

## **SEC Adopts Amendments to Advisers Act Custody Rule**

**January 7, 2010**

On December 30, 2009, the Securities and Exchange Commission (SEC) adopted amendments to the custody rule under the Advisers Act of 1940 (the Custody Rule) designed to strengthen controls over the custody of client assets by registered advisers and their related persons. The proposed amendments would have imposed sweeping new obligations on advisers that have custody or are deemed to have custody of client assets by, among other things, requiring an annual surprise examination to verify client assets and promoting the use of independent qualified custodians.

The final rule, however, takes a more measured approach by providing certain exceptions from the annual surprise examination requirement, including exceptions for investment advisers with the authority to deduct fees and advisers to pooled investment vehicles that deliver annual audited financial statements to investors. The final rule continues to promote the use of independent qualified custodians by requiring registered advisers that self-custody client assets, or have related persons that custody client assets, to obtain an internal control report that includes an opinion from an independent public accountant registered with the Public Company Accounting Oversight Board (PCAOB). In the final rule, the SEC also noted that it is currently reviewing recommendations to enhance the oversight of broker-dealer custody of client assets.

### **Implications for Advisers with Authority to Deduct Fees**

Under the final rule, a registered adviser that is deemed to have custody of client assets *solely* because of its authority to deduct fees will not have to undergo an annual surprise examination. This exception does not extend to investment advisers that act as trustees on behalf of clients. The SEC did state, however, that advisers with authority to deduct fees should adopt appropriate controls to address the risk that the adviser or its personnel could deduct fees to which the adviser is not entitled under the terms of its advisory contracts. According to the SEC, such controls might include the following, to the extent applicable:

- Periodic sampling of the accuracy of fee calculations
- Testing of the reasonableness of all fees deducted from client accounts based on the adviser's aggregate assets under management
- The segregating of duties of employees responsible for billing clients, reviewing invoices for accuracy, and reconciling the amount of advisory fees deducted

The final rule also sets forth policies and procedures that all advisers with custody of client assets should consider incorporating as part of their compliance programs under Advisers Act Rule 206(4)-7.

### **Implications for Advisers That Custody Client Assets Through Related Persons**

The final rule provides that registered advisers whose client assets are held by a "related person," a person indirectly or directly controlled by or under common control with the adviser, are deemed to have custody of client funds and securities and are therefore subject to the annual surprise examination and internal control report requirements.

### *Exception to Annual Surprise Examination for Advisers That Are Operationally Independent*

However, an exception from the annual surprise examination requirement is provided for registered advisers that (i) are deemed to have custody solely as a result of their related persons' having custody of client assets, and (ii) are "operationally independent" from such related person custodians. The SEC incorporated prior no-action guidance (see *Crocker Investment Mgmt. Corp.* (Apr. 14, 1978)) to identify the following circumstances under which a registered adviser would be considered operationally independent of a related-person custodian:

- Client assets in the related person's custody are not subject to the claims of the adviser's creditors
- Advisory personnel do not have custody or possession of or access to client assets of which the related person has custody, or the power to control the disposition of such assets to third parties for the benefit of the adviser or its related persons
- Advisory personnel and personnel of each related person that has access to the assets of advisory clients are not under common supervision
- Advisory personnel do not hold any position with the related persons or share premises with the related persons

An adviser relying on this exception is required to create and maintain a memorandum describing its relationship with its related persons in connection with the advisory services provided and documenting the basis for determining that it has overcome the presumption that it is not operationally independent. In addition, the SEC adopted changes to Form ADV Part II designed to identify all related persons of the registered adviser that are broker-dealers or that serve as qualified custodians. These changes to the Form ADV Part II also require that the adviser state whether such related persons are operationally independent of the adviser, and allow the SEC to collect other information relating to compliance with the amended Custody Rule.

### *Internal Control Report*

In addition to the foregoing requirements, to the extent a registered adviser or its related persons have custody of client assets, the adviser must obtain (or receive from each related person with custody) an annual internal control report that demonstrates that the adviser or its related persons have established appropriate custodial controls.

- The report must include an opinion from a PCAOB-registered independent public accountant as to whether internal custodial controls have been placed in operation as of a specific date, are suitably designed, and are operating effectively to meet control objectives related to custodial services, including the safeguarding of advisory client assets during the year.
- The registered adviser is required to maintain the internal control reports in accordance with the recordkeeping requirements of the Advisers Act and make such reports available to the SEC upon request. The SEC stated that a Type II SAS 70 report would be sufficient; however, other types of reports could also satisfy the internal control report requirement.
- The accountant preparing the report must verify that the client funds and securities (including privately offered securities) are reconciled to a depository other than the registered adviser or its related persons. The accountant may either obtain direct confirmation from such depositories or use an alternative method designed to verify that the data used in reconciliations performed by the qualified custodian is obtained from unaffiliated depositories and is unaltered.
- Advisers must obtain or receive their first internal control report within six months of the effective date of the final rule, 60 days after publication in the *Federal Register* (Effective Date).

