WINSTON & STRAWN LLP

BRIEFING

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SEC Adopts Amendment to Advisers Act Custody Rule to Better Protect Investor Funds

The Securities and Exchange Commission (the "SEC") has issued a release (the "Adopting Release") adopting amendments to Rule 206(4)-2 (the "Custody Rule") and related recordkeeping rules and Forms ADV and ADV-E under the Investment Advisers Act of 1940, as amended (the "Advisers Act") (the "Amendments").[1] According to the Adopting Release the Amendments represent a first step in the SEC's effort to enhance custody protections. The Amendments are designed to provide additional safeguards under the Advisers Act when an investment adviser registered with the SEC (an "RIA") has custody of client funds or securities, by requiring such RIA to maintain its clients' assets with a qualified custodian, such as a broker-dealer or a bank. The Amendments also require most RIAs that have custody of client assets, among other things: (i) to undergo an annual surprise examination by an independent public accountant to verify client assets; (ii) to have a reasonable basis, after due inquiry, for believing that the qualified custodian maintaining client funds and securities sends account statements directly to the advisory clients; and (iii) unless client assets are maintained by an independent custodian (*i.e.*, a custodian that is not the RIA itself or a "related person"[2]) to obtain, or receive from a related person, a report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board (the "PCAOB").

The Amendments are substantially similar to rule changes that the SEC proposed in May 2009 (the "Proposals")[3] with the exception of certain aspects of those rule changes, such as the application of the "surprise audit" to RIAs to pooled investment vehicles (a "Fund"), and to RIAs who are deemed to have custody solely because they may deduct their fees from a client's account.

The current Rule and the Amendments only apply to RIAs. Thus, managers of hedge funds or private equity funds that rely on the exemption from SEC registration in Section 203(b)(3) of the Advisers Act, as well as state-registered advisers, are not affected.

This briefing discusses the four principal components to the Amendments: (i) expansion of the "surprise exam" requirement; (ii) requiring an "SAS 70" report for RIAs with physical custody of client assets; (iii) imposing a pubic reporting requirement on RIAs and their accountants; and (iv) requiring direct delivery of account statements. This briefing also provides a summary

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[1] Investment Advisers Act Release No. IA-2968 (December 30, 2009), __ FR _____ (January __, 2010).

[2] A related person is defined in the Amendments as a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser. *See* the Release, Rule 206(4)-4(d)(7).

[3] Investment Advisers Act Release No. IA-2876 (May 20, 2009); *See* the Winston & Strawn Briefing "SEC Proposes Amendments to Advisers Act Custody Rule to Better Protect Investor Funds Against Madoff-Type Investment Scams" available at: http://www.winston.com/siteFiles/Publications/5_21_09_SEC_Proposes_Amendment.pdf

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of the Amendments that are applicable to pooled investment vehicles, and discusses SEC guidance on compliance policies and procedures relating to the Custody Rule.

Surprise Exam

The SEC adopted, as proposed, an amendment to the Custody Rule that eliminates an alternative to the requirement that a "qualified custodian" send an account statement, at least quarterly, to each client for which the qualified custodian maintains funds or securities. Under the alternative an adviser could send quarterly account statements to clients if it undergoes a surprise examination by an independent public accountant at least annually.[4]

The Proposals would have required all RIAs with custody of client assets to undergo an annual "surprise exam" by a public accountant that meets the standards for independence described in SEC Regulation S-X to verify the existence of the assets, and would have included RIAs to pooled investment vehicles (a "Fund"), even if the Fund was audited annually and distributed its audited financial statements to its limited partners (or other investors) within 120 days of the end of its fiscal year. However, under the Amendments, an RIA to a Fund that is subject to an annual financial statement audit by an independent public accountant registered with, and subject to regular inspection by, the PCAOB, and that distributes the audited financial statements prepared in accordance with generally accepted accounting principles to the pool's investors, is deemed to have satisfied the annual surprise examination requirement.[5]

The Proposals would also have significantly increased the number of RIAs subject to the Rule by subjecting RIAs who have the ability to deduct fees from client accounts (such as RIAs that manage Funds) to the surprise audit requirement. However, the SEC took note of comments that the surprise examination would not provide materially greater protection to advisory clients when the RIA has custody of client assets *solely* because of its authority to deduct advisory fees from client accounts ("Fee-Only RIA"), and included an exception for such advisers in the Amendments. Instead, the SEC is recommending that RIAs adopt appropriate internal policies and procedures regarding their fee deduction practices.

