

Morgan Lewis

Rule 206-4(2) Custody Webinar
Understanding the New Requirements
Affecting RIAs

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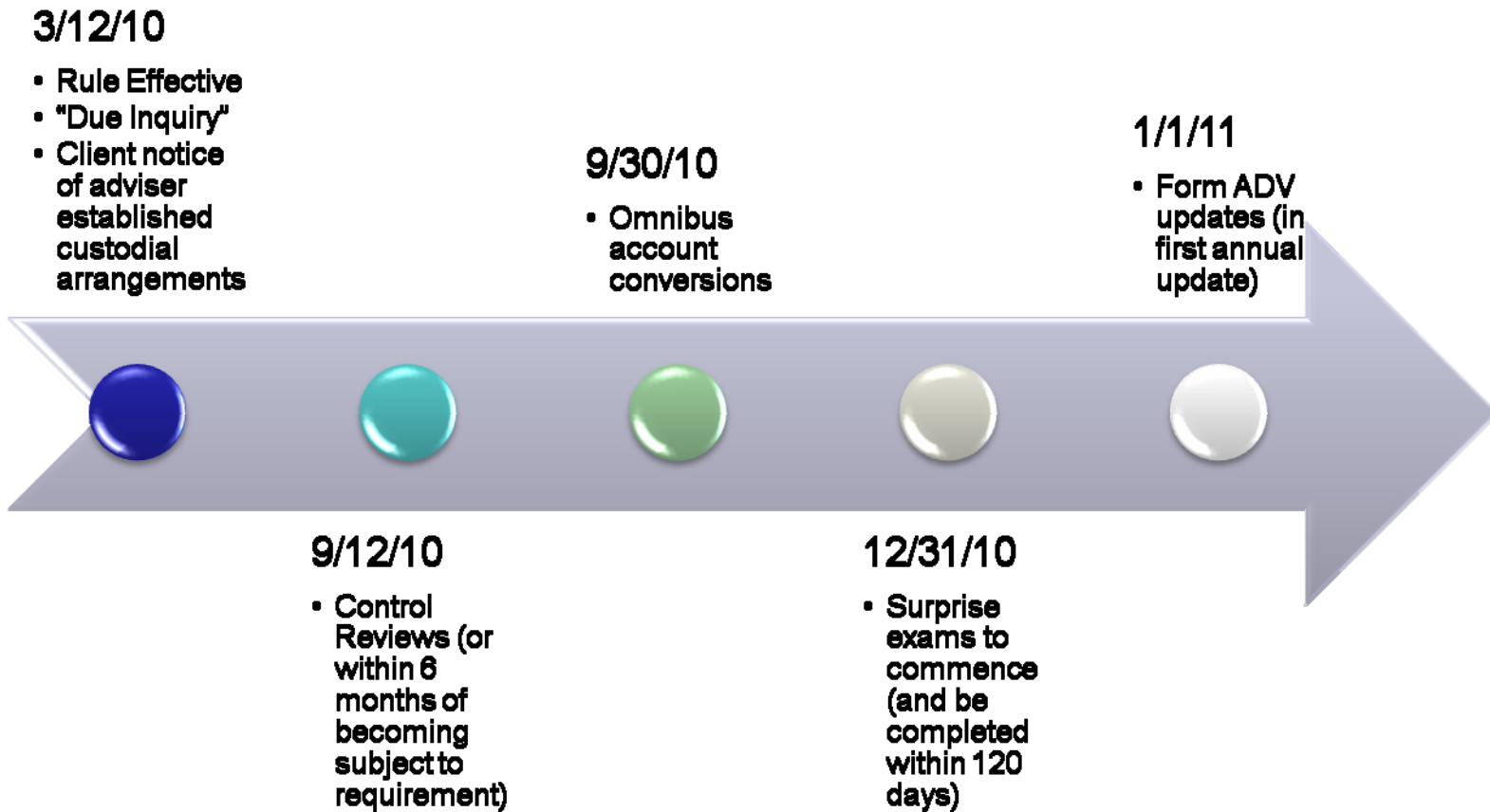
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Rule 206-4(2) Custody Webinar

