



SEC ISSUES FINAL AMENDMENTS TO CUSTODY RULE

*SEC Approves Stronger Safeguards to Protect Clients' Assets
Controlled by Investment Advisers*

I. INTRODUCTION

On December 16, 2009, the Securities and Exchange Commission (the "SEC") voted to adopt certain amendments to Rule 206(4)-2 (the "Custody Rule") of the Investment Advisers Act of 1940, as amended (the "Advisers Act").¹

The SEC originally proposed amendments to the Custody Rule on May 20, 2009,² as part of its larger effort to enhance custody protections following several high profile fraud cases brought against investment advisers and custodians.

The final rule which was released on December 30, 2009³ incorporates many of the amendments proposed in May, but as discussed in more detail below, they also contain several modifications from the May 2009 proposal, particularly with respect to the impact of the amendments on advisers to pooled investment vehicles. Most notably, the proposed amendments would have required *all* registered investment advisers that have custody of client assets (including advisers to pooled investment vehicles that are already subject to an annual financial statement audit) to be subject to an annual surprise custody examination. *Under the final amendments an adviser to a pooled investment vehicle that is subject to an annual financial statement audit by an independent public accountant, and that distributes the audited financial statements prepared in accordance with generally accepted accounting principles to the pool's investors within the required timelines, will be "deemed" have satisfied the annual surprise examination requirement, provided that the audit is performed by an independent public accountant registered with, and subject to regular inspection by, the PCAOB.*

More details on the final rule are provided below.

III. DISCUSSION OF FINAL RULE – SUMMARY OF PROVISIONS APPLICABLE TO FUND ADVISERS

The final rule adopts amendments to Rule 206(4)-2 to strengthen controls over the custody of client assets by registered investment advisers and to encourage the use of independent custodians as well as related amendments to rule 204-2, Form ADV, and Form ADV-E.

¹ The press release announcing the adoption of the Final Rule can be viewed on the SEC website at <http://sec.gov/news/press/2009/2009-269.htm>

² See The SEC release proposing the original amendments can be viewed at <http://www.sec.gov/rules/proposed/2009/ia-2876.pdf>

³ The SEC release adopting the Final Rule can be viewed at <http://sec.gov/rules/final/2009/ia-2968.pdf>

The Custody Rule's application to investment advisers to pooled investment vehicles will change in several aspects as a result of the amendments. A more detailed discussion of each of these changes appears throughout multiple different sections of this memorandum, but a centralized summary is provided below.

Under amended Rule 206(4)-2, advisers to pooled investment vehicles may be deemed to comply with the surprise verification requirements of the rule by obtaining an audit of the pool and delivering the audited financial statements to pool investors within 120 days of the pool's fiscal year-end. It should be noted that the release for the amended Custody Rule clarifies that the amended Rule does not affect the view of the SEC stated in a no-action letter which clarified that advisers to "fund of funds" are required to deliver the audited financial statements within 180 days of the pool's fiscal year-end. The audit must be conducted by an accounting firm registered with, and subject to regular inspection by, the PCAOB. If the pooled investment vehicle does not distribute audited financial statements to its investors as outlined, the adviser must obtain an annual surprise examination and must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement of the pooled investment vehicle to its investors in order to comply with the custody rule. The rule requires the accounting firm performing the surprise examination to verify privately offered securities, along with other funds and securities, held by a pool that is not subject to a financial statement audit. Regardless of whether an adviser to a pooled investment vehicle obtains a surprise examination or satisfies that requirement by obtaining an audit, if the pooled investment vehicle's assets are maintained with a qualified custodian that is either the adviser to the pool or a related person of the adviser, the adviser to the pool would have to obtain, or receive from the related person, an internal control report. Finally, the rule requires advisers to pools complying with the rule by distributing audited financial statements to investors to also obtain an audit upon liquidation of the pool when the liquidation occurs prior to the fund's fiscal year-end.

