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Private Funds Alert

FEBRUARY 2010

Amendments To The Custody Rules: New Controls On Custody Of Client Assets

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Summary/Background

The Securities and Exchange Commission (**"SEC"**) recently adopted amendments to Rules 206(4)-2 (the **"Rule"**) and 204-2 of the Investment Advisers Act of 1940 (the **"Amendments"**), and Forms ADV and ADV-E. The Amendments are designed to strengthen controls on SEC-registered investment advisers with custody of client assets and deter fraudulent conduct and increase the likelihood of early detection of such conduct.

Subject to certain exceptions, the Amendments require a registered investment adviser with custody of client assets to, among other things:

1. engage an independent public accounting firm to conduct an annual surprise examination to verify the existence of client assets;
2. require the custodian to send account statements directly to the advisory clients; and
3. obtain a report on the adequacy of internal controls relating to the custody of client assets (e.g., a SAS-70 Report) from an independent public accountant that is registered with the Public Company Accounting Oversight Board (**"PCAOB"**) unless client assets are maintained by an independent custodian (*i.e.*, a custodian other than the adviser or a related person of the adviser).

Except as noted below, an adviser must comply with the Amendments **commencing March 12, 2010**.

What Constitutes Custody?

An adviser is deemed to have custody of client assets under Rule 206(4)-2(d)(2) when it holds client funds or securities or has authority to obtain possession of them. Thus, under the Amendments, an adviser who deducts advisory fees from a client account or has authority to withdraw client funds will be deemed to have custody of those assets. Typically, this would include the general partner of a limited partnership or the manager or managing member of a limited liability company. Additionally, the Amendments provide that an adviser has custody of any client assets that are held by a "related person" in connection with advisory services provided by the adviser. A "related person" is defined under the Rule as a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser, which would include an affiliated broker-dealer. The SEC believes that the authority or influence an adviser may have over a related person presents sufficient risk that the related person could obtain

client assets, and as such, the adviser to a related person should be deemed to have custody of such client assets.

Annual Surprise Examination of Client Assets

The Amendments require, with certain exceptions, that advisers with custody of client assets engage an independent accounting firm to conduct an annual surprise examination (or an audit, if applicable) of those assets to verify the existence of those assets. Advisers who are NOT required to undergo a surprise examination include the following:

- Advisers that have custody of client assets solely because of their authority to deduct advisory fees from client accounts;
- Advisers of pooled investment vehicles that are subject to annual financial statement audits by a PCAOB-registered independent public accountant and that distribute the audited financials prepared in accordance with generally accepted accounting principles to such pools' investors within 120 days of the end of such pools' fiscal year (180 days for a fund of fund); and
- Advisers that are presumed to have custody solely because a related person is acting as custodian if such advisers are "operationally independent" of their related person.[1]

An adviser who is subject to the new surprise examination requirement must enter into a written agreement with an independent public accountant to conduct the examination **by December 31, 2010**.

In addition, the SEC has acknowledged the concerns raised by commentators with respect to the impact of the surprise examination requirement on smaller advisers whose client assets are maintained by an independent qualified custodian, and the SEC is undertaking a study to evaluate the impact. The results of the review, along with any recommendations for amendments to improve the effectiveness of the Rule as it applies to these advisers, will be provided by the SEC staff after the completion of the first round of surprise examinations of these advisers. Shipman & Goodwin will monitor the SEC's progress and update you with any new developments.

Delivery of Account Statements and Notice

The Amendments require that advisers or their qualified custodians deliver quarterly account statements directly to the client.[2] This requirement applies to advisors who have custody solely because of fee withdrawals. The Amendments eliminate the alternative delivery method which allowed a registered investment adviser to deliver quarterly account statements to clients if it underwent a surprise examination by an independent public accountant at least annually. Under the Amendments, an adviser must have a reasonable belief after "due inquiry" that the qualified custodian sent account statements to advisory clients. The SEC has not prescribed any

1 Amended Rule 206(4)-2(d)(5) defines "operationally independent." The conditions to achieving such independence in the rule are as follows: (i) client assets in the custody of the related person are not subject to claims of the adviser's creditors; (ii) advisory personnel do not have custody or possession of, or direct or indirect access to, client assets of which the related person has custody, or the power to control the disposition of such client assets to third parties for the benefit of the adviser or its related persons, or otherwise have the opportunity to misappropriate such client assets; (iii) advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision; and (iv) advisory personnel do not hold any position with the related person or share premises with the related person.

2 A qualified custodian under the Rule includes the types of financial institutions to which clients and advisers customarily turn for custodial services, such as, a bank or a savings association, a registered broker-dealer and a futures commission merchant.

specific method for establishing a reasonable belief after "due inquiry" but stated that the custodian's providing the adviser with a copy of the account statement that was delivered to the clients would satisfy the due inquiry requirement. The Amendments require advisers to notify their clients promptly upon opening a custodial account and when there are changes to the information required in that notification. If an adviser intends to deliver its own account statements in addition to the account statements delivered by the qualified custodian, the Amendments require the advisers to include a legend in the notice advising clients to compare the account statements they receive from the custodian with those they receive from the adviser.