The exception from the surprise examination requirement for Funds and Fee-Only RIAs is limited in the case of an RIA that is deemed to have custody solely because client securities or funds are directly or indirectly held by a related person. In response to comments, the SEC is providing a limited exception from the surprise examination requirements in such circumstances. The exception is available to an RIA that is (i) deemed to have custody solely as a result of certain of its related persons holding client assets, and (ii) "*operationally independent*" of the custodian. The conditions set out in the rule for this exception are that: (i) client assets in the custody of the related person are not subject to claims of the RIA'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 RIA 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. In adopting this exception, the SEC stated that it would not consider a related person that shared management persons with the RIA, including an owner that was actively involved in the management of the two firms, to be operationally independent.[6]

An RIA required to obtain a surprise examination must enter into a written agreement with an independent public accountant that provides that the first examination will take place by December 31, 2010.

SAS 70 Report

In order to encourage RIAs to use independent custodians, the Proposals provided that when an RIA or an affiliate directly holds client assets, *i.e.*, it has physical custody, the RIA would have to obtain a written control report that includes an opinion from an independent accountant registered and inspected by the PCAOB that, among other things, describes the controls in place, tests the operating effectiveness of those controls, and provides the results of those tests. These reports are commonly known as SAS-70 reports. This review would have to meet PCAOB standards — providing quality control over the accountants performing the review. The SEC revised the Proposals to state that, for the internal control report to satisfy the rule's requirements, the independent public accountant preparing the report must verify that the client funds and securities are reconciled to a custodian other than the RIA or its related person.

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4 Rule 206(4)-2(a)(3)(ii).

5 In a companion accounting release, the SEC is providing updated guidance for accountants that addresses the surprise examination, as well as the internal control report requirements in the amended Custody Rule, and the relationship between them. Investment Advisers Act Release No. IA-2969 (December 30, 2009), __ FR _____ (January __, 2010).

6 In light of the Amendments to the definition of custody the SEC is withdrawing several no-action letters to the extent that such letters are inconsistent with this definition, including *Crocker* and *Pictet et Cie*, SEC Staff Letter (Jun. 22, 1980). RIAs, including those firms that have relied on these letters in the past, now must instead comply with the amended rule.

Public Reporting (Amendments to Form ADV and Form ADV-E)

The SEC also proposed imposing on RIAs public reporting requirements designed to alert the SEC staff and investors to potential problems at an RIA, and provide the SEC with important information for risk assessment purposes. Under the Proposals an RIA would be required to disclose in its Form ADV Part I, among other things, the identity of the independent public accountant that performs its "surprise exam," and amend its Form ADV if it changes accountants. The accountant would have to report the termination of its engagement with the RIA and, if applicable, any problems with the examination that led to the termination of its engagement. If the accountants find any material discrepancies during the surprise examination, the accountant would have to report them to the SEC within one business day. The SEC adopted these requirements as proposed.

RIAs must provide responses to the revised Form ADV in their first annual amendment after January 1, 2011.

Delivery of Account Statements

The Proposals would require that all custodians holding advisory client assets, subject to applicable consumer privacy laws, deliver custodial statements directly to advisory clients rather than through the RIA, and that RIAs opening custody accounts for clients instruct those clients to compare account statements they receive from the custodian with those received from the RIA. The Amendments add a new provision that precludes RIAs from using layers of pooled investment vehicles to avoid meaningful application of the protections of the Custody Rule. The Amendments also require each RIA, if the RIA sends account statements in addition to those sent by the custodian, to add a legend in its notification to clients upon opening a custodial account on their behalf, and in any subsequent account statements that it sends to those clients, urging them to compare the account statements from the qualified custodian to those from the RIA.

