## SEC ADOPTS AMENDMENTS TO THE ADVISERS ACT CUSTODY RULE

At an open meeting this week, the Securities and Exchange Commission voted to adopt amendments to Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940. While the final language of these amendments is not yet public, discussion at the open meeting indicates that the SEC has modified the rule amendments from those that it proposed in May 2009 to reflect comments by industry participants and others.[1] Significant modifications relate to advisers that have custody solely because of fee deductions, advisers to private funds and advisers with affiliated custodians.

***Advisers that have custody solely because of fee deductions***. As originally proposed in May, all advisers deemed to have custody under the rule would have been required to obtain an annual surprise examination by an independent public accountant even if client assets were held by an independent qualified custodian. At the meeting this week, the SEC voted to exempt an adviser that is deemed to have custody solely because of its ability to deduct management fees from having to obtain an annual surprise exam. SEC Chairman Mary Schapiro noted that an adviser with "relatively limited form of custody has not, to date, presented the same opportunity for fraud and misappropriations as situations for which the [SEC] is enhancing additional controls."[2]

***Private fund advisers***. Under the revised rule, as adopted this week, an adviser to a private fund that (i) is subject to annual audits by a qualified auditor registered with, and subject to inspection by, the Public Company Accounting Oversight Board ("PCAOB"), and (ii) sends copies of such audited financial statements to the fund's investors would not have to obtain an annual surprise exam.[3]

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1 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), *available at* http://www.willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C2985%5CSEC_Proposes_Changes_To_The_Advisers_Act_Custody_Rule_To_Increase_Reliance_On_Auditors.pdf.

2 At the meeting this week, the SEC supported a recommendation provided in a comment letter that fee deduction issues be addressed through compliance policies and procedures. The staff indicated that the release accompanying the final rule will include guidance for advisers to consider in connection with their compliance policies and procedures.

3 Under the revised Custody Rule, such an adviser would be deemed to have obtained the annual surprise exam because of its having undergone an annual audit by a PCAOB-registered and -inspected auditor.

***Advisers with affiliated custodians***. Under the SEC's original proposal, an adviser deemed to have custody of client assets because either the adviser itself or its affiliate[4] acts as the qualified custodian for client assets would have been required to obtain an annual surprise exam *and* obtain or receive an annual written report (an "internal control report") from a PCAOB accounting firm with respect to its or its affiliated custodian's custody controls over client assets.[5] The SEC determined at the meeting this week that an adviser that uses an affiliated custodian to hold client assets would not be required to obtain an annual surprise exam if the adviser is deemed to be "operationally independent" of the affiliated custodian — that is, where the adviser and the affiliate operate as distinct entities with no overlap of, for example, personnel or office space and no common supervision. Such an adviser, however, would still be required to obtain an internal control report with respect to its affiliated custodian's custody controls.

An adviser will be able to demonstrate "operational independence" from its affiliated custodian by meeting certain factors. The revised rule establishes a rebuttable presumption that an adviser and its affiliated custodians are *not* operationally independent, and the adviser will be faced with the burden of demonstrating independence. Although the full list of factors and the definition of "operational independence" were not discussed in detail at the meeting, the SEC indicated that details would be provided in the release accompanying the final rule. The SEC suggested that if the location of an affiliated custodian was in close proximity to that of the adviser (*i.e.*, next door), "operational independence" would be more difficult to demonstrate than would be the case if the two locations were geographically distant, which could make rebutting the presumption easier.

The SEC is expected in the coming weeks to publish the text of the revised rule, together with an adopting release that will provide additional clarification as to how the rule will work in practice. At that time, we will provide more in-depth analysis of the effect of the rule. The new rule will be effective 60 days after it is published in the Federal Register.

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If you have any comments regarding this memorandum, please contact James G. Silk (202-303-1275, jsilk@willkie.com), Martin R. Miller (212-728-8690, mmiller@willkie.com), David W. Blass (202-303-1114, dblass@willkie.com), Jane H. Kim (202-303-1242, jkim@willkie.com), or the Willkie attorney with whom you regularly work.

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[4] While the SEC referred to "affiliated custodians" at the meeting, we understand this to mean custodians that are "related persons" of the adviser, which was defined in the amendments originally proposed in May as a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser.

[5] A Type II SAS 70 Report conducted in accordance with PCAOB standards would satisfy the requirements of the internal control report.

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