SEC PROPOSES CHANGES TO THE ADVISERS ACT CUSTODY RULE TO INCREASE RELIANCE ON AUDITORS

Last week, in response to recent well-publicized *Ponzi* schemes and other allegations of theft or misuse of client assets by certain investment advisers, the Securities and Exchange Commission proposed new audit and independent examination requirements for SEC-registered investment advisers that are deemed to have custody of client assets.[1] The SEC's proposal would, if adopted, make three significant changes to Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940 (the "Advisers Act"):

- *All* SEC-registered investment advisers that have custody of client assets, including advisers deemed to have custody because they can deduct advisory fees directly from client accounts or either act themselves or have related persons that act as general partners to limited partnerships that they advise, would be required to arrange for an annual surprise examination by an independent public accountant.

- SEC-registered advisers that are also "qualified custodians" for client assets, and therefore self-custody client assets, or that use a related person to custody client assets, would be required to obtain an additional report on internal controls (a Type II SAS 70 Report).

- SEC-registered advisers would have to arrange for statements to be sent to clients directly from the qualified custodian, thereby requiring almost all registered advisers to disclose client identity to the custodian. The Custody Rule, however, would preserve the exemption for advisers to pooled investment vehicles that send audited financials to the investors in those vehicles.

The SEC's proposal also would make amendments to Form ADV to require disclosure of the identity of the adviser's auditor and would make a change to the requirements for managers of private funds that, upon liquidation, send audited financial statements to the limited partners in the fund. In addition, the proposal would amend the investment adviser recordkeeping rules to require the adviser to retain any reports issued by an auditor for five years.

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[1] *Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2876 (May 20, 2009) (the "Release"), available at http://www.sec.gov/rules/proposed.shtml. The Release mentions *SEC v. Stanford International Bank, et al.*, Litigation Release No. 20901 (Feb. 17, 2009) (complaint alleges that the affiliated bank, broker-dealer, and advisers colluded with each other in carrying out an $8 billion fraud) and *SEC v. Bernard L. Madoff, et al.*, Litigation Release No. 20889 (Feb. 9, 2009) (complaint alleges that Madoff and Bernard L. Madoff Investment Securities LLC (a registered investment adviser and registered broker-dealer) committed a $50 billion fraud).

Comment Period

Throughout the Release, the SEC asks numerous questions seeking input from the industry on the proposed changes. All comments are due by July 28, 2009.

Background

The Custody Rule was amended effective April 1, 2004 to provide 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 client funds of securities. Accordingly, an adviser must comply with the Custody Rule when it has access to client funds and securities as well as when the adviser holds those assets. The Custody Rule defines "custody" to include: (1) possession or control of client funds or securities, even briefly; (2) authority to withdraw funds or securities from a client's account; and (3) legal ownership of the client assets or access to those assets.[2]

Currently, pooled investment vehicles, such as limited partnerships or limited liability companies, that are audited annually and the investors of which receive financial statements within a certain period, are exempt from having to obtain a surprise examination.

SEC Proposed Amendments

1. Annual Surprise Examination

Under the proposal, *all* registered investment advisers with custody of client assets must arrange for an annual surprise examination, including those whose clients receive account statements directly from a qualified custodian and advisers that rely on the exception for audited limited partnerships and other types of pooled investment vehicles. Specifically, the proposed rule would require investment advisers to enter into a written agreement with an independent public accountant that obligates the accountant to (1) conduct the annual surprise examinations, (2) report to the SEC within one business day any findings of material discrepancies, and (3) file a Form ADV-E (within 120 days of the time chosen by the accountant for the surprise examination) stating that it conducted an examination and describing the nature and extent of the examination.[3] The accountant also would file Form ADV-E to notify the SEC of a termination of engagement, within four days of termination, and include a statement in the form explaining

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[2] 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. One common example of having "access" to client assets is a firm or an affiliate acting as both general partner and investment adviser to a limited partnership. By virtue of its position as general partner, the adviser or its affiliate generally has authority to dispose of funds and securities in the limited partnership's account and thus has custody of client assets.

[3] An independent public accountant would be defined as a public accountant that meets the standards of independence described in Rule 2-01(b) and (c) of Regulation S-X.

any problems relating to the examination scope or procedures that contributed to such termination.

Currently, if a qualified custodian sends the statements to the adviser's clients, such adviser is not required to obtain an annual surprise examination. The proposal would eliminate this exception, and the proposal would apply even if the adviser has custody only by virtue of fee deductions. The SEC specifically asked for comment on this latter point, indicating a willingness to change it, and suggested alternative approaches such as an annual CCO certification.[4]

Additionally, all privately offered securities that investment advisers hold on behalf of their clients would be subject to the surprise examination requirement.[5] Currently, such securities are excluded from all aspects of the Custody Rule.

2. Additional Report for Self-Custody by Adviser or Its Related Persons

Under the proposed amendments, if the adviser itself, or a related person (as defined below), serves as the qualified custodian for client assets, the adviser would have to obtain or receive from the adviser's related person, no less frequently than once each calendar year, a written report (a Type II SAS 70 Report) that includes an opinion from an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB"), with respect to the adviser's or related person's controls relating to custody of client assets.[6] For purposes of the internal control report, the registered independent public accountant would conduct tests, in accordance with PCAOB standards, analyzing the effectiveness of controls over custodial operations as well as the general control environment and information systems.[7] The SEC staff estimates that the average cost for the report would be approximately $250,000 per year.[8] Such cost may outweigh the benefit of having a Type II SAS

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[4] Interestingly, the SEC does not change the Form ADV reporting instruction in which an adviser can answer "no" in response to whether it has custody if it has custody only by virtue of fee deductions; furthermore, the deduction of fees does not seem to be implicated in the Madoff case or other similar *Ponzi* schemes cited by the staff.

