requires all investment advisers registered (or required to be registered) under the Advisers Act that have custody of client assets (including privately offered securities) to undergo a surprise annual audit by an independent public accountant. In furtherance of the surprise examination requirement, the amendments to the Rule require all applicable investment advisers to enter into a written agreement with an independent public accountant to conduct the mandatory surprise examinations. The written agreement must require the accountant to notify the SEC within one business day of finding any material discrepancies relating to client assets and to submit Form ADV-E to the SEC within 120 days of the time chosen for the surprise examination. Form ADV-E describes the nature and extent of the surprise examination and the accountant’s services rendered to the investment adviser. Form ADV-E must also be filed by the accountant within 4 business days of its resignation, dismissal, removal or other termination with respect to the applicable engagement.

#### **Exceptions to Surprise Examination Requirements**

Unlike the SEC’s initial proposed amendments to the Rule, the final Rule amendments exempt from the surprise examination (i) investment advisers to pooled investment vehicles subject to an

annual audit (provided that the audited financial statements are delivered to the pool’s investors within 120 days of the pool’s fiscal year end (180 days for funds of funds) and (ii) investment advisers that have custody of client funds or securities solely because of their authority to deduct advisory fees from client accounts. It should be noted, however, that an adviser exempt from the annual surprise examination pursuant to clause (i) above must nonetheless undergo an annual surprise examination of non-pooled investment vehicle assets of which it has custody.

#### **Investment Advisers Acting as Custodian**

The SEC ultimately decided not to adopt their earlier proposal that client assets be maintained by an independent qualified custodian rather than by an investment adviser or related person, although the SEC continues to encourage the use of independent custodians for this purpose where feasible. Instead, the amendments to the Rule provide for additional custody procedures and reports if the adviser or a “related person” maintains client funds or securities as a qualified custodian in connection with advisory services.<sup>8</sup>

The final amended Rule requires that the independent public accountant engaged by any such investment adviser to perform the surprise examination be a member registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (a “PCAOB Accountant”). In addition to the surprise examination by a PCAOB Accountant, any such investment adviser must obtain or receive from its related person an annual “internal control report” describing the investment adviser’s or its related person’s custody controls. Such report must include an opinion from a

PCAOB Accountant addressing the nature and extent of such custody controls. A limited exception exists for advisers that are (i) deemed to have custody solely as a result of its related persons holding client assets and (ii) “operationally independent” of the custodian. An adviser wishing to qualify for this exemption must rebut a presumption that the exemption does not apply by showing that no facts and circumstances exist that can reasonably be expected to compromise the operational independence of the related person.

### **Account Statements**

Investment advisers registered (or required to be registered) under the Advisers Act with custody of advisory client assets must now have a reasonable basis, formed after “due inquiry,” for believing that a qualified custodian sends account statements, at least quarterly, to each of the investment adviser’s advisory clients.<sup>9</sup> The amended Rule eliminates the ability of an investment adviser to send account statements directly to clients if it undergoes a surprise examination by an independent public accountant at least annually. As noted previously, there is an exemption from this custodial account statements delivery requirement for investment advisers to pooled investment vehicles subject to an annual audit (and a final audit upon liquidation). For investment advisers that continue to send statements directly to clients, the amended Rule requires cautionary disclosure language in such statements advising clients to compare the statements to any account statements received directly from the custodian. This cautionary statement must also be included as a legend in the written notice to clients required by the Rule upon opening an account with a

qualified custodian (and in any subsequent related notices to clients).

### **Amendments to Form ADV**

Pursuant to the amendments, the SEC has implemented certain revisions to Form ADV that are designed to provide the SEC with additional detail relating to registered investment advisers’ custody practices. Specifically, registered advisers will be required to disclose all related persons who are broker-dealers and to identify which, if any, serve as qualified custodians with respect to client funds or securities. Additionally, such investment advisers will be required to disclose on Form ADV certain information relating to the accountants that perform annual audits or surprise examinations and/or prepare internal control reports.