Privately Offered Securities

Accountants conducting the annual surprise inspection are now required under the amended Rule to examine certain privately offered securities. **"Privately offered securities"** are securities which (i) were acquired from the issuer in a transaction or chain of transactions not involving any public offering; (ii) are uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client; and (iii) are transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer. In a companion release, the SEC requires auditors to confirm the privately offered securities with their issuer or counterparty. However, the SEC is not requiring auditors to confirm the valuation of such securities.

Internal Control Report

The new internal control requirement requires advisers to obtain an internal control report from its independent public accountant that demonstrates that the advisers or their respective related persons have established appropriate custodial controls. The report must include the accountant's opinion as to whether the qualified custodian's internal controls have been placed in operation as of a specific date and are suitably designed, and are operating effectively to meet control objectives related to custodial services. The SEC is not requiring a particular type of report so long as the report satisfies the Rule's requirements. The SEC has indicated that a related person custodian may be able to use a Type II SAS 70 report to satisfy the requirement; therefore, accountants of qualified custodians may be able to utilize audit work already performed to meet existing regulatory requirements, which should increase cost-effectiveness in the audit process.

Form ADV and ADV-E

The SEC has also adopted several companion amendments to Form ADV in order to secure more detailed information about adviser custody practices in their registration form and to update their information. In Item 7 and Section 7.A. of Schedule D, the SEC is requiring each adviser to report all related persons who are broker-dealers and to identify which, if any, serve as qualified custodians with respect to client assets. In addition, the SEC is now requiring a registered adviser to report whether it has overcome the presumption that it is not operationally independent from a related person broker-dealer acting as a qualified custodian. Unless it is operationally independent, it is required to obtain a surprise examination of the custodian. In addition, under Item 9 of Part 1A, the SEC requires an adviser with custody to report the amount of client assets and the number of clients for whom

the adviser has custody. Those advisers that have custody solely by virtue of the deduction of fees can continue to answer "no" to Item 9.A. Schedule D was also amended to identify and provide certain information about the accountants that perform audits or surprise examinations and that prepare internal control reports and to identify related persons, such as banks, that serve as qualified custodians but are otherwise not reported in Item 7.

The SEC adopted the following three amendments to the instructions to Form ADV-E: (i) the form and the accountant's examination certificate must be filed electronically through the Investment Adviser Registration Depository (**"IARD"**); (ii) the surprise examination certificate must be filed within 120 days of the time chosen by the accountant for the surprise examination; and (iii) a termination statement must be filed by an accountant within four business days of its resignation, dismissal or removal.

Compliance Policies and Procedures

Rule 206(4)-7 requires SEC-registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Investment Advisers Act of 1940 and its rules. The Amendments provide guidance as to what policies and procedures relating to safeguarding client assets advisers should consider for inclusion in their compliance programs. Advisers should consider, among other things, the following policies and procedures:

- Conducting background and credit checks on employees who have (or could acquire access to) client assets;
- Requiring the authorization of more than one employee before moving assets within, and withdrawals or transfers from, a client's account as well as requiring authorization before making changes to account ownership information;
- If the adviser serves as a qualified custodian, segregating duties of its advisory personnel from those of its custodial personnel to prevent the misuse of client assets;
- Requiring employees to bring any problems to the attention of the management of the adviser; and
- Prevention of individual employees from acquiring custody (e.g., acting as trustees of client assets).

The SEC recognizes that different controls may be appropriate for different advisers in designing effective compliance programs and no single set of policies and procedures is required to ensure compliance with the rule.

Compliance Dates

SEC-registered investment advisers must comply with the Amendments and Forms ADV and ADV-E, as amended, **on or after March 12, 2010**, except as otherwise described in the **chart on the final page of this Alert**.

Questions or Assistance

If you would like to discuss these issues in further detail, please contact Peter Bilfield at (203) 324-8151 or pbilfield@goodwin.com, John Lawrence at (860) 251-5139 or jlawrence@goodwin.com, or Donna Brooks at (860) 251-5917 or dbrooks@goodwin.com.

To view the final SEC release, see http://www.sec.gov/rules/final/2009/ia-2968.pdf.

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KEY COMPLIANCE DATES FOR AMENDED CUSTODY RULE

Rule Amendment		Compliance Date or Period
Surprise Examination		• By December 31, 2010, adviser must enter into a written agreement with an independent public accountant; • Advisers that become subject to the surprise examination requirement after the effective date, within six (6) months after becoming subject to the requirement; or • Advisers that maintain client assets as qualified custodians (*i.e.*, self-custody), the first surprise examination must be no later than six (6) months after obtaining the internal control report described below.
Internal Control Reports		• Advisers required to obtain an internal control report because it or a related person is a qualified custodian, must obtain or receive such report within six (6) months of becoming subject to the requirement.
Pooled Investment Vehicles		• Advisers to a pooled investment vehicle may rely on the annual audit provision if the adviser (or related person) becomes contractually obligated to obtain an audit of the financial statements of the pooled investment vehicle for fiscal years beginning on or after January 1, 2010.
Forms ADV and ADV-E		• Advisers must provide responses to the revised Form ADV in their first annual amendment after January 1, 2011. Accountants providing surprise examinations should continue paper filings of Form ADV-E until IARD is updated.

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