Understanding the New Requirements Affecting RIAs

- Custody Timeline
- Key Definitions
- Sources of Custody
- Transition from Physical Custody
- Imputed Custody – Related Party Custodians
- Introducing Brokers
- Surprise Examinations
- Internal Control Reviews
- Delivery of Account Statements
- Form ADV Disclosures
- Pooled Investment Vehicles
- Checklist of Next Steps

Custody Timeline



Key Definitions

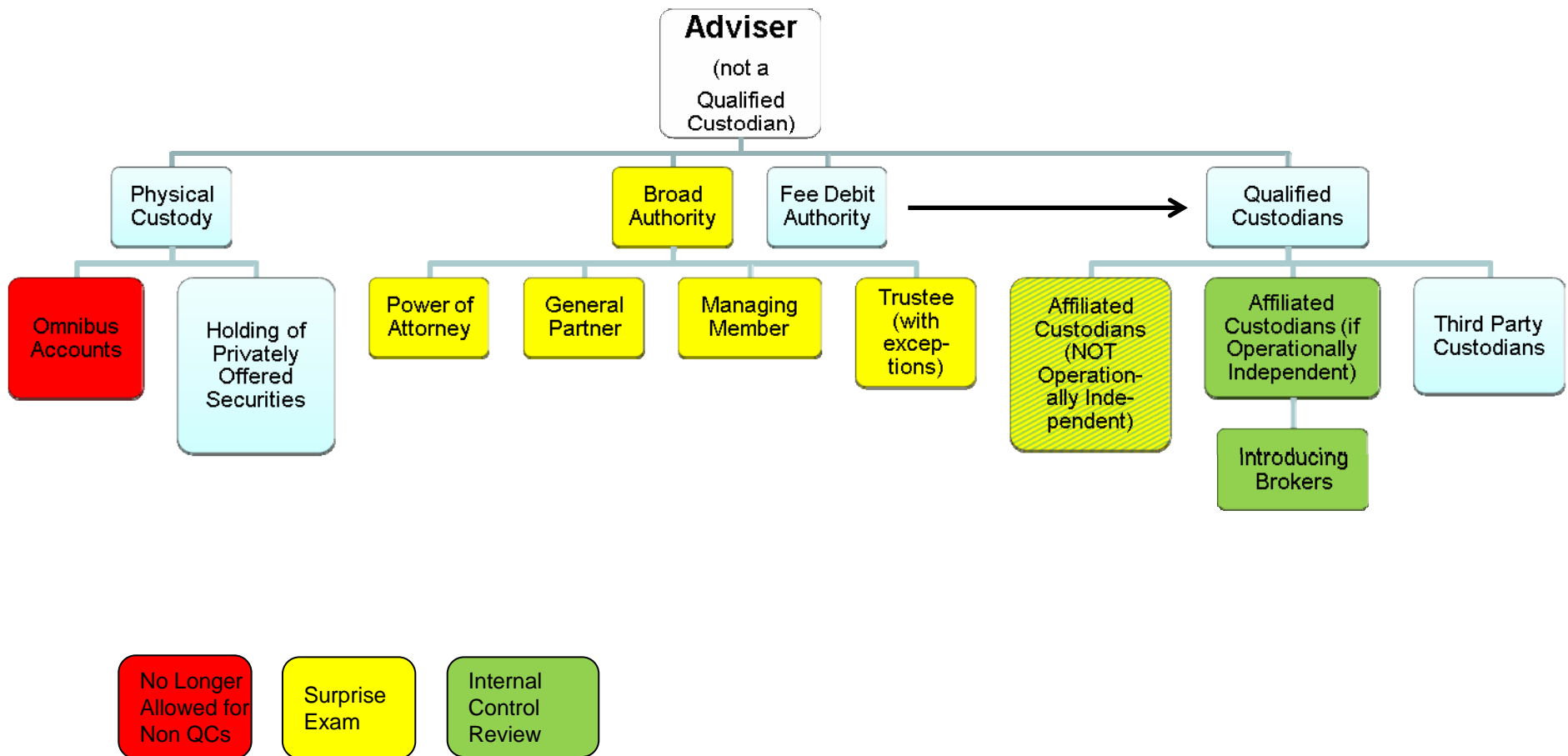
- Custody

- Direct or indirect holding client funds or securities or having authority to obtain possession of them
 - Physical possession of client funds or securities
 - Any arrangement (including power of attorney) where an adviser is authorized or permitted to withdraw client funds or securities with a custodian on the adviser's instruction to the custodian
 - Clarification on transfers between and among accounts for the same client
 - Any capacity (*i.e.*, GP, managing member, trustee or comparable position) giving an adviser (or a supervised person) legal ownership of or access to client funds or securities

Key Definitions

- **Qualified Custodian**
 - A bank, broker-dealer, FCM and foreign financial institution that customarily holds financial assets for its customers and keeps advisory clients' assets in customer accounts segregated from its proprietary assets
- **Privately Offered Securities**
 - Securities that are (i) acquired from the issuer in trades not involving a public offering, (ii) uncertificated, with ownership thereof recorded only on the books of the issuer (or its transfer agent) in the client's name, and (iii) transferable only with prior consent of the issuer or holders of its outstanding securities
- **Related Person**
 - Any person, directly or indirectly, controlling or controlled by, and any person that is under common control with, an adviser
- **Independent Public Accountant**
 - Effectively must be registered with, and subject to regular inspection by, the PCAOB

Sources of Custody



Transition from Physical Custody

- Non-qualified custodian advisers required to transition physical custody to qualified custodians effective 3/12
- Omnibus Accounts – Transition deadline effectively extended to 9/30 if the adviser
 - Completes transition so custodian can send account statements to clients for 3Q10
