

INVESTMENT FUNDS ALERT

AMENDMENTS TO CUSTODY RULE WILL NOT REQUIRE ANNUAL SURPRISE AUDIT FOR MOST FUND MANAGERS

On December 30, 2009, the Securities and Exchange Commission (SEC) published amendments to Rules 206(4)-2 (the “Amended Custody Rule”) and 204-2 under the Investment Advisers Act of 1940 (the “Advisers Act”) and Form ADV. The changes to the Amended Custody Rule will, among other things—

(1) expand the requirement for an independent public accountant to conduct an annual surprise audit to verify the funds and securities of clients over which a registered investment adviser maintains custody (an “Annual Surprise Audit”) to apply to **all** client accounts of **all** registered investment advisers, subject to three exceptions for accounts of the following clients:

(a) pooled investment vehicles that deliver audited financial statements to their investors

(b) clients for which registered investment advisers are only able to deduct fees but have no other custodial powers

(c) clients whose funds and securities are held with an operationally independent related person of the adviser.

(2) require registered investment advisers who maintain physical custody or use a related person as a qualified custodian to have an annual independent audit of the internal controls of the adviser or related person custodian

(3) require the qualified custodians for each client account of a registered investment adviser to deliver directly to the client quarterly account statements

showing all positions held at the end of the quarter and all transactions effected during the quarter (unless the client is a pooled investment vehicle that complies with the annual audit requirement)

(4) require registered investment advisers to pooled investment vehicles that deliver audited financials to use an auditor that is registered and inspected by the Public Company Accounting Oversight Board (PCAOB) and to deliver audited financial statements to pool participants upon dissolution of the pool.

The adopting release relating to the Amended Custody Rule also provides guidance regarding compliance procedures for the safeguarding of client assets.

The Amended Custody Rule will become effective 60 days after publication in the *Federal Register*. In this alert, we answer some key questions about the Amended Custody Rule and changes to Form ADV.

CUSTODY RULE

How will the Amended Custody Rule affect registered investment advisers to hedge funds or other “pooled investment vehicles” that deliver audited financial statements to investors?

Registered investment advisers to hedge funds and other pooled investment vehicles will continue to be exempt from the Annual Surprise Audit and quarterly statement delivery requirements for those clients if audited financial statements are delivered to all pool investors within 120 days after the end of the fund’s fiscal year.¹ Starting with the audit relating to fiscal years beginning on or after January 1, 2010, the fund’s financial statements will, however, be required to be audited by an independent accountant (as defined by Rule 2-01(b) and (c) of Regulation S-X) that is registered and subject to inspection by the PCAOB² as of the commencement of the professional engagement period and as of each calendar year-end. A registered investment adviser will also now be required to conduct an audit upon dissolution of the fund and promptly deliver audited financial statements after the audit is completed.

¹ For fund of funds, the SEC confirmed in a footnote to the adopting release of the Amended Custody Rule that its prior interpretation that the 180-day audit delivery requirement for fund of funds will remain in effect.

² For a list of accountants that are registered with the PCAOB, see http://www.pcaob.org/Registration/Registered_Firms.pdf.

How does the Amended Custody Rule apply in the case of a “master fund” or other special purpose investment vehicle?

Hedge fund managers often form “master funds” or other special purpose investment vehicles (SPVs) to commingle single investments or multiple investments of fund clients. As a practical matter, there will be only two ways to avoid the need for an Annual Surprise Audit of each SPV: either (1) the annual audit of the financial statements of each participating fund that invests in the SPV must be conducted in a way that “looks through” the SPV to audit the participating fund’s share of the assets and liabilities of the underlying SPV or (2) the SPV itself must have annual audited financial statements that are provided to all investors in all participating funds that invest in the SPV.

Are *all* registered investment advisers required to have an Annual Surprise Audit at least once per year under the Amended Custody Rule for *all* of their client accounts?

