ARNOLD & PORTER LLP

ADVISORY

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SEC PROPOSES MODIFICATIONS TO CUSTODY PRACTICES FOR REGISTERED INVESTMENT ADVISERS

On May 20, 2009, the US Securities and Exchange Commission (SEC) issued a proposing release in which it introduced a number of rule proposals to amend various provisions of the Investment Advisers Act of 1940, as amended from time to time (Advisers Act), designed to strengthen the controls over the custody of client funds and securities by investment advisers. The SEC noted that its actions were prompted by recent SEC-initiated enforcement actions in which nearly two dozen investment advisers, including Bernard L. Madoff Investment Securities LLC, were recently charged with fraud for misappropriating client assets. In commenting on the rule proposals, SEC Chairman Mary Schapiro noted, "[t]he new safeguards are designed to decrease the likelihood that an investment adviser could misappropriate a client's assets and go undetected." Nonetheless, the rule proposals, if adopted, would increase the operational costs for many investment advisers.

THE CURRENT CUSTODY RULE

In its current form, Rule 206(4)-2 under the Advisers Act (Custody Rule) generally imposes enumerated requirements on registered investment advisers that are deemed to have "custody" of client funds or securities (covered advisers) to safeguard such assets. The Custody Rule does not govern custody of other assets such as commodities or title to real property. As currently defined in the Custody Rule, an investment adviser is deemed to have custody of client funds and securities "when an adviser holds, directly or indirectly, client funds or securities or [has] any authority to obtain possession of them." While investment advisers generally do not physically custody client funds or securities (as many banks and broker-dealers generally do), an investment adviser is nonetheless deemed to have "custody" of client funds or securities if it has the authority to withdraw funds or securities from a client's account. Most advisers to pooled investment vehicles such as hedge funds are deemed to have custody of the pooled investment vehicle's funds and securities because such pooled investment vehicles are organized as limited partnerships or limited liability companies, and the adviser or one of its affiliates serves as the general partner or managing member of such limited partnerships or limited liability companies with authority to manage the affairs of such entities.

In its current form, the Custody Rule imposes three specific requirements on covered advisers. First, covered advisers must generally maintain client funds

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and securities with a "qualified custodian," which includes generally any US bank, US registered broker-dealer, US futures commission merchant (limited to holding client funds and security futures and any other securities incidental to client futures transactions), and any foreign financial institution that customarily holds customer assets and that segregates customer assets from its own assets. Second, covered advisers must also provide clients with notice of custodial arrangements including the name and address of any qualified custodian retained and the manner in which the client's funds and securities are being maintained. Such notice must be provided promptly after the custodial arrangement is established and after the information previously provided has changed. Third, the Custody Rule generally requires that a client be provided with quarterly account statements identifying the amount of funds and of each security in its account as well as details of all transactions in the client's account for the covered period. If the quarterly account statement is sent by the investment adviser, the investment adviser is subject to an annual surprise examination to be conducted by an independent public accountant designed to independently verify the adviser's accounting for the client's funds and securities.

During a surprise examination, an independent public accountant generally must (a) confirm with the custodian *all* funds and securities held by the custodian, including physical examination of securities if applicable, and reconcile all such cash and securities to the books and records of client accounts maintained by the adviser, (b) verify the adviser's books and records with respect to client accounts by examining the security records and transactions since the last examination and by confirming with clients *all* funds and securities in client accounts, and (c) confirm with clients, on a test basis, closed accounts or securities or funds that have been returned since the last examination. The independent public accountant is required to report any material discrepancies to the SEC's Office of Compliance Investigations and Examinations within one day of the examination and to file a Form ADV-E with the SEC within 30 days of the completion of the surprise examination detailing the nature and extent of the examination. However, if the investment adviser has a reasonable belief that the qualified custodian is disseminating quarterly account statements to the investment adviser's clients, a surprise examination by an independent public accountant is not required.

Historically, the Custody Rule has exempted hedge funds and other pooled investment vehicles from the quarterly account statement delivery requirement if the adviser arranges for an independent public accountant to prepare audited financial statements for the pooled investment vehicle that are prepared in accordance with US generally accepted accounting principles (GAAP) and distributed to all investors within 120 days of the end of the fiscal year of the pooled investment vehicle (and 180 days in the case of a fund of funds).

