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June 15, 2009

The SEC's Proposed Custody Rule Changes An Analysis of the Impact on Hedge Fund Managers

The SEC recently voted to propose changes to the Advisers Act custody rule. The SEC initiated this action with the intention of providing additional safeguards when an adviser has custody of client assets. The proposed changes follow a series of recent enforcement actions involving alleged misappropriation or other misuse of client assets. *See Custody of Funds or Securities of Clients by Investment Advisers*, Advisers Act Release No. 2876 (May 20, 2009), available at www.sec.gov/rules/proposed/2009/ia-2876.pdf.

The proposed changes would primarily impose two new requirements on registered advisers with custody of client assets. First, those advisers would need to undergo an annual surprise examination by an independent public accountant to verify client assets. Second, those advisers who are qualified custodians and self custody client assets or use a related person who is a qualified custodian (rather than an "independent" qualified custodian) would need to obtain a written report from an independent public accountant. The report would include an opinion as to the qualified custodian's controls regarding the custody of client assets.

While the proposed changes would impact all registered advisers with custody of client assets, the changes would also have unique application to hedge fund managers. This client alert examines the proposed changes to the custody rule from the perspective of a hedge fund manager. It begins with a brief review of the rule's history, then examines the current requirements under the rule and finally describes the proposed changes, including those most relevant to hedge fund managers.

Background

The SEC originally adopted the custody rule in 1962. The original rule contained a brief set of conditions, including generally that an adviser with custody of client assets (1) segregate client securities and keep them in a place reasonably free from risk of destruction or other loss; (2) deposit any client funds in bank accounts in the name of the client or the adviser as trustee; (3) notify the client in writing of the place and manner in which the securities and funds are maintained; and (4) send to the client at least quarterly an itemized statement showing the funds and securities in custody of the adviser at the end of the quarter

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and all transactions in the client's account during the quarter. The original rule also required advisers with custody of client assets to obtain annually a surprise examination of the assets by an independent public accountant. Finally, Form ADV Part II Item 14 required advisers with custody of client assets to submit to the SEC an annual audited balance sheet of the adviser, which then became a public document.

The original version of the custody rule contained a number of gaps, which became apparent in the years after its adoption. For example, the rule did not contain a definition of the term "custody." In addition, the rule did not address whether and in what circumstances a hedge fund manager might be deemed to have custody of a fund's assets.

To address gaps in the original rule, the SEC staff issued approximately 90 no-action letters and one interpretive release over the next four decades. These undertakings included a series of no-action letters addressing custody by hedge fund managers. In effect, the no-action letters concluded that, because a hedge fund manager could directly deduct its advisory fees and redeem its capital commitment from a fund's account without investor approval, a hedge fund manager had custody of client assets and was subject to the custody rule.

Hedge fund managers, however, sought guidance on procedures to avoid custody due in part to the annual surprise audit requirement, and also due to the requirement to submit a publicly-available annual balance sheet. The SEC staff provided the guidance and accepted a detailed set of procedures that excluded hedge fund managers from the custody rule. The procedures included the use of an independent bank or broker-dealer custodian, certain limitations on the ability to transfer a fund's assets, and the use of an independent representative to approve all fee payments and withdrawals by the manager. *See, e.g., PIMS, Inc.*, SEC No-Action Letter (Oct. 21, 1991).

The SEC eventually decided to update and modernize the custody rule and to consolidate prior guidance by the staff. The SEC proposed sweeping revisions to the rule in 2002 and adopted the changes in 2003. *See Custody of Funds or Securities of Clients by Investment Advisers*, Advisers Act Release No. 2176 (Sept. 25, 2003) (adopting release), available at www.sec.gov/rules/final/ia-2176.htm. The revised custody rule included a definition of the term "custody" and made clear that hedge fund managers have custody of client assets. Interestingly, the proposed amendments would have excluded hedge fund managers from most aspects of the rule if managers had their funds audited and the financial statements distributed to investors within 90 days of the end of a fund's fiscal year. The final amendments, however, generally excluded only the requirement to send account statements to investors. The final amendments did not exclude the requirements to maintain client assets with a qualified custodian(s) and to notify investors of the name of the qualified custodian(s).

Current Custody Rule Requirements

As currently in effect, the custody rule contains three basic requirements for registered advisers with custody of client assets. First, an adviser must maintain client assets with a "qualified custodian," as

defined in the rule. Second, an adviser must notify a client of each qualified custodian used by the adviser on behalf of the client and provide the qualified custodian's name, address and the manner in which the assets are maintained. Third, an adviser must have a reasonable basis for believing that the qualified custodian sends at least quarterly account statements to clients identifying the amount of funds and each security in the account at the end of the quarter and setting forth all transactions in the client's account. As an alternative, an adviser itself may send the account statements, but must then arrange for an annual surprise examination by an independent public accountant to verify the assets held in accounts over which the adviser has custody.

As suggested above, the current custody rule substantially limits the circumstances in which an adviser with custody of client assets needs to obtain an annual surprise examination by an independent public accountant. The SEC explained the reason for eliminating the annual surprise examination in most circumstances in its 2002 proposing release. The SEC noted that advisers complained about the cost of examinations and acknowledged that, "because the surprise examination is performed only annually, many months may pass before the accountant has an opportunity to detect a fraud." The SEC believed that the delivery of account statements by a qualified custodian provided more effective protection.

Finally, the 2003 amendments eliminated the need for advisers to submit an annual audited balance sheet for their operations. The adopting release noted that a "balance sheet may give an imperfect picture of the financial health of an advisory firm, because many advisers, including very profitable firms, have few financial assets." The adopting release also noted that another rule, specifically Rule 206(4)-4, separately requires advisers to inform clients whenever an adviser experiences financial difficulties that may preclude the adviser from meeting its contractual commitments to clients.

