

SEC Proposes Changes to Investment Adviser Custody Rule

Executive Summary

In the wake of numerous enforcement actions centering around the misuse or misappropriation of client funds, the Securities and Exchange Commission (SEC) has proposed several changes to Rule 206(4)-2 (Custody Rule) adopted under the Investment Advisers Act of 1940 (Advisers Act) in an attempt to address what the Commission perceives as weaknesses in the current regulatory framework.

The most significant of the proposed changes would require any investment adviser that is registered or is required to be registered with the SEC and that has "custody" of client assets to undergo an annual surprise examination by an independent certified public accountant intended to verify the existence of those client funds. In addition, for those investment advisers that place client funds with affiliated custodians, there would be enhanced obligations with respect to that annual surprise examination.

As an interesting backdrop to this discussion, there are legislative proposals currently under consideration that would result in many, if not most, hedge fund managers being required to register as investment advisers, either with the SEC or with one or more state securities regulators. If that legislation does materialize (which we believe is likely to happen), these proposed changes would have an even broader effect since the number of registered advisers would substantially increase and most state securities laws mirror the federal requirements.

According to the SEC's proposing release, the impetus for the proposed changes to the Custody Rule is the number of recent enforcement actions taken by the SEC alleging misuse and/or misappropriation of client funds. While, the most obvious of these enforcement actions is the recent SEC case filed against Bernard Madoff relating to his alleged \$50 billion Ponzi scheme, it is one of only six cases cited by the SEC in the proposing release. Each of these cases alleges that the respondent misappropriated client funds and failed to accurately report client assets.

The Custody Rule as currently formulated requires registered investment advisers to comply with certain operational requirements when they have or are deemed to have custody of client funds. The circumstances under which an investment adviser has custody of client funds under the Custody Rule are not being changed under this proposal, so any registered adviser that currently needs to comply with the Custody Rule would have to comply with the revisions.

Surprise Examination Requirement

For most registered investment advisers, the most significant change under the proposed amendments would be a requirement to have any client funds for which the investment adviser has custody independently verified on an annual basis. The verification examination would have to be conducted by an independent certified public accountant pursuant to a written agreement on a surprise basis and on a time frame that changes from year to year (*i.e.*, the accountant would determine when to conduct the verification examination and the date of each annual examination would have to change regularly). Under the current Custody Rule, certain types of securities (*e.g.*, shares of mutual funds and privately offered securities) are exempt from certain requirements. Those exemptions are generally still in place under the proposed Custody Rule, but those securities are included in the client funds that must be verified by the annual surprise examination.

The accountant would be required to file an examination completion certificate with the SEC within 120 days of the completion of the examination. However, if the accountant detects any material discrepancies in the course of the examination, the accountant must notify the SEC within one business day. Finally, if the accountant is no longer conducting the verification examination for a registered investment adviser (whether due to resignation, removal or any other reason), the accountant would be required to notify the SEC of this development as well as any circumstances that led to the discontinuation of the accounting services.

Affiliated Custodians

For those registered investment advisers that use an affiliated qualified custodian, there is heightened scrutiny relating to the annual surprise examination. Specifically, if the qualified custodian holding the funds of a registered investment adviser's clients is affiliated with the investment adviser, the accountant selected to conduct the annual surprise examination must be a member of the Public Company Accounting Oversight Board (PCAOB). In addition, the investment adviser must receive no less than annually from the affiliated qualified custodian a written internal control report prepared by an independent certified public accountant who is a member of the PCAOB (commonly known as a SAS 70 Report).

Client Statements

Another proposed change to the Custody Rule relates to the requirement that the registered investment adviser's clients receive periodic statements from the qualified custodian holding client funds. The proposed additions to the Custody Rule would require the investment adviser to urge its clients in writing to compare the statements the clients receive from the qualified custodian to those that the clients receive directly from the investment adviser. This requirement would not apply to pooled investment vehicles that comply with the annual audit alternative under the Custody Rule since the investors in that investment vehicle generally would not receive statements from the qualified custodian holding the assets of the pooled investment vehicle.

A related change would require a registered investment adviser to make “due inquiry” into the qualified custodian’s operations in order to have a reasonable basis to believe that the qualified custodian is sending client statements no less frequently than quarterly.

Fund-of-Funds Audit Alternative

Finally, under the current Custody Rule, a fund-of-funds is granted a longer window in which to issue its audit and still be eligible for relief from both the requirement that fund investors receive statements directly from the qualified custodian holding the fund’s assets and the requirement that privately offered securities be held by a qualified custodian. The proposed changes to the Custody Rule do not include this extended window for funds-of-funds. However, according to an SEC Investment Management staff attorney, the extended 180-day window for funds-of-funds is still valid pursuant to the American Bar Association No-Action Letter (Aug. 10, 2006). In this No-Action Letter, the American Bar Association asked for confirmation from the Staff that the decision by the U.S. Court of Appeals for the District of Columbia Circuit in *Goldstein v. Securities and Exchange Commission* did not vacate the portion of the current Custody Rule that allows a fund-of-funds 180 days to issue its annual audit.

Investment Management Practice Group

If you have any questions or concerns regarding the proposed changes to the Custody Rule or its effect on your firm, don't hesitate to call any of the lawyers in our Investment Management Group - we would be happy to assist you in any way that we can.

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