The Custody Rule also exempts certain "privately offered securities" from its coverage, including: (a) securities acquired from the issuer in a transaction or chain of transactions not involving any public offering, (b) securities that are uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client, and (c) securities transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer. However, "privately offered securities" held by pooled investment vehicles are exempt only if the pooled investment vehicle delivers annual GAAP-compliant audited financial statements to investors within the above-referenced time frames.

THE RULE PROPOSALS

To begin with, the first rule proposal would expand the definition of "custody" to state that an adviser would be deemed to have custody of any client funds or securities 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" would be defined as a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser. For purposes of this definition, the rule proposal would define "control" as the power, directly or indirectly, to direct the management or policies of a person,

whether through ownership of securities, by contract, or otherwise. These definitions would therefore capture many custodial arrangements whereby an affiliate of a registered investment adviser maintains custody of the investment adviser's clients' funds and securities. Additionally, if an adviser or its related persons served as the qualified custodian, they would be subject to additional requirements as described below that would not be applicable to advisers that custody client funds or securities with independent custodians. The SEC reasoned that these additional safeguards were required because the SEC believes that custody of client funds and securities by an adviser or its related persons presents higher risks of fraud than custody of such assets with an independent custodian.

Additionally, the rule proposals would continue to allow pooled investment vehicles to deliver annual GAAP-compliant audited financial statements to investors in lieu of the quarterly account statements required to be delivered by the Custody Rule. However, in order to rely on this exemption from the quarterly account statement delivery requirement, advisers to pooled investment vehicles that are liquidating would also be required to prepare and deliver GAAP-compliant audited financial statements to investors promptly after the completion of the liquidation audit.

Another rule proposal would extend the requirement that an independent public accountant conduct an annual surprise examination to verify the funds and securities in a client's account to almost all registered investment advisers with custody of client funds and securities. This rule proposal would eliminate the exemption from the surprise examination requirement for investment advisers that reasonably believe that a qualified custodian was disseminating quarterly account statements to the investment adviser's clients. Additionally, while advisers to pooled investment vehicles that deliver annual GAAP-compliant audited financial statements to investors would be exempt from the quarterly account statement delivery requirement, they would nonetheless be required to retain an independent public accountant to conduct annual surprise examinations of their custodial arrangements. Additionally, "privately offered securities" that were previously exempt from coverage of the surprise examination would no longer be exempt from the surprise examination.

Covered advisers would be required to enter into and maintain written agreements with independent public accountants for the performance of the annual surprise examination. In addition, if the adviser or a related person served as the qualified custodian, the independent public accountant that conducts the annual surprise examination must be registered with and subject to regular examination by the Public Company Accounting Oversight Board (PCAOB). Such accountants would be required to report any material discrepancies in their examinations to the SEC within one business day. However, in contrast to the current deadline for filing Form ADV-E within 30 days of the completion of the surprise examination, accountants would not be required to file Form ADV-E with the SEC until 120 days after the time chosen by the accountant for the examination. The SEC also proposes to require independent public accountants to file Form ADV-E electronically via the Investment Adviser Registration Depository. In addition, the rule proposal would require that the written agreement require the independent public accountant to submit Form ADV-E to the SEC within four business days of its resignation, dismissal from, or other termination, of the engagement, or upon removing itself or being removed from consideration for being reappointed, accompanied by a statement that includes (a) the date of the termination event as well as the name, address, and contact information of the accountant, and (b) an explanation of any problems relating to examination scope or procedure that contributed to the termination event.

