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SEC Proposes Amendments to Custody Rule

On May 20, 2009, the Securities and Exchange Commission (“SEC”) proposed revisions to Rule 206(4)-2 of the Investment Advisers Act of 1940 (the “Custody Rule”) and is seeking comments on its proposal.¹ The proposed amendments are intended to better safeguard client funds held by investment advisers. In sum, the proposed rule would require the following changes for advisers.

- Advisers deemed to have custody of client funds and securities, including hedge fund managers that serve as the fund’s general partners, as well as advisers that have custody solely because they have authority to withdraw advisory fees from client accounts:
 - *currently*, are not required to undergo a surprise annual examination if they have a reasonable belief that a qualified custodian provides account statements directly to clients;
 - *under the proposed rule*, would be subject to an annual surprise examination by an independent public accountant *and* would have to conduct “due inquiry” to form the basis of a reasonable belief that the qualified custodian sends account statements to clients.
- 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:²
 - *currently*, are not subject to additional regulation;
 - *under the proposed rule*, would have to obtain from the related person a SAS-70 report from a Public Company Accounting Oversight Board (“PCAOB”)-registered independent public accountant, and would also be subject to a surprise audit by a PCAOB-registered independent public accountant.
- Advisers undergoing a surprise examination by an independent public accountant:
 - *currently*, must require that Form ADV-E be filed within 30 days of the completion of the audit;
 - *under the proposed rule*, would have to require that Form ADV-E be filed within 120 days from the date the audit *commences*. In addition, Form ADV-E would have to be submitted to the SEC within 4 days of the departure, dismissal, or removal of itself from being considered for reappointment along with an explanation of any problems relating to the surprise examination of any contracted accountant.

¹ Investment Advisers Act Rel. No. 2876 (May 20, 2009).

² The release makes clear that the SEC staff will withdraw the *Crocker Investment Management Corp.* no-action letter (April 4, 1978) if the proposed amendment is adopted. *Crocker* set forth factors the SEC staff would consider in determining whether an adviser has “indirect custody” through its related person. The proposed rule would automatically impute custody if a related person acts as a qualified custodian for the adviser’s clients’ assets.

Summary of Proposed Changes

Advisers with custody. The proposed rule would require *all* registered investment advisers with custody of client assets to undergo an annual surprise examination by eliminating the current exceptions for advisers (i) whose client assets are held by qualified custodians that provide account statements directly to the adviser's clients; and (ii) that act as general partners to pooled investment vehicles that distribute audited financial statements to their limited partners within 120 days of the end of the fiscal year.³ In addition, privately offered securities would become subject to the surprise examination.

The proposal also would (i) eliminate advisers' option to deliver quarterly account transaction reports directly to clients; and (ii) require advisers to conduct "due inquiry" to form the basis of a reasonable belief that reports are sent by the qualified custodian to the adviser's clients. The SEC states that the provision of reports directly to clients by the qualified custodian would better assure their integrity.

Advisers that act as general partners to pooled investment vehicles would continue to be excepted from the requirement to have a qualified custodian send account statements to limited partners if the pool is audited annually, distributes audited financial statements to the limited partners within 120 days of fiscal year end, and upon liquidation distributes audited financial statements to the limited partners promptly after the audit's completion. Even though such advisers would be exempt from the requirement to have qualified custodians send account statements to the limited partners, they would still be required to undergo an annual surprise examination.

Advisers are currently required to give notice to clients upon opening of a custodial account on the client's behalf. The proposed rule would require advisers to include in this notice a statement urging clients to compare their account statements from the custodian with those from the adviser.

³ We note that the proposal is silent on issues related to private funds of funds. We anticipate the treatment of funds of funds to be raised in comments to the proposal.

Related persons as qualified custodians. Under the proposed rule, if an independent custodian does not hold client assets, the adviser would be deemed to have custody and would have to obtain from the related person annually an internal control report that includes an opinion from an independent public accountant registered with the PCAOB. The internal control report would have to contain a description of control objectives, controls, accountant's tests, and the results of those tests. The adviser would have to retain a copy of the internal control report for five years from the end of the fiscal year in which it is issued. Because the adviser's custody would have to be "in connection with" its advisory services, an adviser would not be deemed to have custody of client assets held by a related qualified custodian with respect to which the adviser does not provide investment advice.

In addition, when an adviser or related person serves as qualified custodian, the adviser's requisite surprise annual examination would have to be performed by an accountant registered with the PCAOB, in accordance with the rules of the PCAOB.

Form ADV-E. The proposed rule would require significant changes to Form ADV-E, including that Form ADV-E be filed by the independent public accountant within 120 days of the date the surprise examination commences. The adviser would have to have a written agreement with the accountant that requires it to submit the Form ADV-E and report to the SEC material discrepancies within one business day. Such 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 (including by itself), accompanied by a statement detailing any problems with the examination scope or procedure that contributed to the departure.

Other proposed changes. In addition, the proposed rule would require amendments to Form ADV designed to provide the SEC and the public with greater information on how advisers are maintaining client funds. More specifically, the proposed rule would amend Item 7 of Part 1A to require, instead of permit, an adviser to report all related persons who are broker-dealers and identify

those which serve as qualified custodians with respect to the clients' funds. Item 9 of Part 1A would require advisers and related persons with custody to report the amount of client assets and number of clients for which they have custody. Schedule D of Form ADV would include additional items requiring identification of accountants that perform audits, surprise examinations, and internal control reports and of related persons that serve as qualified custodians.

Conclusion

Recently, the SEC has brought several enforcement actions against investment advisers and broker-dealers alleging fraudulent conduct. With these amendments, the SEC seeks to prevent further misuse of client assets and allow for earlier detection of fraudulent activities. In order to best accomplish its objectives, the SEC has requested comment on several key issues, including whether:

- an accountant's "termination statement" should be made publicly available;
- the SEC should simply require that an independent qualified custodian hold client assets;
- the SEC should continue to exempt advisers of pooled vehicles audited at least annually from the surprise examination requirement;
- it is feasible to require advisers to obtain a surprise examination with respect to privately offered securities; and
- circumstances exist in which a related person's custody of client assets should not be imputed to the adviser.

Comments on the proposal must be received by July 28, 2009.

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