

**SEC ADOPTS AMENDMENTS TO THE ADVISERS ACT CUSTODY RULE**

The Securities and Exchange Commission (the “Commission”) celebrated the new year by adopting a number of significant amendments to Rule 206(4)-2 under the Investment Advisers Act of 1940 (the “Advisers Act”), which regulates custody activities of entities registered under the Advisers Act<sup>1</sup> (the “Custody Rule”). The final amendments reflect a significant improvement in terms of their scope and operation over those proposed by the Commission in May 2009.<sup>2</sup> The amendments do, however, make significant changes to the Custody Rule and will likely substantially affect the practices of many investment advisers and other industry participants.

The effective date of the amendments is March 12, 2010. Registered advisers must comply with the amendments beginning on that effective date, except as noted below.

**Overview**

Summarized in the overview below are a number of the new requirements embedded in the amendments for registered advisers that have custody of client funds or securities. Following the overview is a more detailed discussion of the new requirements and related changes to the Advisers Act.

- ***Annual Surprise Examination.*** Like the amendments to the Custody Rule proposed last May, the final amendments require certain registered investment advisers to undergo an annual surprise examination by an independent public accountant to verify client assets. However, a significantly smaller number of advisers are subject to the requirements under the final amendments than under the proposed amendments. In particular, the following advisers will *not* be required to obtain an annual surprise examination:
  - (i) an adviser to a pooled investment vehicle that sends audited financial statements of the pool to pool investors, so long as an independent public accountant registered with, and subject to regular inspection by, the Public Company

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<sup>1</sup> See *Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2968 (December 30, 2009) (the “Release”), available at <http://www.sec.gov/rules/final.shtml>. See also the Willkie Client Alert, [“SEC Adopts Amendments to the Advisers Act Custody Rule” \(December 18, 2009\)](#).

<sup>2</sup> The amendments were proposed by the SEC in May 2009. See *Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2876 (May 20, 2009) (the “Proposing Release”), available at <http://www.sec.gov/rules/proposed.shtml>. See also the Willkie Client Memorandum, [“SEC Proposes Changes to the Advisers Act Custody Rule to Increase Reliance on Auditors” \(May 27, 2009\)](#).

Accounting Oversight Board (a “PCAOB Accountant”) performs the audit of the pooled investment vehicle’s financial statements;

- (ii) an adviser deemed to have custody solely because the adviser has authority to deduct fees directly from client accounts; and
  - (iii) an adviser that is deemed to have custody solely because it uses a related person as a custodian for client assets but is “operationally independent” from the related person.
- ***Delivery of Account Statements.*** A registered investment adviser is required under the Custody Rule, as amended, to have a reasonable basis for believing that the “qualified custodian” (as defined in the Rule) maintaining client funds and securities will send quarterly account statements directly to the advisory clients, except in the case of advisers to pooled investment vehicles that send pool financials audited by a PCAOB Accountant to pool investors.
  - ***Internal Control Reports.*** The amendments provide that, if the registered adviser itself or a related person is the custodian of client funds or securities, the adviser must obtain, or receive from the related person, a report of the internal controls relating to the custody of client assets from a PCAOB Accountant.
  - ***Special Purpose Vehicles.*** When a registered adviser is using a special purpose vehicle or other intermediary entity (“SPV”) to facilitate investment by pooled investment vehicles, the adviser must, under the amendments, either (i) treat the SPV as a separate client for purposes of the Custody Rule and distribute account statements and audited financials for the SPV to the investors in the pooled investment vehicle, or (ii) include the assets of the SPV as part of the audits and account statements for the pooled investment vehicle.

The changes to the Custody Rule described above are supplemented by modifications the Commission has made to Form ADV, the form under the Advisers Act used to register an entity under the Act. Form ADV, as amended, requires additional public disclosure of information about the custodial practices of a registered investment adviser.

In addition, the Commission in its release outlining the amendments to the Custody Rule (the “Release”) has suggested specific compliance policies and procedures for a registered adviser to consider adopting if it has custody of client funds or securities. In a companion release (the “Companion Release”), the Commission provides guidance for accountants with respect to the surprise examination and new internal control report required under the amended Custody Rule.<sup>3</sup>

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<sup>3</sup> See *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 2969 (December 30, 2009), available at <http://www.sec.gov/rules/interp.shtml>. The guidance discusses the relevant auditing and attestation standards that apply to these engagements, and, among other things, the nature and extent of the accountant’s procedures with respect to the surprise examination.

