

## Investment Funds Alert

### SEC Staff Provides Guidance on Compliance with the Amended Custody Rule

March 18, 2010

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On March 5, 2010, and, subsequently, on March 10, 2010 and March 15, 2010, the staff of the Securities and Exchange Commission's Division of Investment Management (the "Staff") published "Staff Responses to Questions About the Custody Rule" (the "Responses"). The Responses supersede previous guidance that the Staff provided relating to the 2003 amendments to Rule 206(4)-2 (the "Custody Rule"). For a link to the Responses, click [here](#).

While several of the interpretations could be divined from close scrutiny of the adopting release<sup>1</sup> and the Custody Rule, the Staff provided useful confirmation and clarification of several issues, including the application of U.S. GAAP to non-U.S. managers, the availability of the Audited Pool Exemption for single investor entities and compliance with the requirement to use a qualified custodian for privately offered securities.

Among other things, the Responses clarify that—

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- There is no minimum number of required investors for the exemption from certain requirements of the Custody Rule for pooled investment vehicles that deliver audited financial statements within 120 days (the "Audited Pool Exemption"), and registered investment advisers may use the Audited Pool Exemption for single limited partner limited partnerships and single member limited liability companies [Question VI.9].
- A registered investment adviser to a pooled investment vehicle that does not rely on the Audited Pool Exemption is not able to use the exemption from the qualified custodian provisions of the Custody Rule for privately offered securities for that client [Question VII.1].
- A registered investment adviser to a pooled investment vehicle that is not able to use the exemption for privately offered securities may satisfy its requirements to hold securities with a qualified custodian for securities only reflected on the books of the issuers by (1) keeping the originally signed subscription agreement with the qualified custodian or (2) having the qualified custodian act as nominee for the pooled investment vehicle [Question VII.2].
- The Staff would not recommend enforcement for a violation of the Custody Rule if a registered investment adviser was reasonably relying on the Audited Pool Exemption but failed to deliver financial statements within the prescribed deadline because of "certain unforeseeable circumstances" [Question VI.7].
- An account that is not a pooled investment vehicle may not use the Audited Pool Exemption even if it invests alongside a pooled investment vehicle [Question X.1].
- Pooled investment vehicles (1) organized outside of the United States or (2) with a general partner or other manager with a place of business outside of the United States may have their financial statements prepared in accordance with accounting

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<sup>1</sup> SEC Release IA-2969 (December 30, 2009).



standards other than U.S. generally accepted accounting principles (U.S. GAAP) so long as (1) they contain information that is substantially similar to that required under U.S. GAAP, (2) any material differences are reconciled and (3) that reconciliation is included in financial statements that are delivered to U.S. persons [Question VI.3].

## General Investment Adviser Guidance

- A registered investment adviser to a client that only holds privately offered securities purchased through a subscription agreement and that has no authority to transfer or redeem securities without client consent would not have “custody” over such securities unless it also has a legal capacity (such as through its status as a general partner of a limited partnership or a trustee of a trust) that gives it legal ownership of such securities [Question VII.3].
- If a registered investment adviser uses three custodians that may or may not have possession of client funds or securities at any given time depending on the trading for the client, that adviser may provide a notice of opening accounts with the three custodians at the initial opening without having to provide a new notice each time assets are moved into or out of one of the accounts [Question V.1].
- Representatives of clients that are appointed by the registered investment adviser would likely not be considered to be independent and would raise fiduciary duty concerns [Question VIII.1].
- Registered investment advisers must comply with the Custody Rule for all clients for which it provides advisory services even if a client does not compensate the adviser for the services [Question II.6].

## Transition Guidance

- The requirement that an auditor for a pooled investment vehicle be registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board in order for the adviser to the vehicle to be exempt from certain requirements of the Custody Rule applies only to audits for fiscal years beginning on or after January 1, 2010. The auditor will be qualified to conduct the audit so long as it is so registered and subject to regular inspection prior to the issuance of the related audit report [Question I.6].
- A registered investment adviser that currently has an omnibus account arrangement with its qualified custodian but must have its account reprogrammed to allow for direct statement delivery may delay its compliance with account statement delivery requirements until the third quarter of 2010 so long as it (1) provides notice to each client no later than the time of sending the account statement for the period ending March 31, 2010 that describes the changes to the account to satisfy the Custody Rule and the timing of such changes and (2) undergoes a surprise examination for 2010 [Question I.2].
- Other than in the case of registered investment advisers that must obtain an internal control report, surprise examinations, to the extent required, must only be commenced (not completed) (1) for advisers subject to the Custody Rule on March 12, 2010, by December 31, 2010, and (2) for advisers that subsequently become subject to the Custody Rule, by the later of six months after becoming so subject and December 31, 2010 [Question I.3].
- The first surprise examination for registered investment advisers that are required to obtain an internal control report must be commenced by the end of the six months after obtaining an internal control report [Question I.3].
- Registered investment advisers do not have to provide responses to the additional questions in amended Form ADV until their first annual updating amendment after January 1, 2011, but accountants must file Form ADV-E electronically as soon as the Investment Adviser Registration Depository (IARD) system is updated to accommodate them [Questions I.10 and I.11].
- The compliance date for obtaining an internal control report for any registered investment advisers that are using a related-party qualified custodian on March 12, 2010, is September 12, 2010, and for those registered investment advisers that subsequently become subject to the internal control report requirement, six months after becoming so subject [Question I.7].

- Internal control reports do not need to address the effectiveness of controls over custodial services prior to March 12, 2010 [Question I.8].

The Staff stated that it plans to update the Responses from time to time as questions present themselves. We will keep you up-to-date on material developments in the Responses.

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