### **Implications for Advisers to Private Investment Funds**

The final rule recognizes that pooled investment vehicles (Funds) that undergo annual audits of their financial statements provide comparable, and in some respects additional, protections to investors. Accordingly, advisers

to Funds that conduct annual audits and send audited financial statements to investors within 120 days of fiscal year end (180 days for funds-of-funds) will be deemed to satisfy the annual surprise examination requirement; *provided*, however, that the annual audits are conducted by a PCAOB-registered independent public accountant and the audited financial statements are prepared and presented in accordance with generally accepted accounting principles (this may raise potential issues relating to the amortization of Fund organizational expenses). Advisers to Funds that distribute annual audited financial statements must also engage a PCAOB-registered independent public accountant to conduct final audits upon liquidation of the Funds and promptly provide investors with final audited financial statements. Because the liquidation of a Fund is a process that does not necessarily happen on a single date, it is not clear which investors would be entitled to receive the final audited financial statements.

- The SEC added a new provision to the Custody Rule designed to prevent advisers from using layers of Funds to avoid sending information to end investors. Under the final rule, sending account statements or distributing audited financial statements to investors *will not* be sufficient to meet the annual surprise examination requirements of the final rule if all of the investors in a Fund to which such statements are being sent are themselves Funds that are related persons of the adviser.
- If a registered adviser uses special purpose vehicles (SPVs) to facilitate investments in certain securities by one or more Funds that the adviser manages, in order to comply with the final rule the adviser would either (i) treat the SPV as a separate client (e.g., distribute audited financial statements of the SPV to the beneficial owners of the underlying Funds), or (ii) treat SPV assets as assets of the underlying Funds of which it has custody, and such assets should be examined pursuant to the audit of the underlying Funds' financial statements or surprise examinations. We believe this second option would apply, for example, in the case of a master-feeder fund, so long as the feeder fund includes the assets of the master fund in its audited financial statements.

If Fund assets are maintained with the registered adviser itself or a related person, the adviser will be required to obtain, or receive from the related person, an annual internal control report, regardless of whether the adviser is able to satisfy the annual surprise examination requirement by conducting an annual audit of the Fund.

### **Written Agreement with Independent Public Accountant**

Registered advisers that are subject to the annual surprise examination requirement must have a written agreement with a PCAOB-registered independent public accountant, for purposes of conducting the annual surprise examination, in place by the Effective Date. The final rule does not provide an exception for non-U.S. SEC-registered advisers from the requirement that the annual surprise examinations be conducted by a PCAOB-registered accountant.

- The agreement must provide that the first annual surprise examination of the adviser will take place before December 31, 2010 (or, for advisers that become subject to the new rules after the Effective Date, within six months of becoming subject to the annual surprise examination requirement).
- If the adviser self-custodies client assets, the agreement must provide that the first surprise examination will occur no later than six months after the adviser obtains its first required internal control report.
- The agreement must require the accountant to notify the SEC within one business day of finding any material discrepancies during the course of a surprise examination.
- The independent public accountant must submit the Form ADV-E to the SEC, accompanied by the accountant's certificate describing the nature and extent of the examination and certifying that the accountant has examined the funds and securities (including privately offered securities), within 120 days of the time chosen by the accountant for the surprise exam.
- The agreement must require that the accountant file a statement regarding its resignation or dismissal within four business days of such an event along with the Form ADV-E.

The annual surprise examination is required to cover all funds and securities, including privately offered securities that are not required to be held with a qualified custodian. However, the final rule does not require accountants to

test the valuation methods as part of the surprise examination. The SEC published a separate companion release that provides interpretive guidance to assist accountants in the verification of client assets and the preparation of internal control reports.

### **Direct Delivery of Account Statements by the Custodian**

The final rule requires qualified custodians to send account statements directly to advisory clients and eliminates the alternative that currently permits registered advisers to elect to send account statements themselves if they undergo an annual surprise examination. In addition, investment advisers, including advisers with authority to deduct fees, must now have a reasonable belief *after “due inquiry”* that the custodian is in fact sending these statements directly to clients. The SEC did not prescribe a particular method for forming a reasonable belief after due inquiry. However, it did validate the widespread practice of advisers obtaining duplicate copies of client account statements, and confirmed that simply having access to account statements through a custodian’s website would not be sufficient to form a reasonable belief after “due inquiry” that the statements were actually sent to clients.

Registered advisers continue to have the option to send their own account statements directly to clients in addition to the custodian’s statements. However, advisers that elect to send these additional statements must include a statement encouraging clients to compare the statements sent by the adviser with those sent by the qualified custodian. This legend must be included in the initial notice notifying clients that a new custodial account has been opened on their behalf, as well as on all subsequent account statements sent by the registered adviser.

The SEC’s Adopting Release is available at <http://www.sec.gov/rules/final/2009/ia-2968.pdf>.

The SEC Guidance Regarding Independent Public Accountant Engagements is available at <http://www.sec.gov/rules/interp/2009/ia-2969.pdf>.

If you have questions regarding any of the changes discussed in this Investment Management FYI, please contact any of the following Morgan Lewis attorneys:

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