

## SEC Proposes Strengthening of Advisers Act Custody Rule

May 15, 2009

As expected, on May 14 the Securities and Exchange Commission (SEC) proposed changes to the custody rule under the Investment Advisers Act of 1940, Rule 206(4)-2, that will affect the roughly 9,600 investment advisers that the SEC reports have custody of client assets either directly, through affiliated custodians, or by virtue of being able to debit their fees from client accounts.

Although the SEC stated that among the proposal's aims is the promotion of independent custodial arrangements, it did not mandate the use of independent custodians as some had feared it might seek to do. In fact, rather than restricting or barring those broker-dealers that are also registered as advisers from serving as qualified custodians for their advised client accounts or the accounts of their investment adviser affiliates, the SEC proposal extends some of the custodial controls now applicable to broker-dealers to investment advisers deemed to have custody of client assets. Based on the discussion at the SEC's open meeting, the proposal would affect custodial arrangements in three principal ways.

### Designation of Accountants to Conduct Surprise Verifications

First, the proposal would require each investment adviser having custody of client assets to hire an independent public accountant to verify, on a surprise basis and at least annually, all funds and securities in the adviser's custody. Currently, an adviser with custody must undergo this verification only if the adviser, rather than the custodian, sends quarterly statements to clients.

- If the independent public accountant finds any material discrepancies, it will be required to notify the SEC within one business day of such finding, as is currently provided in paragraph (a) of the rule.
- An adviser with custody will also be required to designate on Form ADV the independent public accountant it has engaged to conduct this examination (similar to the requirement applicable to broker-dealers under Exchange Act Rule 17(a)-(5)(f)(2)). Although the details were sketchy, it appears that investment advisers would also have to notify the SEC of any resignation or replacement of the independent public accountant, together with an explanation of the change (similar to the approach taken under Rule 17(a)-5(f)(4) for broker-dealers).
- The SEC also clarified that it proposes to correct a drafting mistake so that privately issued securities held in the custody of an investment adviser would be included in the scope of a surprise examination.
- Notably, these requirements would apparently apply to the roughly 3,600 advisers that have physical custody of client funds and securities **and**—controversially—to the roughly 6,000 advisers that may be deemed to have custody, by virtue of being able to debit their fees from client accounts. It is hoped that the SEC or its staff will resurrect the prior no-action positions that enabled an adviser to negate custody where it debits fees from client accounts if either the amount of the fee is calculated by the custodian or the adviser simultaneously sends to the client and the custodian a statement setting forth the amount of the fee, the manner in which it was calculated, and the value of assets upon

