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# SEC Proposes Significant Additional Burdens on Registered Advisers Who Have Custody of Client Assets

At an open meeting on May 14, 2009 ("Open Meeting"), the U.S. Securities and Exchange Commission ("SEC" or "Commission") voted unanimously to propose amendments to Rule 206(4)-2 ("Custody Rule") under the Investment Advisers Act of 1940 ("Advisers Act").[1] Last amended in 2003, the Custody Rule imposes certain safekeeping and disclosure requirements on registered investment advisers ("RIAs")[2] who have "custody" of client assets, as defined by the Custody Rule.[3] Unlike the previous amendments to the Custody Rule, which were seen as easing burdens on advisers by limiting the number of advisers that would be subject to annual, surprise examinations and eliminating the requirement that RIAs with custody include an audited balance sheet with their Form ADV brochure,[4] the proposed amendments to the Custody Rule would impose significant additional burdens on advisers having custody, including:

- requiring **all** RIAs with custody (as defined in the Custody Rule) to undergo an annual surprise examination by an independent public accountant ("surprise audit"), a report of which would be filed with the SEC through the Investment Adviser Registration Depository ("IARD") system on Form ADV-E;[5]
- where an RIA self-custodies or uses an affiliated custodian, requiring the RIA or such affiliate to obtain a written report from an independent public accountant registered with the Public Company Accounting Oversight Board ("PCAOB") that includes an opinion regarding the RIA's (or affiliate's) controls relating to custody ("control report");
- requiring an independent accounting firm engaged to perform the surprise audit to inform the SEC within four days of resigning or being terminated from the engagement;

1 *Proposed Rule*: *Custody of Funds or Securities of Clients by Investment Advisers*, Rel. No. IA-2876 (May 20, 2009) ("2009 Proposing Release"). *See also,* Press Release, SEC Proposes Rule Amendments to Strengthen Safeguards of Investor Funds Controlled by Investment Advisers (May 14, 2009), available at http://www.sec.gov/news/press/2009/2009-109.htm. An archived webcast is at http://www.connectlive.com/events/secopenmeetings/secopenmeeting-051409-archive.asx.

2 By its terms, the Custody Rule applies to any adviser who is registered, or required to be registered, under the Advisers Act. For ease of reference, the term "RIA" is used herein to refer both to advisers who are registered and those who are not, but should be, registered.

3 Under the Custody Rule, an RIA has "custody" if it "hold[s], directly or indirectly, client funds or securities, or ha[s] any authority to obtain possession of them." While few RIAs have true, physical custody of client funds or securities, the Custody Rule deems an RIA to have custody where, among other things, the RIA (i) has the ability to withdraw its fees from client custodial accounts or (ii) acts as general partner or managing member of a private fund which is a client. The Custody Rule does not apply to the account of any investment company registered under the Investment Company Act of 1940.

4 See, *Final Rule: Custody of Funds or Securities of Clients by Investment Advisers*, Rel. No. IA-2176 (Sept. 25, 2003) ("2003 Adopting Release"); *Proposed Rule: Custody of Funds or Securities of Clients by Investment Advisers*, Rel. No. IA-2044 (July 18, 2002).

5 Until the IARD is updated to accept Form ADV-E, filings will be made in paper form.

- requiring that, in all cases, the client's qualified custodian provide account statements directly to the client (or the client's "independent representative") without such statements being routed through the RIA;

- imposing additional Form ADV, Part 1 disclosure requirements with respect to custody, including disclosure of: (i) the number of custodial clients and amount of custodial assets; (ii) the identity of any related persons who serve as qualified custodians for advisory clients; and (iii) the identity of the relevant firm(s) engaged to perform the surprise audit or prepare the control report; and

- requiring public availability, through the SEC's Investment Adviser Public Disclosure ("IAPD") website, of Form ADV-E, which would include (i) the independent accounting firm's report regarding the surprise audit and (ii) where applicable, notification of the resignation or termination of such firm.

Prior to the SEC adopting any amendments to the Custody Rule, the notice and comment process must be completed. As discussed in more detail below, the SEC has posed a number of specific questions about the proposed amendments. RIAs and other interested persons should consider the potential effect of the proposed amendments to the Custody Rule on the industry and, in particular, their firm, and may wish to submit a comment letter. All comment letter letters must be submitted to the SEC by July 28, 2009.

## Genesis of the Proposed Amendments

The proposed Custody Rule amendments are the SEC's first major rulemaking response to the alleged Ponzi schemes and other frauds discovered by regulators in the wake of the collapse of the bull market.[6] A central theme of those alleged frauds was that, in many cases, client assets were subject to theft or misuse by advisers who had custody of client assets or the authority to gain possession of them, while clients (or investors in private funds sponsored by the adviser) were unaware of the adviser's actions – often due to apparent affirmative efforts on the part of the adviser to mislead clients as to the amount or nature of the assets held on their behalf. In response to these problems, the proposed amendments take a three-pronged approach: (i) separating advisory and custodial services, including discouraging self-custody or custody with an affiliate of the RIA;[7] (ii) requiring a "second set of eyes" to review the custody of client assets and custodial controls through surprise audits of RIAs that have "custody" and to issue control reports with respect to RIAs who self-custody or use an affiliated custodian; and (iii) improving the ability of clients and the SEC to understand and review custodial arrangements and potential weaknesses, and to provide early warnings of concerns through enhanced disclosures and reporting by RIAs and independent accounting firms.