No. The amendments proposed by the SEC in May 2009 would have required an Annual Surprise Audit for all clients’ accounts in the actual or constructive custody of all registered investment advisers. After proceeding through the comment process, however, the SEC excluded the following client accounts from the Annual Surprise Audit requirement: (1) pooled investment vehicles that provide audited financial statements in accordance with the Amended Custody Rule, (2) accounts only deemed to be in an adviser’s custody because of the adviser’s ability to deduct fees and (3) accounts held by a related party of the adviser if the adviser is able to demonstrate that the related party custodian is “operationally independent” from the adviser.³

The SEC also limited the scope of the privately offered securities exception, so that it will only provide an exception from the requirement to hold those securities with a qualified custodian. Unless a client’s privately offered securities are subject to an exception listed above, they will be subject to the Annual Surprise Audit.

³ See more information below on the expanded definition of custody and related persons as custodians.

What is required for an Annual Surprise Audit?

Each registered investment adviser that is subject to the Annual Surprise Audit requirement will be required to engage a qualified accounting firm to conduct the first examination by December 31, 2010.⁴ The engagement agreement must require the 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 by facsimile or e-mail of any material discrepancy found in the course of the examination and (3) file Form ADV-E with the SEC (which will be publicly available) 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. The accountant performing the surprise audit must be independent of the adviser, and, if the registered investment adviser or a related person serves as the qualified custodian, it must also be registered and inspected by the PCAOB.

An interpretive release⁵ published contemporaneously with the adopting release for the Amended Custody Rule sets out procedures that accountants should follow in connection with the physical verification of funds and securities in the Annual Surprise Audit. Accountants will be required to obtain records from the registered investment adviser describing client funds and securities and the qualified custodians of those assets (including for accounts closed during the period). The accountant's procedures for verification of client assets held with a qualified custodian should normally include: (1) confirmation with the appropriate qualified custodian of the assets and that the client's assets are held in an appropriately segregated manner, (2) confirmation with the client of assets held in the account as of the date of the examination and (3) reconciliation of confirmations and other evidence in the registered investment adviser's records. The accountant will also be required to verify privately offered securities by confirming with the issuer of those securities. At the end of the examination, the accountant will be required to deliver an opinion as to whether the investment adviser was in compliance in all material respects with the requirements for segregation of client assets maintained with qualified custodians in the Amended Custody Rule.

⁴ For registered investment advisers that become subject to the Amended Custody Rule after its effectiveness, the firm must engage an accounting firm to perform the examination within six (6) months of becoming subject to the Annual Surprise Audit requirement or of receiving the internal control report if a related qualified custodian is used.

⁵ SEC Release IA-2969 (December 30, 2009).

If a related person of a registered investment adviser has custody under the Amended Custody Rule, will it be subject to an Annual Surprise Audit?

Maybe. The Amended Custody Rule expands 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. Therefore, a related person that has authority over client assets, such as an affiliated investment adviser or broker-dealer, would be subject to the annual surprise audit requirements unless it is operationally independent of the adviser.⁶

If a related person serves as a qualified custodian for a registered investment adviser’s clients, what is required under the Amended Custody Rule?

Any registered investment adviser who acts as a qualified custodian or uses a related person as a qualified custodian will be subject to rigorous internal control audits relating to custodial services. Such advisers will be required to obtain a written internal control report within six (6) months of becoming subject to the Amended Custody Rule requirement and no less frequently than once each calendar year thereafter from an independent auditor that is registered and inspected by PCAOB as of the commencement of the professional engagement period and as of each calendar year-end. A change to Rule 204-2 will require advisers subject to the internal control requirement to retain any internal controls report as part of the adviser’s required books and records.

May registered investment advisers deliver quarterly account statements?