 - Sends notice to clients (no later than when it sends 1Q10 account statements) clearly describing the transition
 - Undergoes a surprise exam for 2010
- Privately Offered Securities
 - May be held by an adviser
 - But, with securities held for an LP or LLC or other pooled vehicle, the pooled vehicle must be audited and audited financial statements must be sent to investors under the rule
- Inadvertent Receipt – If an adviser inadvertently receives
 - Client securities, it must return them to the sender in 3 business days
 - Tax refunds from tax authorities or distributions from administrators in legal proceedings, it must forward them to the client or qualified custodian within 5 business days

Imputed Custody – Related Party Custodians

- Adviser has custody if a related person
 - Directly or indirectly holds client funds or securities
 - Or has authority to obtain them
 - In connection with advisory services the adviser provides to clients
- Advisers are exempt from the surprise exam requirement if they can establish and document Operational Independence from the related party custodian by meeting the following conditions
 1. Client assets are not subject to claims of the adviser's creditors
 2. Advisory personnel do not have custody, possession of, or the power to control the disposition of such client assets
 3. Advisory personnel and personnel of the related person are not under common supervision
 4. Advisory personnel do not hold any position with the related person or share premises with the related person
 5. No other circumstances can reasonably be expected to compromise the operational independence of the related person

Introducing Brokers

- An adviser would have custody of client funds or securities maintained by a related person introducing broker
- But, an adviser with a related person introducing broker would not have custody if
 - Client funds and securities are maintained with a carrying broker that is not a related person of the adviser
 - The related person introducing broker does not receive client funds or securities (other than checks drawn by clients and made payable to third parties such as the carrying broker)
 - Neither the adviser nor its related persons has authority to withdraw client funds or securities maintained by the carrying broker

