ADVISER CUSTODY RULE AMENDED

The Securities and Exchange Commission (the "Commission") has amended its rule governing registered investment advisers having custody of client assets. Since the Commission staff this week issued a report recommending that hedge fund managers be required to register under the Advisers Act, and since many hedge fund managers would be deemed to have custody of client assets, the amendment will be relevant to those managers as well, if and when the Commission acts favorably upon that recommendation.

Rule 206(4)-2 under the Investment Advisers Act of 1940 (the "Advisers Act") has been amended to:

1. Add a definition of custody to the Rule and provide examples;

2. Require registered advisers that have custody to maintain client funds and securities with broker-dealers, banks or other "qualified custodians" and have the qualified custodian send quarterly account statements directly to all the adviser's advisory clients, or alternatively be subject to an annual surprise audit;

3. Exempt registered advisers to pooled investment vehicles that are subject to annual audit by an independent public accountant from the requirement of a surprise audit or delivery of quarterly statements by custodians to investors in the pool; and

4. Delete the requirement in Form ADV that advisers with custody include an audited balance sheet in Part II of their ADV or their disclosure brochure.

The effective date of the amendments is November 5, 2003. Advisers must comply with the amended Rule by April 1, 2004. By this compliance date, an adviser with custody of clients' funds and securities must ensure that those assets are kept in accounts with qualified custodians. Also by this date, the adviser must have established its reasonable belief that the qualified custodians send quarterly account statements directly to the clients or to their independent representatives or, as an alternative, follow the requirements of sending quarterly statements themselves to clients and undergoing an annual surprise examination. In addition, by this date, advisers to limited partnerships that are not currently subject to annual audits must ensure that those partnerships have become obligated to undergo annual audits if the adviser intends to avoid the requirement to have the custodian send quarterly statements directly to investors.

I. Custody Definition

The amended Rule provides that an adviser has custody of client assets when it holds, directly or indirectly, client funds or securities or has any authority to obtain

possession of them. Accordingly, an adviser must comply with the Rule when it has access to client funds and securities as well as when the adviser holds those assets. The Rule includes three examples designed to illustrate circumstances under which an adviser has custody of client assets.

The first example clarifies that an adviser has custody when it has any possession or control of client funds or securities, even briefly. However, to avoid causing an adviser to violate the Rule inadvertently as a result of actions by other persons, the Rule expressly excludes inadvertent receipt by the adviser of client funds or securities, so long as the adviser returns them to the sender within three business days of receiving them. An adviser's possession of a check drawn by the client and made payable to a third party will not be considered possession of client funds for purposes of the custody definition.

The second example clarifies that an adviser has custody if it has the authority to withdraw funds or securities from a client's account. An adviser with power of attorney to sign checks on a client's behalf, to withdraw funds or securities from a client's account, or to dispose of client assets for any purpose other than authorized trading has access to the client's assets. Similarly, an adviser authorized to deduct advisory fees or other expenses directly from a client's account has access to, and therefore has custody of, the client funds and securities in that account. The Commission staff is withdrawing no-action letters that provided an adviser would not have custody merely by being able to directly bill the client if both the client and the custodian were sent the bill.

The last example clarifies that an adviser has custody if it is the legal owner of the client assets or has access to those assets. One common instance is a firm that acts as both general partner and investment adviser to a limited partnership. By virtue of its position as general partner, the adviser generally has authority to dispose of funds and securities in the limited partnership's account and thus has custody of client assets. The Commission is eliminating the option established in a series of no-action letters (the so-called "Bennett Letter procedure") for investment advisers affiliated with the general partner of the limited partnership client to avoid being deemed to have custody by engaging a third party, typically an accounting firm, to verify the calculation of the adviser's fee before it is paid by the custodian. Registered advisers, including those firms that have relied on these letters in the past, must comply with the amended Rule.

II. Use of Qualified Custodians

Rule 206(4)-2 currently requires advisers to maintain client funds with a bank, but does not require that client securities be held in a brokerage account or with any other type of financial institution. The Commission has amended the Rule to require that advisers maintain both client funds and securities with a qualified custodian in a separate account for each client under the client's name or in accounts containing only

clients' funds and securities under the adviser's name as agent or trustee for its clients. Advisers must also promptly notify clients in writing upon opening an account on the client's behalf with a qualified custodian, specifying the custodian's name, address and the manner in which the funds or securities are maintained, and of any subsequent changes to such information.

"Qualified custodians" under the amended rule include the types of financial institutions that clients and advisers customarily use for custodial services. These include U.S. banks and savings associations and U.S. registered broker-dealers holding client assets in customer accounts. In order to allow advisers that also offer futures advice to comply with Commodity Futures Trading Commission rules, "qualified custodians" also include registered futures commission merchants.