III. DISCUSSION OF FINAL RULE

A. Delivery of Account Statements and Notice to Clients

The SEC adopted, as proposed, an amendment to the rule that eliminates an alternative to the requirement under which an adviser can send quarterly account statements to clients if it undergoes a surprise examination by an independent public accountant at least annually. The SEC believes that direct delivery of account statements by qualified custodians will provide greater assurance of the integrity of account statements received by clients.

B. Annual Surprise Examination of Client Assets

1. Applicability of Surprise Examination

The rule will require all advisers with custody of client assets to obtain a surprise examination (or an audit, if applicable in the case of a pooled investment vehicle) of client assets by an independent public accountant, other than as discussed below.

2. Advisors Exempt from Surprise Examination Requirement

(a) Advisors to Pooled Investment Vehicles Subject to Audit by PCAOB Accountant

The rule as proposed would have require all registered investment advisers with custody of client assets to obtain an annual surprise examination, which included pooled investment vehicles subject to an annual financial statement audit. In response to comments that a surprise examination would be duplicative of the annual financial statement audit and would not materially benefit investors, the SEC amended the rule to deem an adviser to a pooled investment vehicle that is subject to an annual financial statement audit by an independent public accountant, and that distributes the audited financial statements prepared in accordance with generally accepted accounting principles to the pool's investors, to have satisfied the annual surprise examination requirement ("annual audit provision").

However, the final rule also added the requirement that in order to satisfy the surprise verification requirement, the audit must be performed by an independent public accountant registered with, and subject to regular inspection by, the PCAOB, as of the commencement of the professional engagement period, and as of each calendar year-end.

It should be noted that an adviser that relies on the annual audit provision must nonetheless undergo an annual surprise examination of non-pooled investment vehicle assets of which it has custody (i.e., non-fund managed account clients).

(b) Advisers with Custody Solely Due to Fee Deduction

An adviser that has custody of client assets solely because of its authority to deduct advisory fees from client accounts will not be subject to the surprise examination requirement. However, as discussed further below, the SEC recommends that such an adviser put appropriate controls in place regarding fee deduction.

3. Commission Reporting

Under amended Rule 206(4)-2, each investment adviser subject to the surprise examination requirement must enter into a written agreement with an independent public accountant to conduct the surprise examination. The agreement must require the accountant, among other things, to notify the Commission within one business day of finding any material discrepancy during the course of the examination, and to submit Form ADV-E to the Commission accompanied by the accountant's certificate within 120 days of the time chosen by the accountant for the surprise examination, stating that the accountant has examined the funds and securities and describing the nature and extent of the examination. The agreement also must provide that, upon resignation or dismissal, the accountant must file within four business days a statement regarding the termination along with Form ADV-E.

4. Privately Offered Securities

The amended Rule 206(4)-2 will no longer permit the accountant conducting the annual surprise examination of client assets to forego examining certain privately offered securities, as defined in the rule. As a result, advisers subject to surprise examinations, the exam will include verification of privately offered securities held behalf of clients.

However, the rule maintained the exemption to maintain private securities with a qualified custodian, including for advisers exempt from surprise exam requirement.

C. Custody by Adviser and its Related Persons

As amended, rule 206(4)-2 imposes additional requirements when advisory client assets are maintained by the adviser itself or by a related person rather than with an independent qualified custodian.

1. Internal Control Report

In addition to the surprise examination discussed above, when an adviser or its related person serves as a qualified custodian for advisory client funds or securities under the rule, the adviser must obtain, or receive from its related person, no less frequently than once each calendar year, a written report, which includes an opinion from an independent public accountant (registered with, and subject to regular inspection by, the PCAOB) with respect to the adviser's or related person's controls relating to custody of client assets ("internal control report"), such as a Type II SAS 70 report. The adviser must maintain the internal control report in its records and make it available to the Commission staff upon request.

2. Related Persons

The Rule as amended will make clear that an adviser has custody of any client securities or funds that are directly or indirectly held by a "related person" in connection with advisory services provided by the adviser to its clients. A related person is defined by the rule as a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser.