The current custody rule contains special provisions for hedge fund managers. As noted above, the rule now includes a definition of custody making clear that a hedge fund manager is deemed to have custody (albeit constructive custody) over its hedge funds' assets. The rule contains no procedures to exclude a manager from the definition. The current rule also exempts a hedge fund manager from the account statement delivery requirements if the manager arranges for its funds to obtain audited financial statements and sends those statements to investors within 120 days of a fund's fiscal year end. The SEC refers to this option as the "audit approach." Also as noted above, the current rule requires a hedge fund manager to maintain client assets with a qualified custodian(s) and to provide investors with information about the qualified custodian(s). A hedge fund manager, however, is only required to obtain a surprise annual examination if it (1) does not satisfy the requirements of the audit approach and (2) opts to send quarterly account statements to investors itself, rather than arrange for the qualified custodian(s) to do so. As a practical matter, hedge fund managers almost invariably satisfy the rule's requirements by using the audit approach.

Proposed Custody Rule Requirements

The latest proposed changes to the custody rule would effectively leave in place the rule's current requirements, but would reinstate a general requirement to obtain an annual surprise examination. The proposed changes would also impose additional requirements on advisers with custody of client assets who use themselves or a related person as the qualified custodian.

With respect to the annual surprise examination, an adviser would be required to arrange for the verification of client funds and securities over which the adviser has custody through an actual examination at least once during each calendar year. The examination would need to be conducted by an independent public accountant at a time chosen by the accountant without prior notice or announcement and at a time that varies from year to year. An adviser also would need to enter into a contract with the independent public accountant (and keep the contract as part of the adviser's records). The contract generally would require the accountant to: (1) file a certificate on Form ADV-E with the SEC within 120 days of the time chosen by the accountant to conduct the examination; (2) notify the SEC within one business day upon finding any material discrepancy during the course of the examination; and (3) file within fours business days a Form ADV-E upon resignation or dismissal (or other termination) of the engagement or upon removing itself or being removed from consideration for reappointment.

With respect to the use of itself or a related person as the qualified custodian, an adviser would need to take additional steps. First, the independent public accountant hired by the adviser to conduct the annual surprise examination would need to be a member registered with the Public Company Accounting Oversight Board (the "PCAOB"). Second, the adviser would need to obtain, or receive from its related person, an annual written internal control report by an independent public accountant. The written control report would need to include an opinion of the accountant, issued in accordance with PCAOB standards, with respect to the description of controls relating to custodial services (including the safeguarding of assets held on behalf of advisory clients) and tests of operating effectiveness. In addition, the accountant preparing the control report would need to be a member registered with the PCAOB.

The proposed changes would also address other areas of the custody rule. For instance, the SEC proposed a requirement that notices to clients regarding the identity of the qualified custodian also include a statement urging clients to compare the account statements received from the custodian to those received from the adviser. The SEC also proposed to eliminate the existing alternative of allowing an adviser to send account statements directly to clients if the adviser arranges for an annual surprise audit. Rather, the qualified custodian must send the account statements. In addition, the SEC proposed a slightly higher standard for advisers to have a reasonable basis "after due inquiry" for believing that the qualified custodian is sending account statements to clients. Finally, the SEC proposed to make changes to the Form ADV Part 1. These changes would require advisers with custody of client assets to provide additional information about their custody arrangements, including the dollar amount of assets and

number of clients for which it has custody, as well as the name and address of the independent public accountant who performs the surprise examination.

Impact of the Proposed Changes on Registered Hedge Fund Managers

The proposed changes to the custody rule generally would not change significantly the manner in which most hedge fund managers comply with the custody rule. In fact, the SEC made clear that hedge fund managers could continue to rely on the "audit approach." Of course, hedge fund managers, like other advisers with custody of client assets, would also be required to arrange for an annual surprise examination. In addition, the proposed changes would "clarify" requirements for hedge fund managers who rely on the audit approach and liquidate a fund prior to the fund's fiscal year end. The proposed changes would, in those circumstances, require a hedge fund manager to arrange for the preparation of audited financial statements upon liquidation and distribution of the fund's assets and distribute to investors the audited financial statement promptly after the completion of the audit.

In addition to the changes actually proposed, the SEC has requested comment on a number of other possible alternatives. These alternatives, if adopted, could have a further impact on hedge fund managers. In particular, the SEC has requested comment on whether it should:

- Require all registered advisers with custody of client assets to adopt specific compliance policies and procedures requiring that the chief compliance officer submit a certification to the SEC on a periodic basis that all client assets are properly protected and accounted for on behalf of clients.

- Exempt hedge fund managers from the annual surprise examination requirement if they rely on the "audit approach" since the annual audit serves a similar purpose.

- Require an accountant to perform testing on the valuation of securities, including "privately offered securities," as part of the surprise examination.

- Consider an alternative to the liquidation audit for hedge funds that are closed prior to their fiscal year end.

Finally, the proposed changes to the custody rule fail to address the delivery of audited financial statements by managers to funds of funds. Previously, the SEC staff had stated that managers to funds of funds could meet the requirements of the audit approach if a manager delivered the fund of fund's audited financial statements to investors within 180 days rather than 120 days. *See, e.g., ABA Subcommittee on Private Investment Entities*, SEC No-Action Letter (Aug. 10, 2006). The SEC proposing release contains no discussion of the fund of funds issue and presumably was an oversight that will be addressed in comment letters. Comments on the SEC's proposed changes to the custody rule are due by July 28.

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