Trustees & Executors

- An adviser has custody if it or a related person acts as trustee or executor to a client
- Arrangements Not Viewed as Involving Custody
 - “Friends and Family” – Related persons serving as trustees as a result of a family or personal relationship with the grantor or beneficiary, not as a result of employment with the adviser
 - Participant-Directed Defined Contribution Plans for the adviser's employees if neither the adviser nor a related person otherwise acts as adviser to the plan or any investment option available under it
 - Co-Trustees – An adviser may be a co-trustee to a client trust
 - Where law or trust instrument requires co-trustees if (i) a co-trustee is a bank qualified custodian (not a related person of the adviser), (ii) the qualified custodian delivers account statements directly to each co-trustee, and (iii) trust instrument or law requires prior written consent of all co-trustee(s) before withdrawal of assets by the adviser
 - Of a grantor trust if (i) the adviser is prohibited by the trust instrument or by law from withdrawing assets without the prior written consent of all co-trustees, (ii) each grantor acts as co-trustee, and (iii) a qualified custodian delivers account statements directly to each co-trustee

Surprise Examinations

- Covered

- Client accounts for which adviser has custody
 - Physical custody by adviser (where allowed) or by related person qualified custodian
 - Independent public accountant must be PCAOB registered and inspected
 - Authority, including power of attorney, acting as GP or trustee, or similar legal authority
 - Independent public accountant need not be PCAOB registered and inspected
- Compliance date for commencement of exams: December 31, 2010

- Not covered

- Client accounts for which adviser has custody solely because the adviser can debit fees
- Client accounts with a related person qualified custodian where adviser can demonstrate “Operational Independence”
- Pooled vehicles governed by special rule

Internal Control Reviews

- If adviser is a qualified custodian or a related qualified custodian maintains client assets, the adviser must obtain an annual written internal control report (e.g., a Type II SAS 70 report) with respect to the controls for custody of client funds and securities
- Compliance date: September 12, 2010

Delivery of Account Statements

- Advisers with custody must have a reasonable belief – after **due inquiry** – that the custodian sends account statements at least quarterly to each client
 - Due inquiry – such as by getting copies of statements
 - E-delivery is okay subject to SEC guidance or E-SIGN
 - Use of “independent representatives”
 - Exception for certain pooled investment vehicles
- Where advisers establish custodial arrangements, the advisers must
 - Provide clients with information on the arrangements
 - Urge clients to compare the account statements they receive from the custodian with any they receive from the adviser

Form ADV Disclosures

- Report number of accounts and AUM for which “custody” exists
- Month in which the last surprise security examination occurred
- Identity of related person custodians and whether “operationally independent”
- Identity of accountant performing surprise examination, control examination, audits of private investment funds, including PCAOB status
- Notice of accountant resignations and dismissals (Form ADV-E) within 4 business days of event

Pooled Investment Vehicles

- Pooled investment vehicles are not subject to the annual surprise examination, notice and account statement delivery requirements if
 - Fund is subject to an annual audit
 - Audit is performed by a PCAOB-registered independent public accountant
 - Audited financial statements prepared in accordance with GAAP are distributed to all investors within 120 days (180 days for funds-of-funds) of fiscal year end
 - In event of liquidation, fund performs a liquidation audit and distributes audited financial statements promptly after completion of audit

Checklist of Next Steps

1. Identify accounts and types of assets for which the adviser is deemed to have custody
2. List custodians and confirm they are “qualified custodians”
3. Determine and document if related person custodians are “operationally independent” and the sufficiency of existing internal control reviews
4. If adviser previously sent statements instead of qualified custodians, arrange for statements to be delivered directly by the custodians, including by transitioning any omnibus arrangements to fully-disclosed arrangements
5. Determine if pooled investment vehicles exceptions apply
6. Undertake due inquiry to form reasonable belief that custodians are sending statements to clients
7. Notify clients promptly in writing about any custodial arrangements the adviser sets up and, if the adviser also sends account statements, urge clients to compare such statements to custodian statements
8. Update policies and procedures, including on fee debit arrangements
9. Hire qualified accountant to conduct surprise exams and internal reviews
10. Update Form ADV when required

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