The rule also adds a limited exception from the surprise examination requirements in circumstances when the adviser is deemed to have custody solely as a result of a related person having custody provided the adviser is "operationally independent" of the custodian.⁴

If an adviser whose client assets are held by a related person does not undergo a surprise examination, it must make and keep a memorandum describing the relationship with the related person in connection with advisory services the adviser provides to clients and including an explanation of the adviser's basis for determining that it has overcome the presumption that it is not operationally independent of the related person with respect to the related person's custody of client assets.

D. Liquidation Audit

As proposed, the amended rule requires that advisers to pooled investment vehicles that distribute the pool's audited financial statements to investors under the rule's annual audit provision must, in addition to obtaining an annual audit, obtain a final audit of the pool's financial statements upon liquidation of the pool and distribute the financial statements to

⁴ See Amended rule 206(4)-2(d)(5) (defining "operationally independent"). The conditions set out in the rule are: (i) client assets in the custody of the related person are not subject to claims of the adviser's creditors; (ii) advisory personnel do not have custody or possession of, or direct or indirect access to client assets of which the related person has custody, or the power to control the disposition of such client assets to third parties for the benefit of the adviser or its related persons, or otherwise have the opportunity to misappropriate such client assets; (iii) advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision; and (iv) advisory personnel do not hold any position with the related person or share premises with the related person. We would not consider a related person that shared management persons with the adviser, including an owner that was actively involved in the management of the two firms, to be operationally independent.

pool investors promptly after the completion of the audit. This amendment is designed to assure that the proceeds of the liquidation are appropriately accounted for so that pool investors can take timely steps to protect their rights.

E. Delivery to Related Persons

The SEC is adopting a new provision in rule 206(4)-2 that would preclude advisers from using layers of pooled investment vehicles to avoid meaningful application of the protections of the Rule. Specifically, they are adding a new paragraph (c), which provides that sending an account statement (paragraph (a)(5)) or distributing audited financial statements (paragraph (b)(4)) will not meet the requirements of the rule if all of the investors in a pooled investment vehicle to which the statements are sent are themselves pooled investment vehicles that are related persons of the adviser.

Investment advisers to pooled investment vehicles may from time to time use special purpose vehicles (SPVs) to facilitate investments in certain securities by one or more pooled investment vehicles that the advisers manage. These SPVs are typically established or controlled by the investment adviser or its related persons who often serve as general partners of limited partnerships (or managing members of limited liability companies, or persons who hold comparable positions for another type of pooled investment vehicle). Therefore, a literal application of the rule could result in account statements and financial statements designed to permit investors to protect their interests being sent to the adviser itself, rather than to the parties the rule was designed to protect.

To comply with the rule, as amended, the investment adviser could either treat the SPV as a separate client, in which case the adviser will have custody of the SPV's assets, or treat the SPV's assets as assets of the pooled investment vehicles of which it has custody indirectly. If the adviser treats the SPV as a separate client, rule 206(4)-2 requires the adviser to comply separately with the custody rule's audited financial statement distribution or account statement and surprise examination requirements (e.g., distribute audited financial statements of the SPV pursuant to the requirements of rule 206(4)-2). Accordingly, advisers should distribute the audited financial statements or account statements of the SPV to the beneficial owners of the pooled investment vehicles. If, however, the adviser treats the SPV's assets as assets of the pooled investment vehicles of which it has custody indirectly, such assets must be considered within the scope of the pooled investment vehicle's financial statement audit or surprise examination.

F. Compliance Policies and Procedures

The rule release provides specific and detailed guidance regarding the types of policies and procedures relating to safekeeping of client assets that advisers should consider including in their compliance programs. HedgeOp will follow up with its clients on an individual basis to determine if changes should be made to their compliance manuals.