## Annual Surprise Examination of Client Assets

The amended Custody Rule requires a registered adviser with custody of client assets or securities<sup>4</sup> to undergo a surprise examination of client assets by an independent public accountant and have a reasonable basis for believing the qualified custodian is sending quarterly account statements to the adviser's clients, unless an exemption applies.<sup>5</sup>

In response to comments on its proposed amendments to the Custody Rule, the Commission determined to provide relief from the surprise examination requirement for certain types of advisers.

### *Advisers That Deduct Fees Directly*

Unlike those proposed last May, the amendments to the Custody Rule as finalized by the Commission will not require a registered adviser deemed to have custody of client assets solely because of its authority to deduct advisory fees from client accounts to undergo a surprise examination of its client accounts. Such an adviser will remain subject, however, to the Custody Rule requirement that the adviser's qualified custodian send quarterly client account statements directly to the adviser's clients.

### *Advisers to Pooled Investment Vehicles*

The Commission had initially proposed to eliminate from the Custody Rule an exemption from the surprise examination requirement for an adviser to a pooled investment vehicle that distributes audited financial statements of the pool prepared by an independent public accountant to the pool's investors. In response to substantial negative comments, the Commission modified its previously stated position and "deemed" an adviser to a pooled investment vehicle to have satisfied the annual surprise examination requirement with respect to the assets of the pooled

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<sup>4</sup> Rule 206(4)-2(d)(2), as amended, provides: Custody means holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. You have custody if a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services you provide to clients. Custody includes: (i) possession of client funds or securities (but not of checks drawn by clients and made payable to third parties) unless you receive them inadvertently and you return them to the sender promptly but in any case within three business days of receiving them; (ii) any arrangement (including a general power of attorney) under which you are authorized or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian; and (iii) any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives you or your supervised person legal ownership of or access to client funds or securities.

<sup>5</sup> Previously, unless an exemption applied, registered advisers with custody of client assets were required either (i) to have had a reasonable belief that client account statements would be sent directly to their clients by the qualified custodian, or (ii) to send account statements to their clients themselves but also obtain a surprise examination of client assets by an independent public accountant.

investment vehicle if the pooled investment vehicle is subject to an annual financial statement audit prepared in accordance with generally accepted accounting principles (“GAAP”) by a PCAOB Accountant, and the audited financial statements are distributed to the pool’s investors within 120 days of the pool’s fiscal year-end (the “Annual Audit Provision”).<sup>6</sup>

An adviser to a pooled investment vehicle that relies on the Rule’s Annual Audit Provision will also have to obtain a final audit of the pool’s financial statements upon liquidation of the pool and to distribute the financial statements to pool investors promptly after the completion of the audit, if liquidation occurs at times other than at the pool’s fiscal year-end. An adviser relying on the Annual Audit Provision would still be subject to the annual surprise examination requirement with respect to any client assets for which it has custody that are not held in an account of a pooled investment vehicle.

### **Delivery of Account Statements and Notice to Client**

The amended Custody Rule will continue to require an adviser that has custody to maintain, subject to certain exceptions, client funds or securities with a “qualified custodian.”<sup>7</sup> Except in the case of a pooled investment vehicle with respect to which the adviser is able to rely on the Annual Audit Provision, the adviser must have a reasonable basis after due inquiry for believing that the qualified custodian sends an account statement, at least quarterly, to each client for which the qualified custodian maintains funds or securities.<sup>8</sup>

The amended Custody Rule requires that an adviser’s reasonable belief that the qualified custodian sends account statements directly to clients must be formed by the adviser after “due inquiry.” The Commission has not prescribed a specific method for forming this belief, indicating that an adviser has the flexibility to determine how best to meet the requirement. One way identified by the Commission by which an adviser can form a reasonable belief after due

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<sup>6</sup> The Commission’s staff has indicated that, in the case of a fund of funds, it will continue to follow its guidance in *ABA Committee on Private Investment Entities*, SEC Staff Letter (Aug. 10, 2006), in which the staff stated it would not recommend enforcement action against an adviser of a fund of funds relying on the audit provision of the Custody Rule if the audited financial statements of the fund of funds are distributed within 180 days of its fiscal year-end. See footnote 45 of the Release.

