SEC Amends the Advisers Act Custody Rule

The SEC recently adopted amendments to the Investment Advisers Act custody rule that are intended to provide advisory clients with additional protections when a registered investment adviser has access to client assets.¹ See Custody of Funds or Securities of Clients by Investment Advisers, Advisers Act Release No. 2968 (Dec 30, 2009). These changes were proposed following a series of enforcement actions involving misappropriation of client assets by investment advisers and broker-dealers and represent the first step in the SEC's effort to enhance custody protections, with enhancements to the broker-dealer customer protection rules likely to follow.

Some significant changes to the custody rule are highlighted below.

- **Definition of Custody.** The definition of custody has been expanded to treat an adviser as having custody of client assets whenever a "related person" (any person controlling, controlled by or under common control with the adviser) holds client funds or securities or has any authority to obtain possession of them.

- **Direct Delivery of Account Statements by Custodian.** Except as described below for pooled investment vehicles, a qualified custodian must directly deliver account statements to clients at least quarterly, showing all transactions effected during the applicable period. Advisers who continue to send their own account statements to clients must include a legend in such statements urging clients to compare account statements they receive from the qualified custodian with those they receive from the adviser. Advisers no longer have the alternative of sending their own account statements and having an annual surprise examination by an independent accountant.

- **Surprise Examinations.** With limited exceptions, the client funds and securities that are in the custody of the adviser must be verified by actual examination at least once during each calendar year by an independent public accountant registered and inspected by the Public Company Accounting Oversight Board (the "PCAOB").² Accounting firms performing surprise

¹ We previously described the history of the custody rule and outlined the proposed amendments to the custody rule in a client publication, The SEC’s Proposed Custody Rule Changes.
examinations are required to report material deficiencies to the SEC within one business day and to report the results of the surprise examination on the amended Form ADV-E within 120 days of the time chosen by the accountant for the surprise examination. In addition, upon resignation or dismissal, accounting firms must file a statement regarding the termination on Form ADV-E within four business days. Form ADV-E will be required to be filed electronically (expected to commence in the fourth quarter of 2010).

- **Pooled Investment Vehicles.** The existing rule exempts advisers to funds that distribute audited financial statements at least annually to all investors from the requirement to deliver account statements to fund investors. This provision has been amended to require (1) that the annual financial statements be audited by an accountant registered and inspected by the PCAOB and (2) an additional audit upon liquidation of the fund and the prompt distribution of those financial statements to all investors. Advisers to funds that comply with this provision are required to maintain the funds and securities of the pooled investment vehicles with a qualified custodian but are not required to comply with the new surprise examination requirement for fund assets and are not required to have the qualified custodian send account statements to investors in the funds.

- **Internal Control Reports.** Advisers who hold client assets themselves or hold client assets through a "related person" must annually obtain a written "internal control report" from an accountant registered and inspected by the PCAOB regarding the soundness of custodial policies and procedures, such as a Type II SAS 70 Report. The internal control report must address controls related to the areas of client account establishment and maintenance, authorization and processing of client transactions, security, processing of income and corporate action transactions, reconciliation of funds and securities to depositories and other unaffiliated custodians, and client reporting.

- **Privately Offered Securities.** Privately offered securities are subject to the surprise examination requirement, unless held by a pooled investment vehicle that sends audited financial statement to investors as described above.

- **Amendments to Form ADV.** The SEC has revised Form ADV, Items 7 and 9 of Part 1A. Advisers must now provide more detailed information about their custodial practices in their Form ADV, including the following information: whether the adviser or its related persons have custody of client assets; a list of all related persons who are broker-dealers that identifies any such broker-dealers serving as qualified custodians with respect to the adviser’s client assets; whether the adviser or a related person acts as an adviser to a pooled investment vehicle and, if so, whether the pool is audited or a qualified custodian sends account statements directly to pool investors; the amount of client assets and the total number of advisory clients for which the adviser has custody. Section 7.A of Schedule D has been amended to require advisers to identify the accountants that perform audits, surprise
examinations and internal control reports, if any, and to include a list of related persons that serve as qualified custodians.

Effective and Compliance Dates

The effective date of the amendments to the custody rule is March 12, 2010.

- Advisers required to obtain a surprise examination must enter into a written agreement with a PCAOB accountant that provides that the first surprise examination will take place by December 31, 2010. If the adviser itself acts as a qualified custodian, the agreement with the PCAOB accountant must provide for the first surprise examination to occur no later than six months after the adviser obtains the internal control report.

- Advisers required to obtain an internal control report must obtain the first report by September 12, 2010.

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

In advance of the effective date, advisers should consider how to revise and tailor their written policies and procedures relating to custody, whether to continue the use of affiliated custodians, how to allocate the expenses for compliance with the new requirements, including accountants’ fees for surprise examinations, internal control reports and liquidation audits and whether to amend fund disclosure documents or separate account agreements to address expense allocation or other issues arising as a result of the new requirements.

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