G. Amendments to Form ADV

The rule adopts several amendments to Part 1A and Schedule D of Form ADV which will require registered advisers to report more detailed information about their custody practices in their registration form and to update the information. HedgeOp will follow up with clients on an individual basis to ensure compliance with the new disclosure requirements.

Item 7. Will require each adviser to report all related persons who are broker-dealers and to identify which, if any, serve as qualified custodians with respect to the adviser's clients' funds or securities. The item had required an adviser to identify on Schedule D of Form ADV each related person that is an investment adviser, but made reporting of the names of related person broker-dealers optional.

Section 7.A. of Schedule D - will require an adviser to report whether it has determined that it has overcome the presumption that it is not operationally independent from a related person broker-dealer qualified custodian, and thus is not required to obtain a surprise examination for the clients' assets maintained at that custodian.

Item 9. – will require each registered adviser to report to: (i) whether the adviser or a related person has custody of client assets, and if so, both the total U.S. dollar amount of those assets as well as the number of clients for whose accounts the adviser or its related person has custody (ii) if the adviser, or a related person, acts as an adviser to a pooled investment vehicle, whether (a) the pool is audited, and (b) the qualified custodians send account statements to pool investors (iii) whether an independent public accountant conducts an annual surprise examination of client assets; and (iv) whether an independent public accountant prepares an internal control report with respect to the adviser and its related person; and (v) whether the adviser or a related person serves as qualified custodian for the adviser's clients.

Schedule D - will require that advisers (i) identify and provide certain information about the accountants that perform audits or surprise examinations and that prepare internal control reports; and (ii) to identify related persons, such as banks, that serve as qualified custodians with respect to their clients' funds or securities, but are not otherwise reported in Item 7. Schedule D will also be amended require an adviser to report whether it has determined that it has overcome the presumption that it is not operationally independent from a related person qualified custodian, and thus is not required to obtain a surprise examination for the clients' assets maintained at that custodian.

In response to requests for clarification or modification of Item 9, the SEC also added an instruction to clarify that an adviser must separately report the amount of assets of which has custody, excluding those assets maintained by a related person qualified custodian, and the amount of assets of which a related person has custody, including when the related person serves as a qualified custodian. The SEC is also revising an existing instruction to Item 9.A. to specify that in addition to advisers that have custody *only* because they have authority to deduct fees, that if they also have custody because a related person maintains client assets but the adviser overcome the presumption of not being operationally independent they may continue to answer "no" to Item 9.A. Advisers must report information about these custody arrangements in Item 9.B.

IV. COMPLIANCE DATES

A. Effective Date

The effective date of the amendments to rules 206(4)-2, 204-2, and Forms ADV and ADV-E is March 12, 2010.

B. Compliance Dates and Related Rule Amendments

Advisers currently registered must comply with amended rules 206(4)-2, 204-2, and Forms ADV and ADV-E, as amended, on and after March 12, 2010, the effective date of these amendments, except as described below.

1. Audits of Pooled investment vehicles

An investment adviser to a pooled investment vehicle may rely on the annual audit provision if the adviser (or a related person) becomes contractually obligated to obtain an audit of the financial statements of the pooled investment vehicle for fiscal years beginning on or after January 1, 2010 by an independent public accountant registered with, and subject regular inspection by, the PCAOB.

2. Forms ADV and ADV-E

Investment advisers must provide responses to the revised Form ADV in their first annual amendment after January 1, 2011.

3. Surprise Examinations

An investment adviser required to obtain a surprise examination must enter into a written agreement with an independent public accountant that provides that the examination will take place by December 31, 2010 or, for advisers that become subject to the rule after the effective date, within six months of becoming subject to the requirement. If the adviser itself maintains client assets as qualified custodian, however, the agreement must provide for the first surprise examination to occur no later than six months after obtaining the internal control report.

4. Internal Control Reports

An investment adviser also required to obtain or receive an internal control report because it or a related person maintains client assets as a qualified custodian must obtain or receive an internal control report within six months of becoming subject to the requirement.

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