<sup>7</sup> The amended Custody Rule does not require “privately offered securities,” as defined in note 12 *infra*, to be maintained with a qualified custodian and allows shares of open end investment companies to be held by the transfer agent in lieu of a qualified custodian. See Rule 206(4)-2(b)(1) and (2). In that the surprise audit is now required for most advisers with custody, the Commission amended the Custody Rule to eliminate the surprise audit as an alternative to the requirement that the qualified custodian send the account statements to clients.

<sup>8</sup> The Release explains that the requirement is designed so that advisory clients will receive a statement from the qualified custodian that they can compare with any statements (or other information) they receive from their adviser to determine whether account transactions, including deductions to pay advisory fees, are proper.

inquiry is for the qualified custodian to provide the adviser with a copy of the account statement that was delivered to the client.

The amended Custody Rule continues to require an investment adviser to notify a client promptly upon opening a custodial account on the client's behalf. Except in the case of a pooled investment vehicle with respect to which the adviser is able to rely on the Annual Audit Provision, the Custody Rule, as amended, also requires an adviser that elects to send its own account statements to clients to include a legend in the notice and in any subsequent statements urging clients to compare the account statements they receive from the custodian with those they receive from the adviser.

### **Custody by the Adviser and Related Persons**

The Custody Rule, as amended, does not mandate an adviser to use an independent custodian.<sup>9</sup> The amended Rule does, however, impose additional requirements when assets of an adviser's clients are maintained by the adviser itself or by a related person rather than by an independent qualified custodian.

#### *Internal Control Report*

The amended Custody Rule requires, in addition to the surprise examination discussed above, that when an adviser or its related person serves as a qualified custodian for advisory client funds or securities under the Rule, the adviser must obtain, or receive from its related person, no less frequently than once each calendar year, a written report that includes an opinion from an independent public accountant with respect to the adviser's or related person's controls relating to custody of client assets (an "internal control report"), such as a Type II SAS 70 report. The adviser must maintain the internal control report in its records and make it available to the Commission's staff upon request. The amended Custody Rule requires that the accountant issuing the internal control report, as well as the accountant performing the surprise examination, be a PCAOB Accountant.<sup>10</sup>

The elements of the required internal control report are described in the Companion Release, which includes guidance for accountants regarding the overall objectives and scope of the internal control examination. The independent public accountant preparing the internal control report must verify that the client funds and securities are reconciled to a custodian other than the

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<sup>9</sup> The Commission does state in the Release that it would encourage the use of custodians independent of the adviser to maintain client assets as a best practice whenever feasible.

<sup>10</sup> The Commission's guidance in the Companion Release for accountants would permit accountants, when preparing an internal control report, to rely on their own relevant audit work performed for other purposes, including audit work performed to meet existing regulatory requirements, which the Commission believes should increase efficiencies in the audit process and help address commenters' concerns about duplication of effort.

adviser or its related person (e.g., the Depository Trust Corporation). As described in the Companion Release, the accountant's verification that client funds and securities are reconciled to an unaffiliated custodian can be accomplished by the accountant (i) obtaining direct confirmation, on a test basis, with unaffiliated custodians or (ii) performing other procedures designed to verify that the data used in reconciliations performed by the qualified custodian was obtained from unaffiliated custodians and is unaltered. No particular type of internal control report need be provided by an adviser under the amended Custody Rule so long as the objectives noted in the Commission's guidance are addressed in the report.

An adviser to a pooled investment vehicle that satisfies the requirements under the Annual Audit Provision would still have to obtain, or receive from the related person, an internal control report if the pooled investment vehicle's assets are maintained with a qualified custodian that is either the adviser to the pool or a related person of the adviser.

### *Related Persons*

Like the Commission's May 2009 proposal, the amended Custody Rule provides that an adviser has custody of any client securities or funds that are directly or indirectly held by a "related person" in connection with advisory services provided by the adviser to its clients. A related person is defined by the Rule as a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser.