Summary of the Application of the Amendments to Pooled Investment Vehicles

As a result of the Amendments, an RIA to a Fund may be deemed to comply with the surprise verification requirements of the Custody Rule by obtaining an audit of the Fund and delivering the audited financial statements to Fund investors within 120 days of the Fund's fiscal year-end. The audit must be conducted by an accounting firm registered with, and subject to regular inspection by, the PCAOB. If the Fund does not distribute audited financial statements to its investors, the RIA must obtain an annual surprise examination and must have a reasonable basis, *after due inquiry*, for believing that the qualified custodian sends an account statement of the Fund to its investors in order to comply with the Custody Rule. The Custody Rule requires the accounting firm performing the surprise examination to verify privately offered securities, along with other funds and securities, held by a Fund that is not subject to a financial statement audit. Regardless of whether an RIA to a Fund obtains a surprise examination or satisfies that requirement by obtaining an audit, if the Fund's assets are maintained with a qualified custodian that is either the RIA to the Fund or a related person of the RIA, the RIA to the Fund would have to obtain, or receive from the related person, an internal control report. Finally, under the Amendments the Custody Rule requires RIAs to Funds complying with the rule by distributing audited financial statements to investors to also obtain an audit upon liquidation of the pool when the liquidation occurs prior to the Fund's fiscal year-end.

Guidance on Compliance Policies and Procedures

Rule 206(4)-7 under the Advisers Act requires RIAs to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules. These policies and procedures should address, among other things, the safeguarding of client assets from conversion or inappropriate use by advisory personnel. In the Adopting Release the SEC stated its belief that an adviser's maintenance of strong policies and procedures is an essential component of the SEC's comprehensive approach to addressing the potential risks raised by an adviser's custody of client assets. The SEC also provided guidance regarding the types of policies and procedures relating to safekeeping of client assets that advisers should consider including in their compliance programs. The SEC stated that advisers with custody of client assets should consider the value of instituting the following policies and procedures as part of their compliance programs:

- conducting background and credit checks on employees of the RIA who will have access (or could acquire access) to client assets to determine whether it would be appropriate for those employees to have such access;
- requiring the authorization of more than one employee before the movement of assets within, and withdrawals or transfers from, a client's account, as well as before changes to account ownership information;
- limiting the number of employees who are permitted to interact with custodians with respect to client assets and rotating them on a periodic basis; and
- if the RIA also serves as a qualified custodian for client assets, segregating the duties of its advisory personnel from those of custodial personnel to make it difficult for any one person to misuse client assets without being detected.

The SEC also stated that advisers should consider including in their policies and procedures a requirement that any problems be brought to the immediate attention of the RIA's chief compliance officer ("CCO") and/or the management of the RIA, and also should consider developing policies regarding the ability of individual employees to acquire custody of client assets, because their custody may be attributable to the RIA, which could result in the RIA being deemed to have custody.[7] The SEC further stated that RIAs that permit employees to serve in capacities whereby the firm acquires custody of client assets should take steps to assure themselves that their employees' custodial practices conform to the firm's policies and procedures, and that the RIA's CCO has access to sufficient information to enforce those policies and procedures.

[7] In the Adopting Release the SEC said that this could occur if an employee becomes a trustee for client assets or obtains a power of attorney for clients separate and apart from the RIA.

The Financial Services Practice Group of Winston & Strawn LLP represents a broad range of financial institutions on all regulatory matters. If you have any questions, or require legal advice in connection with the matters discussed in this briefing; or if you need assistance in preparing policies or procedures relating to the Custody Rule, please contact any of the Winston & Strawn attorneys listed below or your usual Winston & Strawn contact:

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