SEC Adopts Revised Custody Rule Enhancing Controls That Apply To Registered Investment Advisers

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On December 16, 2009, the Securities and Exchange Commission (the "SEC" or "Commission") approved the adoption of amendments to Rule 206(4)-2 of the Investment Advisers Act of 1940 (the "Advisers Act"), which relates to custody of client assets. The final rule was published on December 30, 2009 and will become effective 60 days after publication. The SEC's long-anticipated action affirms the Commission's renewed focus on regulating investment advisers and providing additional safeguards for investors entrusting their money and securities with SEC registered investment advisers.

Rule 206(4)-2 regulates the custody practices of investment advisers registered under the Advisers Act. The new rule targets investment advisers that have "custody" of client assets. The rule defines "custody" to mean "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them" (Revised §275.206(4)-2(d)(2)), which is consistent with the definition of "custody" under the current rule. A general partner of a limited partnership has custody, for example, by virtue of its powers as general partner.

Delivery of Quarterly Reports and Other Notifications to Clients

As under the current rule, subject to a few exceptions, registered investment advisers with custody of client funds or securities must use a "qualified custodian" to maintain such assets. In addition, consistent with the current rule, account statements must be delivered to clients on a quarterly basis. Unlike the current rule, however, under the new rule such reports must be delivered directly to clients by qualified custodians and can no longer be sent to clients by the adviser.

An adviser will be in compliance with this reporting requirement if such adviser has a reasonable basis, after due inquiry, to believe that the qualified custodian is sending quarterly account statements directly to clients. While the Commission does not indicate how an adviser shall perform "due inquiry" when asserting a reasonable belief that a qualified custodian sends these statements to clients, in the accompanying release (Release No. IA-2968) (the "Release") the Commission suggests that an adviser "could form a reasonable belief after "due inquiry" if the qualified custodian provides the adviser with a copy of the account statement that was delivered to the clients."

Under the current rules, investment advisers to hedge funds and other pooled investment vehicles are not required to comply with the quarterly reporting rules if the vehicle is subject to an annual audit and the audited financial statements are delivered to investors within 120 days after the end of the fiscal year. Under the new rule, to comply with the reporting requirements in the same fashion, an adviser would be required to engage an auditor who is registered with, and subject to regular inspection by, the PCAOB. In addition, audited financial statements must be prepared and distributed upon liquidation of such pooled investment vehicle.

It should be noted that the new rules specifically preclude an adviser from satisfying the delivery requirement by interposing other vehicles, such as feeder funds or special purpose investment vehicles, into a fund structure. Specifically, the rule provides that an adviser's delivery of account statements or audited financial statements to pooled investment vehicles that are related persons of the adviser does not satisfy the new rule. Accordingly, delivery must be made to the underlying investors.

The new rule also adds a requirement that registered advisers who send account statements to clients include in both the notification to clients regarding the opening of a custodial account on behalf of such client, as well as any subsequent statements sent to such client, a cautionary legend urging clients to compare any account statements received from the adviser with those received from the qualified custodian.

Annual Surprise Examination

Under the new rule, registered investment advisers with custody of client assets will be required to enter into a written agreement with an independent public accountant to perform surprise examinations of client assets, including privately offered securities held on behalf of a client, and determine whether client assets are being properly maintained. The first surprise examination must take place by December 31, 2010 or, for advisers becoming subject to the requirement after the effective date, within six months of becoming subject to the requirement. These examinations will be conducted by independent public accountants who are engaged by investment advisers to conduct these examinations and mandated under the new rules to report any finding of material discrepancies to the Commission within one day. Independent public accountants conducting such surprise examinations are also required to file a Form ADV-E within 120 days of the date of the surprise examination and within 4 business days of the termination of the engagement of such accountant by the adviser. The new rule provides certain exceptions to the annual surprise examination requirement.

Advisers to hedge funds and other pooled investment vehicles subject to an annual audit and with respect to which financial statements are delivered to investors within 120 days after the end of the fiscal year and upon liquidation are deemed to have complied with the annual surprise examination requirement with respect to such pooled investment vehicle provided that the auditor to such vehicle is registered with, and subject to regular inspection by, the PCAOB.

Custody by advisers or related persons

Registered investment advisers that act as qualified custodian with respect to client assets, or that have a related person act as such qualified custodian, are subject to additional requirements under the new rule, including an annual assessment of custody controls conducted by an independent public accountant registered with, and subject to regular inspection, by the PCAOB.

Guidance on Compliance Policies and Procedures

As part of the Release, the SEC also provided guidance regarding the requirements of Rule 206(4)-7, which requires advisers with custody of client assets to adopt policies and procedures designed to prevent misuse or misappropriation of client assets. Included among the suggestions contained within the Release are conducting background and credit checks on all employees who could access client assets, requiring authorization from more than one employee in connection with any movement of client assets, and developing procedures for Chief Compliance Officers to periodically test the effectiveness of such controls.

The SEC also adopted amendments to Form ADV to require the disclosure of more detailed information about custody practices, and Form ADV-E to reflect the changes in reporting requirements respectively resulting from the new rules.

The new rules will be effective **February 28, 2010**. Foley Hoag will monitor the Commission's continued interest and actions in this area.

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