The amended Custody Rule provides a limited exception from the surprise examination requirements in circumstances in which an adviser (i) is deemed to have custody solely as a result of certain of its related persons holding client assets, and (ii) is "operationally independent" of the custodian.<sup>11</sup> The adviser must, however, comply with the other provisions of the amended Custody Rule, including notifying the client as to where the assets are maintained, obtaining an internal control report from the related person that is a qualified custodian, and (unless an exception is available) forming a reasonable belief after due inquiry that the qualified custodian is sending the requisite client account statements.

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<sup>11</sup> A related person that holds, or has authority to obtain possession of, advisory client assets is presumed not to be operationally independent of the adviser unless the adviser can meet the definition of operationally independent in the amended Custody Rule. Rule 206(4)-2(d)(5), as amended, provides: a related person is presumed not to be operationally independent unless each of the following conditions is met and no other circumstances can reasonably be expected to compromise the operational independence of the related person: (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.

An adviser whose client assets are held by a related person but is able to rely on the exception and therefore does not need to undergo a surprise examination must, under the Custody Rule, as amended, make and keep a memorandum describing the relationship with the related person, including an explanation of the adviser's basis for determining that it has overcome a presumption built into the Rule that the adviser is not operationally independent of the related person. An adviser cannot rebut the presumption if it has custody for reasons in addition to, or other than, the related persons having custody. An adviser that is a trustee with respect to client assets held in an account at a broker-dealer that is a related person, for example, would have custody as a trustee. Such an adviser could not rely on the exception from the surprise examination on the grounds that the broker-dealer was operationally independent, and would be subject to the surprise examination requirement.

### **Privately Offered Securities**

The amended Custody Rule, as was proposed by the Commission last May, no longer permits the accountant conducting the annual verification of client assets to forgo examining certain "privately offered securities," as defined in the amended Custody Rule. As a result, many advisers that only maintain custody of privately offered securities on behalf of clients will be subject to the surprise examination requirement.<sup>12</sup>

### **Special Purpose Vehicles**

The amended Custody Rule contains a new provision specifically precluding an adviser from using layers of pooled investment vehicles to avoid meaningful application of the protections of the Custody Rule. The new provision, paragraph (c) of the amended Custody Rule, specifies that if all of the investors in a pooled investment vehicle are themselves pooled investment vehicles that are related persons of the adviser, then sending account statements or distributing audited financial statements only to such persons will not meet the requirements of the amended Custody Rule.

The new provision reflects the Commission's understanding that many pooled investment vehicles use special purpose vehicles or other intermediary entities (SPVs) controlled by the investment adviser or its related persons to facilitate investments in certain securities. The Commission was concerned that a literal application of the Custody Rule could result in account statements and financial statements concerning the assets in an SPV being sent to the related

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<sup>12</sup> Rule 206(4)-2(b)(2), as amended, states that privately offered securities are securities which are: (a) acquired from the issuer in a transaction or chain of transactions not involving any public offering; (b) uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client; and (c) transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer. Advisers to pooled investment vehicles investing in privately offered securities that can rely on the Annual Audit Provision would not be required to obtain a surprise examination. In the Companion Release, the Commission provides guidance for accountants regarding conducting a surprise examination of client assets, including privately offered securities.

persons or the adviser controlling the SPV and not to the persons the Custody Rule was designed to protect, the investors in the pooled investment vehicles that in turn invest in the SPV.

In seeking to address the Commission's concern, the Custody Rule, as amended, requires that the investment adviser either treat an SPV as a separate client, for which the adviser will have custody of the SPV's assets, or include the SPV's assets as assets of the pooled investment vehicles for purposes of the amended Custody Rule. Under the Custody Rule, if the adviser treats the SPV as a separate client, the adviser needs either to distribute the audited financial statements or account statements of the SPV to the beneficial owners of the pooled investment vehicles, or to comply with the surprise examination requirements.

If, however, the adviser treats the SPV's assets as assets of the pooled investment vehicles of which it has custody indirectly, the assets must be included in preparing the pooled investment vehicle's financial statement audit or surprise examination.