### **Compliance Policies and Procedures Guidance**

As part of the final rule release, the SEC has provided guidance with respect to certain policies and procedures that registered advisers with custody of client assets should consider adopting as part of their compliance programs. The SEC states in the final Rule release that they are not suggesting a single set of policies, since investment advisers are too varied in their operations and size. However, the SEC does recommend, among other items, that investment advisers consider:

- conducting background checks and credit checks on employees who have access to client assets;
- requiring the authorization of more than one employee before the movement of assets within, and withdrawals or transfers from, a client account;
- limiting the number of employees who are permitted to interact with

custodians with respect to client assets and rotate such employees on a periodic basis; and

- for investment advisers that also serve as a qualified custodian for client assets, segregating the duties of advisory personnel from those of the custodial personnel to make it difficult for any one person to misuse client assets without being detected.

### **Analysis and Next Steps**

The effective date of the amendments discussed above is March 12, 2010, with the first surprise examination to be conducted by a PCAOB Accountant no later than December 31, 2010. Also, beginning in 2011, advisers must use the revised Form ADV in filing their annual amendments. Before the amendments take effect, federally registered investment advisers should determine the extent of their increased exposure to regulatory oversight by the SEC and the additional costs relating to such regulation. Foremost among such costs, for those investment advisers subject to the requirements, will be the costs of obtaining (i) an internal control report or (ii) the services of an independent public accountant to conduct surprise examinations annually. Federally registered investment advisers will also incur additional responsibilities and incremental costs relating to the “due inquiry” requirement with respect to qualified custodian account statements (if applicable), document retention (e.g., retention of any accountant contracts relating to the surprise examinations) and disclosure. Since the final Rule assumes that client securities and assets can either be held by a qualified custodian or satisfy the requirements of the privately offered securities exemption, investment advisers may also incur additional costs relating to

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the treatment of assets that do not easily fall within either category.

Finally, and perhaps most importantly, investment advisers should review their compliance policies and procedures in light of the recommended guidelines provided by the SEC in the final Rule release. We recommend that both registered and unregistered investment advisers (as a best practices policy) review these guidelines and implement them to the extent applicable to their business.

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Lowenstein Sandler's Investment Management Regulatory and Compliance Group is available to assist our clients with preparing for, or to further discuss, the requirements analyzed in this alert.

Lowenstein Sandler's Investment Management Practice Group will continue to monitor and report on other industry developments that may be of importance to our clients.

**Please contact any of the attorneys below, or any other member of Lowenstein Sandler's Investment Management Group, for further information on the matters discussed herein.**

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1 See, SEC Release No. IA-2968; File No. S7-09-09, available [here](#).  
2 The Lowenstein Sandler client alert analyzing the proposed rule is available [here](#).  
3 "Privately offered securities," discussed in more detail in this client alert, are not subject to the qualified custodian requirement.  
4 Advisers to pooled investment vehicles that distribute the pool's audited financial statements to investors within specified timeframes are not subject to this requirement.  
5 The amended Rule also requires investment advisers that elect to send statements directly to clients to include the cautionary disclosure in such statements.  
6 The following advisers/assets are exempt from the surprise examination requirement: (1) investment advisers to pooled investment vehicles subject to an annual audit, (2) investment advisers that have custody of client funds or securities solely because of their authority to deduct advisory fees from client accounts, and (3) investment advisers that have custody of client funds or securities solely as a result of its "related persons" holding client assets if such investment adviser is "operationally independent" from such related persons.  
7 "Privately Offered Securities" are securities that are (i) acquired from the issuer in a transaction or chain of transactions not involving any public offering, (ii) uncertificated, with ownership recorded only on the books of the issuer or its transfer agent, and (iii) transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.  
8 A "related person" is defined as a person directly or indirectly controlling or controlled by an investment adviser and any person under common control with the adviser, while "control" is defined as the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise.  
9 The "due inquiry" standard may be satisfied by receiving some proof of actual delivery to the client (such as receiving a copy of the delivered statement).

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