Foreign financial institutions that customarily hold financial assets for their customers also qualify as "qualified custodians", provided that the foreign financial institution keeps advisory clients' assets in customer accounts segregated from its proprietary assets. Where an adviser selects a foreign financial institution to hold clients' assets, the Commission staff believes the adviser's fiduciary obligations require it either to have a reasonable basis for believing that the foreign institution will provide a level of safety for client assets similar to that which would be provided by a "qualified custodian" in the United States or to fully disclose to clients any material risks attendant to maintaining the assets with the foreign custodian.

The Commission recognizes that advisers that are also U.S. registered broker-dealers or banks (or separately identifiable departments or divisions of banks) may custody their own clients' funds and securities, subject to the account statement requirements described below and the custody rules imposed by the regulators of the advisers' custodial functions. Advisers may also maintain client assets with affiliates that are qualified custodians.

The amended Rule contains specific exceptions for two types of securities. An adviser may use a mutual fund transfer agent in lieu of a qualified custodian for book-entry shares of an open-end investment company if the transfer agent sends the quarterly reports and otherwise acts as a qualified custodian under the Rule. Advisers are also excepted from the Rule with respect to privately-offered uncertificated securities in their clients' accounts, if ownership of the securities is recorded only on the books of the issuer or the transfer agent in the name of the client, and the transfer of ownership is subject to prior consent of the issuer or holders of the issuer's outstanding securities. However, this privately offered securities exemption is not available for an account of a pooled investment vehicle unless the vehicle is audited and audited financials are distributed as described in Section IV.B. below.

III. Delivery of Account Statements to Clients

Rule 206(4)-2, as amended, requires that advisers with custody of clients' funds or securities have a reasonable belief that the qualified custodian holding the assets provides quarterly account statements to those clients. An adviser could form this reasonable belief if, for example, the qualified custodian provides the adviser with a copy of the account statement that was delivered to the client. Account statements may be delivered electronically as well as on paper. Electronic delivery must comply with the Commission's interpretive guidelines on delivering documents electronically. A client may designate an independent representative, as defined in the Rule, to receive on his or her behalf notices and account statements required by the Rule.

If a client does not receive account statements directly from the qualified custodian, the adviser must continue sending quarterly account statements to that client and to undergo an annual surprise examination by an independent public accountant to verify the funds and securities of that client. The accountant is required to notify the Commission's Office of Compliance Inspections and Examinations within one business day of finding any material discrepancies during an examination.

The amendments require account statements to be sent directly to the limited partners of a limited partnership or investors in a pooled investment vehicle (or to their independent representatives) if the adviser to the pooled investment vehicle also acts as its general partner, managing member or in a similar capacity and has custody of client assets, unless the pooled investment vehicle qualifies for the exemption described in Section IV. B. below.

IV. Exemptions

A. Registered Investment Companies: Advisers need not comply with the Rule with respect to clients that are registered investment companies. Registered investment companies and their advisers must comply with the strict requirements of section 17(f) of the Investment Company Act of 1940 and the custody rules adopted thereunder.

B. Pooled Investment Vehicles: Advisers need not comply with the quarterly reporting requirements of the Rule with respect to pooled investment vehicles, such as limited partnerships or limited liability companies, if the pooled investment vehicle (i) is audited at least annually; and (ii) distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or members or other beneficial owners) within 120 days of the end of its fiscal year.

An adviser may use financial statements prepared in accordance with International Accounting Standards or some comprehensive body of accounting standards other than U.S. generally accepted accounting principles ("U.S. GAAP") to qualify for this exception with respect to pools that have a place of organization outside the U.S. or a general partner or other manager with a principal place of business outside the U.S., if such financial statements contain information that is substantially similar to financial statements prepared in accordance with U.S. GAAP and contain a footnote reconciling any material variations between such comprehensive body of accounting standards and U.S. GAAP. The financial statements must discuss and quantify any material variations in the manner described in Item 17 of Form 20-F (except that the financial statements need not provide reconciliation to Regulation S-X as required of issuers under Form 20-F). For both U.S. and foreign pooled investment vehicles, the Rule provides that "audit" has the meaning under section 2(d) of Article 1 of Regulation S-X, and pooled investment vehicles' financial statements must be audited in accordance with U.S. generally accepted auditing standards (whether or not subject to U.S. GAAP).

V. Elimination of the Requirement for a Balance Sheet in Client Brochures

The requirement in the Rule prior to amendment that an adviser with custody must include an audited balance sheet in its brochure or Part II of Form ADV distributed to clients has been deleted.

If you have any questions regarding this Memorandum, please contact Daniel Schloendorn at (212) 728-8265 or Martin R. Miller at (212) 728-8690.

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