### **Suggestions for Compliance Policies and Procedures**

Rule 206(4)-7 under the Advisers Act requires a registered investment adviser to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules. When adopting the amendments to the Custody Rule, the Commission made clear its general view that compliance with Rule 206(4)-7 requires an adviser with custody to adopt controls over access to client assets that are reasonably designed to detect and prevent misappropriation or misuse of client assets, and to take appropriate action if any misuse does occur. The Commission went on to provide more specific compliance guidance regarding adviser custody.

#### *Generally*

According to the Commission, advisers with custody of client assets should consider the following policies and procedures as part of their compliance programs:

- conducting background and credit checks on employees of the investment adviser 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;
- if the adviser 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;

- requiring that any problems be brought to the immediate attention of the management of the adviser;
- restricting the ability of individual employees to acquire custody of client assets, because their custody may be attributable to the firm;<sup>13</sup> and
- requiring the adviser's chief compliance officer to periodically test the effectiveness of the firm's controls over the safekeeping of client assets.

*Procedures for Advisers That Deduct Fees Directly*

The Commission is of the view that an adviser having custody as a result of its authority to deduct advisory fees directly from client accounts held by a qualified custodian should have policies and procedures in place that address the risk that the adviser or its personnel could deduct fees to which the adviser is not entitled under the terms of the advisory contract. The adviser's policies and procedures should be designed to reflect how and when clients will be billed, and to ensure the amount of assets under management on which the fee is billed is accurate and is reconciled with amounts in Form ADV and other communications. The Commission said such procedures could include:

- periodic testing on a sample basis of fee calculations for client accounts to determine their accuracy;
- testing of the overall reasonableness of the amount of fees deducted from all client accounts for a period of time based on the adviser's aggregate assets under management; and
- segregating duties between those personnel responsible for processing billing invoices or listings sent to custodians to deduct fees, those personnel responsible for reviewing the invoices and listings for accuracy, and those personnel responsible for reconciling those invoices and listings with deposits of advisory fees by the custodians into the adviser's proprietary bank account.

**Amendments to Form ADV**

The Commission has adopted several amendments to Part 1A and Schedule D of Form ADV to require the reporting of more detailed information about custody practices. Those amendments are as follows:

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<sup>13</sup> The Commission noted in particular that many firms preclude employees from acquiring custody by prohibiting them from, for example, becoming trustees for client assets or obtaining powers of attorney for clients separate and apart from the advisory firm. Advisers that permit employees to serve in capacities whereby the firm acquires custody of client assets should, the Commission said, take steps to assure themselves that their employees' custodial practices conform with the firm's procedures, and that the adviser's chief compliance officer has access to sufficient information to enforce those policies and procedures.

*Item 7*

Each registered adviser must now list *all* related persons who are broker-dealers and which, if any, serve as qualified custodians with respect to the adviser's clients' funds or securities. An adviser must also report whether it is operationally independent from such broker-dealer qualified custodian that is a related person and thus not required to obtain a surprise examination for the clients' assets maintained at that custodian.

*Item 9*

Each registered adviser must now report to the Commission: (i) whether the adviser or a related person has custody of client assets, and, if so, both the total U.S. dollar amount of those assets and the number of clients whose accounts the adviser or its related person has custody; (ii) if the adviser, or related person, acts as an adviser to a pooled investment vehicle, whether (a) the pool is audited and (b) the qualified custodians send account statements to pool investors; (iii) whether an independent public accountant conducts an annual surprise examination of client assets; (iv) whether an independent public accountant prepares an internal control report with respect to the adviser or its related person; and (v) whether the adviser or a related person serves as qualified custodian for the adviser's clients. In addition, Schedule D to Form ADV now requires that an adviser (i) identify and provide certain information about the independent public accountants that perform audits or surprise examinations and that prepare internal control reports; (ii) identify related persons, such as banks, that serve as qualified custodians with respect to their clients' funds or securities, but are not otherwise reported in response to Item 7 of the Form (which reports related broker-dealers); and (iii) require the adviser to report whether it has determined that it has overcome the presumption that it is not operationally independent from the related person qualified custodian and therefore not subject to a surprise examination for the clients' assets maintained by that custodian.