After the effectiveness of the Amended Custody Rule, account statements will be required to be delivered to an adviser’s clients directly by the qualified custodian. Registered investment advisers may, however, continue to deliver their own statements in addition to the statements delivered by the qualified custodian. A registered investment adviser that delivers these additional account statements

⁶ A related person will be presumed not to be operationally independent of a registered investment adviser unless it can establish that (1) the client assets are not subject to the claims of the registered investment adviser’s creditors, (2) personnel of the registered investment adviser do not have custody, possession, access to (either directly or indirectly) or power to control the disposition of client assets to third parties for the benefit of the registered investment adviser, (3) personnel of the registered investment adviser are not under common supervision with personnel of the related person who have access to advisory client assets and (4) personnel of the registered investment adviser do not hold any position with the related person or share premises with the related person. Also, the related person cannot have any other relationship with the registered investment adviser that would compromise operational independence or otherwise provide the opportunity to misappropriate funds. A change to the recordkeeping rule, Rule 204-2 under the Advisers Act, will require registered investment advisers that claim to be operationally independent to retain a memorandum describing the basis for the determination that the related person is independent.

must include a legend, in the account statements and in any notice to clients regarding the opening of a new qualified custodian account, that urges the client to compare the statements from the custodian with the statement from the adviser.

Are registered investment advisers required to verify that the qualified custodians deliver account statements to clients?

Registered investment advisers will be required to have a reasonable belief after “due inquiry” that qualified custodians delivered account statements to clients. The SEC did not specify which methodology must be used by advisers to verify that statements have been delivered. One manner that the SEC suggested would satisfy the due inquiry requirement is to have a copy of the account statement delivered to the adviser. The SEC noted that viewing an electronic copy of the statements would not, however, be sufficient to satisfy the requirement to verify the delivery of statements.

COMPLIANCE POLICIES

Are registered investment advisers required to update their compliance procedures to comply with the Amended Custody Rule?

While the SEC did not amend the compliance rule, Rule 206(4)-7 under the Advisers Act, to require additional procedures related to custody, the SEC did include additional guidance with respect to compliance procedures relating to safekeeping of client assets in the adopting release for the Amended Custody Rule. The SEC suggested that registered investment advisers with custody of client assets (1) perform background checks on all employees that have access to client assets, (2) require two signatories for transfers of assets, (3) limit employees that interact with custodians and rotate the employees on a periodic basis and (4) segregate advisory personnel if a registered investment adviser is also a qualified custodian. Advisers should also consider requiring employees to immediately report issues relating to safekeeping of client assets and limiting employees’ ability to obtain custody through power of attorney or trustee relationships.

Per the SEC, if a registered investment adviser has custody only due to its ability to deduct fees from a client account, the investment adviser should focus its policies on verifying the amount of the fee. The

SEC suggested (1) periodic testing of sample fee calculations, (2) testing of the reasonableness of fee calculations and (3) segregating billing and review roles for invoices.

FORM ADV

Are there any changes to the disclosure requirements for investment advisers?

The SEC also made changes to Form ADV to ensure that registered investment advisers report their compliance with the Amended Custody Rule in addition to Form ADV-E discussed above. Amended Item 7 will 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 and whether any of them are operationally independent. Amended Item 9 will 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 will 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 will require advisers to report the name, address, PCAOB status and type engagement of each of the auditors that perform the functions required by the Amended Custody Rule and whether the accountant's report was qualified. Finally, advisers will also be required to identify any related person who serves as a qualified custodian, including the name, address and the type of qualified custodian. Registered investment advisers will be required to provide responses to the additional questions listed above in their first annual amendment filed after January 1, 2011.

CONCLUSION

Many registered investment advisers whose only clients are pooled investment vehicles will not be materially impacted by the changes to the custody rule so long as they ensure that audited financial statements are delivered in accordance with the Amended Custody Rule, and their auditors are registered and inspected by the PCAOB. Investment advisers who only have the ability to deduct fees from a client account will also be largely unaffected by the Amended Custody Rule. In order to substantiate their limited authority over client assets, such advisers should consider amending or

entering into new advisory contracts to explicitly state that the adviser does not have authority over client assets held by the custodian. Some other investment advisers, however, may have to bear the extra cost and burden of an Annual Surprise Audit (currently estimated by the SEC to cost \$1,000 for medium-sized advisers and \$125,000 for larger advisers) or an internal control report (currently estimated by the SEC to cost \$250,000). Registered investment advisers of all types should update their policies and procedures to reflect the changes to the custody rule and the guidance provided by the SEC.

For a link to a comparison of the Amended Custody Rule to the current rule, click [here](#).

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