Another rule proposal would require that, if a covered adviser or its related person serves as the qualified custodian (as opposed to an independent custodian) in connection with the adviser's advisory activities, the adviser or its related person must annually obtain a written report (Internal Control Report) that among other things, describes the adviser's custody controls, tests the operating effectiveness of those controls, and details the results of such tests. The Internal Control Report must be prepared

by an independent public accountant registered with and subject to regular inspection by the PCAOB and contain an opinion prepared in accordance with PCAOB standards with respect to the description of controls placed in operation relating to custodial services, including the safeguarding of assets held by either the adviser or a related person on behalf of the adviser's clients, and tests of operating effectiveness. The SEC noted that a report commonly known as a Type II SAS 70 report would be sufficient to satisfy the requirement for an Internal Control Report. The SEC noted that the Internal Control Report would serve as an additional safeguard for investors and provide additional information to independent public accountants that conduct annual surprise examinations of an adviser's custodial arrangements. As part of the rule proposals, the SEC would amend Rule 204-2 under the Advisers Act to require advisers that obtain or receive an Internal Control Report to maintain such reports for five years from the end of the fiscal year in which the Internal Control Report was finalized. The rule proposal does not require that the independent public accountant that prepares the Internal Control Report be different from the independent public accountant that conducts the annual surprise examination of the adviser's custodial arrangements. The SEC noted that, based on discussions with accountants, while there could be wide variations in the cost to prepare an Internal Control Report based on the size and services offered by the qualified custodian, it estimated that the average cost would be approximately US$250,000 per year, which would make custodial arrangements with an adviser's affiliates prohibitively expensive for many advisers despite the administrative advantages of such arrangements.

Another rule proposal would eliminate the provision that permitted investment advisers to disseminate the quarterly account statements required by the Custody Rule. Instead, qualified custodians would be expected to directly deliver quarterly account statements to the adviser's clients. As proposed, all covered advisers would be required to have a reasonable belief that qualified custodians maintaining client funds and securities were delivering quarterly account statements to the adviser's clients. The rule proposal would require an adviser to conduct "due inquiry" to form such a reasonable belief. The SEC noted that the requirement for the covered adviser to conduct "due inquiry" would be satisfied if the covered adviser received either copies of the quarterly account statements disseminated to clients or a written confirmation from the custodian affirming that it had distributed quarterly account statements to the adviser's clients.

In addition, the rule proposals would require that whenever a covered adviser opened a custodial account on behalf of a client, the notice required to be delivered to clients would not only require information about the custodian's name and address and manner in which the client's assets were custodied, but also a statement urging the client to compare quarterly account statements delivered by the qualified custodian against any account statements delivered by the investment adviser.

The rule proposals would also amend Part 1A and Schedule D of Form ADV. Specifically, Item 7 of Part 1 of Form ADV would be amended to require a registered adviser to disclose any related persons that are broker-dealers that have custody of the investment adviser's clients' funds or securities. Item 9 would be amended to require a covered adviser to disclose the amount of client assets and number of clients whose funds or securities are custodied by the adviser or a related person. Additionally, a new subsection to Item 9 would require an adviser to disclose: (a) whether a qualified custodian sends quarterly account statements to investors in pooled investment vehicles the adviser manages, (b) whether the financial statements of the pooled investment vehicles the adviser manages are audited, (c) whether the adviser's clients' funds or securities are subject to a surprise examination, and (d) whether an independent public accountant registered with, and subject to regular inspection by, the PCAOB prepares an Internal Control Report with respect to the adviser or its related persons' custodial services when acting as a qualified custodian for advisory client funds or securities. Item 9 would also be amended to require an adviser that is subject to the surprise

examination requirement to disclose the month in which the last surprise examination commenced. Schedule D of Part I of Form ADV would also be amended to require an adviser to identify, with respect to accountants retained, the name, address and PCAOB registration status of accountants retained by the adviser, the type of engagement for which the accountant was retained (e.g., to perform audits, perform surprise examinations and/or to prepare Internal Control Reports) and whether the accountant's report was unqualified. Additionally, with respect to qualified custodians, Schedule D would require advisers using related persons to custody client assets to identify the related person's name and address and indicate whether the related person qualified custodian is a bank, futures commission merchant, or foreign financial institution.

In commenting on these rule proposals, Chairman Schapiro noted that "we believe that use of third-parties to hold client assets, verify the existence of client assets, or assess the custody controls employed by the adviser or an affiliated custodian will provide a critical, independent layer of protection for advisory clients."

Comments on the proposed rule amendments are required to be submitted to the SEC by July 28, 2009.

We will be closely monitoring any developments in this area, including public comments, and will prepare additional advisories as new information is provided. We hope that you have found this advisory useful. If you have any questions, please contact your Arnold & Porter attorney or:

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