

INVESTMENT FUNDS ALERT

PROPOSED AMENDMENTS TO CUSTODY RULE ENCOURAGE USE OF QUALIFIED CUSTODIANS

On May 14, 2009, the Securities and Exchange Commission (SEC) proposed amendments to Rules 206(4)-2 and 204-2 under the Investment Advisers Act of 1940, as amended, and Form ADV. The proposed changes to Rule 206(4)-2 would, among other things, (1) require an annual surprise audit for all registered investment advisers with custody (including advisers to pooled investment vehicles that satisfy the requirements of the current custody rules by delivering audited financial statements to investors), (2) require registered investment advisers who maintain physical custody or use an affiliated custodian of securities to have an independent audit of the internal controls of the adviser or affiliated custodian, (3) prohibit registered investment advisers from delivering account statements to their clients directly and (4) remove the 180-day audit timeline for fund of funds.¹ Form ADV would also be amended to gather information from an adviser to confirm compliance with the proposed custody rule.

CUSTODY RULE

Annual Surprise Audit

The proposed rule would extend the current requirement to have a surprise examination by an independent accountant of client funds and securities over which an adviser has custody to (1) advisers that use qualified custodians but retain the ability to

¹ The omission of the 180-day financial statement delivery requirement for fund of funds may have been inadvertent, as the adopting release does not discuss its deletion.

cause the qualified custodian to pay fees, (2) advisers that only hold privately offered securities and (3) advisers to limited partnerships and limited liability companies that provide audited financials. Each adviser would be required to enter into a written agreement with an independent accountant that would require the independent accountant to (1) file a certificate on Form ADV-E with the SEC within 120 days after the date of the commencement of the surprise examination, (2) notify the SEC within one business day of any material discrepancy found in the course of the examination and (3) file Form ADV-E with the SEC within four business days after dismissal or termination of the audit, disclosing the date of resignation or other termination, the contact information for the accountant and an explanation of any problems relating to the examination.

Internal Controls Audit

Any registered investment adviser who acts as a qualified custodian or uses a related person as a qualified custodian would be subject to rigorous internal control audits based on increased audit standards. Such advisers would be required to obtain a written internal control report from an independent auditor that is registered and inspected by the Public Company Accounting Oversight Board (PCAOB). The audit report would be required to include an opinion that describes the controls on operation of the qualified custodian relating to custodial services and the results of tests of the effectiveness of those controls. In addition, the independent auditor for the annual surprise examination described above would be required to be registered and inspected by the PCAOB. A proposed change to Rule 204-2 would require an adviser to retain any internal controls report as part of the adviser's required books and records.

Delivery of Account Statements

The proposed rule would no longer allow registered investment advisers to deliver account statements directly to their clients. Investment advisers to limited partnerships and limited liability companies would still be excused from the requirement to deliver account statements if investors in the vehicles receive audited financial statements, but the proposed rule clarifies that the audits must be delivered upon liquidation as well as annually. In addition, the 180-day audit delivery requirement for fund of funds was omitted from the proposed rule without explanation.

Other Changes to the Custody Rule

In addition to the above changes, the SEC proposed several other minor changes and clarifications to the custody rule. For example, the notice to clients of opening an account with a qualified custodian would be required to include a statement urging clients to compare statements from the custodian with statements from the adviser. Further, the exception from the custody rule for privately offered securities would be scaled back to exempt only privately offered securities from the safekeeping provision of the custody rule. In addition, registered investment advisers would be required to conduct “due inquiry” into whether qualified custodians send account statements to clients on a timely basis. Finally, the proposed rules would expand the definition of custody to include client funds and securities held directly or indirectly through a related person in connection with advisory services provided by a registered investment adviser.

FORM ADV

The SEC also proposed changes to Form ADV to ensure that registered investment advisers report their compliance with the custody rule in addition to Form ADV-E discussed above. Amended Item 7 would require an adviser to report all related broker-dealers, investment advisers, municipal securities dealers or government securities brokers or dealers serving as custodians with respect to client assets. Amended Item 9 would require an adviser to report the amount of client assets and number of clients for which the adviser or its related persons serve as qualified custodian. A new subsection of Item 9 would require an adviser to report whether a qualified custodian sends account statements to investors in managed pooled investment vehicles, whether audited financial statements of the pooled investment vehicles are provided to investors, whether the assets are subject to a surprise examination, whether an internal control examination is conducted and when the last surprise examination was commenced. In addition, revised Part D of Form ADV would require advisers to report the name, address, PCAOB status and type engagement of each of the auditors that perform the functions required by the proposed custody rule and whether the accountant’s report was qualified. Finally, advisers would also be required to identify any related person who serves as a qualified custodian, including the name, address and the type of qualified custodian.

CONCLUSION

If adopted as proposed, these changes could have a significant impact on the policies and procedures used by registered investment advisers (including advisers to funds) to comply with the custody rule. The SEC is soliciting comments on several key aspects of the proposed rule changes, including, among other things, whether to use enhanced compliance procedures instead of a surprise examination and whether to permit related-party qualified custodians to hold any client assets. The comment period will end on July 28, 2009.

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