## Background: Current Requirements Regarding Custody

Under the Custody Rule, as currently in force, an RIA is deemed to have custody in circumstances where it "hold[s], directly or indirectly, client funds or securities, or ha[s] any authority to obtain possession of them."[8] Because RIAs who have custody must assure that most assets are held by a "qualified custodian" such as a bank or broker-dealer, few RIAs (other than "dual registrants" – *i.e.*, RIAs that are also broker-dealers) are in a position to self-custody client assets or otherwise to have actual, physical custody of client assets. However, many RIAs have arrangements that provide them with authority to obtain such assets, such as: (i) direct billing arrangements pursuant to which advisory fees are debited from the client's custodial account[9] and

6 At the Open Meeting, Chairman Mary L. Schapiro specifically noted that the proposed amendments are "in response to major investment scams—such as Madoff—and many other potential Ponzi schemes." The 2009 Proposing Release cites, in addition to the enforcement actions against Madoff and Stanford, several less well known cases involving the alleged misappropriation of client funds and securities by RIAs.

7 Currently, RIAs who are qualified custodians (*e.g.*, dual registrants) or who have an affiliate that is a qualified custodian are not subject to any specific, additional obligations under the Custody Rule.

8 Rule 206(4)-2(c)(1).

9 An adviser is deemed to have "custody" under the Custody Rule if the adviser is "authorized or permitted to withdraw client funds or securities maintained with a custodian upon [the adviser's] instruction to the custodian." Rule 206(4)-2(c)(1)(ii). Please note that this covers situations where the adviser can deduct advisory fees from the client's account, but does not cover situations where the custodian makes all fee calculations based on the advisory contract and the adviser does not calculate the fee or send a fee bill. *See* Staff Responses to Questions about

(ii) situations where the RIA (or an affiliate) serves as general partner or managing member of a private fund advised by the RIA.[10]

The Custody Rule now requires RIAs having custody to: (i) maintain client funds and securities[11] in separate accounts for each client under the client's name or in accounts that include only client assets, in the adviser's name, as agent or trustee for the clients, held at a qualified custodian such as a bank, broker-dealer, futures commission merchant ("FCM") (but only regarding assets associated with investments commonly handled by FCMs) or appropriate foreign financial institution;[12] (ii) provide clients with information regarding the identity of the custodian and the manner in which assets are held; and (iii) assure that clients receive account statements no less frequently than quarterly from the qualified custodian (or the RIA, provided that the RIA submits to a surprise audit). Under the current Custody Rule, advisers to private funds can avoid the account statement delivery requirement if audited financial statements with respect to the private fund are distributed annually to investors ("audit method").[13]

## Proposed Amendments to the Custody Rule

### Surprise Audit Requirement

Perhaps the most significant of the proposed changes is to require all RIAs who are deemed to have custody to undergo an annual surprise audit, which was generally the case prior to the 2003 amendments to the Custody Rule. The SEC believes that surprise audits "may uncover problems indicating that client assets may be at risk" and, therefore, the requirement to undergo surprise audits is designed "to provide timely information to the [SEC] staff in the event that the accountant discovers a problem during the examination."[14] The surprise audit must be performed by an independent public accountant,[15] pursuant to a written agreement with the RIA, at least once during each calendar year and completed within 120 days of its commencement. The accountant is responsible for choosing a date for the audit (which must vary from year to year) and may

Amended Custody Rule, (Jan. 10, 2005) ("FAQ"), available at http://www.sec.gov/divisions/investment/custody_faq.htm, at III.3.

10 Rule 206(4)-2(c)(1)(iii). Several of the alleged frauds cited by the SEC in the 2009 Proposing Release involved circumstances where the RIA was able to access client assets by virtue of the RIA's control over a private fund. *See*, 2009 Proposing Release, *supra* n. 1, at note 11.

11 Under the Custody Rule, the following types of assets need not be held with a qualified custodian: (i) mutual fund shares, which can be held by the fund's transfer agent; and (ii) certain privately offered securities that are (a) acquired from the issuer in a transaction or chain of transactions not involving a public offering; (b) uncertificated, with ownership recorded only on the books of the issuer or its transfer agent in the client's name; and (c) transferable only with the prior consent of the issuer or the holders of its outstanding securities.