**Amendments to Form ADV-E**

Under the amended Custody Rule, each investment adviser subject to the surprise examination requirement must enter into a written agreement with an independent public accountant to conduct the surprise examination. The agreement must require the accountant, among other things, to notify the Commission within one business day of finding any material discrepancy during the course of the examination, and to submit Form ADV-E under the Advisers Act to the Commission, accompanied by the accountant's certificate, within 120 days of the time chosen by the accountant for the surprise examination, stating that the accountant has examined the funds and securities and describing the nature and extent of the examination. The agreement also must provide that, upon resignation or dismissal, the accountant must file within four business days a statement regarding the termination along with Form ADV-E.

Amended instructions to Form ADV-E require (i) that the form and the accompanying accountant's examination certificate be filed electronically with the Commission through the Investment Adviser Registration Depository ("IARD") when it begins accepting electronic filings of Form ADV-E, which is expected in the fourth quarter of 2010; (ii) that the surprise

examination certificate be filed within 120 days of the time chosen by the accountant for the surprise examination; and (iii) that a termination statement be filed by the accountant within four business days of its resignation, dismissal, or removal.

### **Required Records**

The Commission adopted, as proposed, amendments to Rule 204-2 under the Advisers Act which specifies recordkeeping requirements for registered advisers. Under the amendments, an adviser must maintain a copy of (i) the internal control report that the adviser is required to obtain or receive from its related person and (ii) the memorandum describing the basis upon which the adviser determined that the presumption that any related person is not operationally independent, pursuant to the Custody Rule, has been overcome, for five years from the end of the fiscal year in which, as applicable, the internal control report or memorandum is finalized.

### **Effective and Compliance Dates**

The effective date of the amendments to the Custody Rule, Rule 204-2, and Forms ADV and ADV-E is March 12, 2010. Registered advisers must comply with the amended Custody Rule, Rule 204-2, and Forms ADV and ADV-E, as amended, beginning on the effective date of these amendments, except as described below.

Immediately upon the effective date, a registered adviser that has custody of client assets must promptly upon opening a custodial account on a client's behalf, and following any changes to the custodial account information as specified in Rule 206(4)-2(a)(2), send a notification to the client and (except with respect to a pooled investment vehicle the financial statements of which are audited and delivered to investors in compliance with the Annual Audit Provision) include a legend urging the client to compare the account statements the client receives from the custodian with those the client receives from the adviser. The legend should also be included in any account statements that the adviser sends to these clients after the adviser is required to send the notification discussed above. In addition, immediately upon the effective date, each registered adviser that has custody of client assets must have a reasonable belief (except with respect to pooled investment vehicles, the financial statements of which are audited and delivered to investors in compliance with the Annual Audit Provision) that a qualified custodian sends account statements directly to clients at least quarterly.

Compliance requirements for other provisions are phased in over time.

### *Surprise Examinations*

An investment adviser 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, or for an adviser that becomes subject to the Custody Rule after the effective date, within six months of becoming subject to the requirement. If the adviser itself maintains client assets as a qualified custodian, however, the agreement must provide for the first surprise examination to occur no later than six months after the adviser obtains the internal control report.

*Internal Control Reports*

An investment adviser required to obtain or receive an internal control report because it or a related person maintains client assets as a qualified custodian must obtain or receive an internal control report within six months of becoming subject to the requirement. As noted above, an adviser obtaining an internal control report because it (rather than a related person) serves as a qualified custodian of its clients' assets (e.g., a broker-dealer) need not undergo a surprise examination until six months after obtaining the internal control report.

*Audits of Pooled Investment Vehicles*

An investment adviser to a pooled investment vehicle may rely on the Annual Audit Provision if the adviser (or a 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 by a PCAOB Accountant.

*Forms ADV and ADV-E*

Responses to the revised Form ADV are required in the first annual amendment filed after January 1, 2011. It is expected that Form ADV will reflect the changes outlined above in the fourth quarter of 2010. Until the IARD system is upgraded to accept Form ADV-E, accountants performing surprise examinations should continue paper filing of Form ADV-E. Investment advisers will be notified as soon as the IARD system can accept filings of Form ADV-E, which is expected to be in the fourth quarter of 2010.

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January 11, 2010

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