[5] "Privately offered securities" exempt from the Custody Rule are securities: (1) acquired from the issuer in a private offering; (2) uncertificated and with ownership recorded in the name of the client; and (3) transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer. Advisers Act Rule 206(4)-2(b)(2)(i). The proposed rule would retain the same definition.

[6] As of May 19, 2009, 2,006 accounting firms are registered with PCAOB. The list of registered accounting firms is available at http://www.pcaobus.org/Registration/index.aspx.

[7] Additionally, if the adviser itself, or a related person, serves as the qualified custodian for client assets, the annual surprise examination must be done by a PCAOB-registered independent public accountant as opposed to one that is not so registered if an independent qualified custodian holds client assets.

[8] Release at Section V.C.

70 Report that relates more to checking processes than certifying or verifying any particular statement.

At the hearing before the Commission, the staff indicated that it wanted to "encourage" advisers to maintain client assets with an independent custodian. The SEC requested comment on whether it should amend the Custody Rule to require that all advisers having custody engage an unrelated qualified custodian.

3. Delivery of Account Statements

Currently, advisers meet the delivery obligations by either having a qualified custodian directly deliver account statements to their clients or, in the alternative, sending account statements themselves to their clients if they undergo a surprise examination by an independent public accountant at least annually.[9] This alternative was made available in order to address concerns by some advisers that did not wish to disclose the names of their clients to custodians to prevent a potential competitor from having access to their lists of clients or to protect the privacy of some well-known clients.[10] Under the proposed amendments, this alternative delivery method would be eliminated. Account statements would no longer be routed through the adviser. In the Release, the SEC staff stated that any confidentiality concerns are outweighed by concerns related to fraud and could be addressed in custodial or other agreements. Advisers would be required to conduct a "due inquiry" to form a reasonable belief that qualified custodians are in fact sending such statements.[11]

The SEC would retain the exemption in Rule 206(4)-2(b)(3) for accounts of limited partnerships or pooled investment vehicles that annually distribute audited financial statements to limited partners within 120 days of their fiscal year-end. However, the proposal appears to delete the current longer period of 180 days after the fiscal year-end for a fund of funds and adds a requirement for the distribution of financial statements *promptly* after completion of an audit of a fund in liquidation at any time other than fiscal year-end.

4. Other Proposed Changes

The SEC proposes to amend the definition of custody such that an adviser would be deemed to have custody if a "related person" holds, directly or indirectly, client assets or has any authority to obtain possession of those assets, in connection with advisory services provided to clients. A "related person" would be defined as a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser. "Control" would be defined as the power, directly or indirectly, to direct the management or policies of a person, whether

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[9] Advisers Act Rule 206(4)-2(a)(3).

[10] Release at Section II.C.

[11] The SEC staff provides examples in the Release illustrating how advisers can meet this proposed requirement: qualified custodians can send copies of the account statements to the adviser and receipt of such copies by the adviser would satisfy the requirement, or qualified custodians can confirm in writing, including in a fax or an email sent to the adviser, that they have sent account statements to the adviser's clients for each quarter covered.

through ownership of securities, by contract, or otherwise. Thus, under the proposed amendments, a related person's custody of client assets is imputed to the adviser, regardless of the separation between the related person and the adviser.[12]

The SEC's proposed changes include amendments to Form ADV that would require an adviser to disclose the following: (1) all related persons who are broker-dealers, identifying which, if any, serve as qualified custodians with respect to the adviser's client assets; (2) the amount in U.S. dollars of client assets and number of clients for which such adviser or its related person has custody; (3) whether a qualified custodian sends quarterly account statements to investors in pooled investment vehicles the adviser manages; (4) whether the financial statements of the pooled investment vehicles the adviser manages are audited; (5) whether the adviser's clients' assets are subject to a surprise examination, and if so, the month in which the last examination commenced; and (6) whether an independent public accountant prepares a Type II SAS 70 Report. The proposed amendments also would require the adviser to identify the accountants performing the surprise examinations and preparing the Type II SAS 70 Report, and other details regarding such accountants, as well as the qualified custodians that are related persons.

With respect to recordkeeping requirements, the proposed amendment would require the adviser to maintain a copy of its Type II SAS 70 Report (or such report from its related person) for five years from the end of the fiscal year in which the internal control report is finalized.

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If you have any questions regarding this memorandum, please contact Benjamin J. Haskin (202-303-1124, bhaskin@willkie.com), David W. Blass (202-303-1114, dblass@willkie.com), Martin Miller (212-728-8690, mmiller@willkie.com), Jane H. Kim (202-303-1242, jkim@willkie.com), or the Willkie attorney with whom you regularly work.

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[12] This proposed amendment reflects a change in the staff's long-standing position on affiliated custodians articulated in *Crocker Investment Management Corp*., SEC No-Action Letter (April 14, 1978). The staff noted that it would withdraw this no-action letter if the proposed amendment is adopted.