12 The SEC noted that in selecting a foreign custodian, the adviser has a fiduciary obligation "either to have a reasonable basis for believing that the foreign institution will provide a level of safety for client assets similar to that which would be provided by a 'qualified custodian' in the United States or to fully disclose to clients any material risks attendant to maintaining the assets with the foreign custodian." *2009 Proposing Release, supra* n. 1, at note 3 (citing the 2003 Adopting Release, *supra* n. 4).

13 RIAs to pooled vehicles may not rely on the exception allowing private securities to be held away from a qualified custodian unless they use the audit method.

14 2009 Adopting Release, *supra* n. 1 at note 10 and accompanying text. The SEC explained that an accountant must notify the staff of the SEC's Office of Compliance Inspections and Examinations within one business day of finding a material discrepancy. An accountant who believes that a material discrepancy may exist "may first take reasonable steps to establish the basis for believing that a material discrepancy exists [as the notice obligation] arises once the accountant has a basis for" such belief, though the SEC believes that "an accountant should be able to determine promptly whether it has a basis for believing that there is a material discrepancy." *Id.*

15 Under the proposed amendments, a public accountant will be "independent" if it "meets the standards of independence described in rule 2-01(b) and (c) of Regulation S-X." Proposed Rule 206(4)-2(c)(3). While the Regulation S-X rules regarding independence are complex and dependent on facts and circumstances, an accountant will generally be independent unless "the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment." Rule 2-01(c) of Regulation S-X contains a list of circumstances and relationships which are inconsistent with a finding that the accountant is independent.

not give prior notice to the RIA.[16] Within 30 days following the surprise audit, the independent accountant must file a Form ADV-E with the SEC.[17]

According to SEC guidance, an independent accountant performing the surprise audit must:

- confirm all cash and securities held, including physical examination of securities if applicable, and reconcile all cash and securities (including mutual fund shares and private securities not required to be held by a qualified custodian) to the RIA's books and records;[18]
- verify the RIA's books and records by examining security records and transactions since the last examination and by confirming with clients all funds and securities being held;
- confirm with clients, on a test basis, closed accounts or securities or funds that have been returned since the last examination;
- include "any other audit procedures that [the independent public accountant] deems necessary under the circumstances";[19] and
- conform its audit to U.S. Generally Accepted Auditing or Attestation Standards ("US GAAS") and any other requirements imposed by the SEC, except that all client funds and securities covered by the examination must be verified or substantiated (*i.e.*, sampling would not be sufficient for this purpose).[20]

This new requirement will impact RIAs who either (i) previously relied on qualified custodians to send quarterly statements to clients or (ii) have custody of a private fund's account and previously relied on the audit method, which allowed RIAs to avoid a surprise audit.

16 The surprise audit must be performed during the calendar year to which it relates and at times that are not repetitive and predictable. *See, e.g., In the Matter of Kaufman, Bernstein, Oberman, Tivoli & Miller, LLC and Howard M. Bernstein*, Rel. No. IA-2194 (Nov. 20, 2003) (finding a violation of the Custody Rule where "the predictable timing of the examinations . . . effectively put [the RIA] on notice that the examinations would begin in the first few days of January each year"); *In the Matter of CMS Fund Advisers, Inc.*, Rel. No. IA-2430 (Sept. 15, 2005) (finding a violation of the Custody Rule where the RIA "failed to timely engage an auditing firm for the [annual] verifications, or provide a specific deadline to the auditor").

17 Requirements with respect to content and filing of Form ADV-E are discussed in more detail below.

18 The SEC requested comment as to whether the surprise audit should also include confirmation of securities holdings with the highest-level unaffiliated sub-custodian (*e.g.*, Depository Trust Company).

19 2009 Proposing Release, *supra* n. 1, at note 45.

20 The SEC reminded RIAs (and auditors) of the standards announced in 1966 with respect to surprise audits. *See Nature of Examination Required to be Made of All Funds and Securities Held in Custody of Investment Advisers and Related Accountant's Certificate*, Rel. No. IA-201 (May 26, 1966) ("Rel. IA-201"). On at least one occasion, the SEC has brought enforcement action against an accounting firm, and the manager and supervising partner engaged to perform the surprise audits, when the surprise audits failed to conform with requirements imposed by the Custody Rule and Rel. IA-201. *See, In the Matter of Weiser LLP, Victor R. Wahba, CPA and Stuart A. Nussbaum, CPA* ("Weiser"), Rel. No. IA-2208 (Jan. 15, 2004) (imposing a cease and desist order against the firm and two individuals, censuring the firm, requiring it to comply with certain remedial undertakings and pay disgorgement, barring the supervising partner for at least four years and barring the other accountant for at least one year).

In *Weiser*, the accountants: (i) failed to determine the accounts for which the RIA had custody; (ii) failed to examine all funds and securities of custodial clients in that they (a) examined only a sampling of the accounts and (b) "failed to verify by actual examination all of the funds and securities" for the selected accounts; (iii) did not attempt to obtain written confirmation from the RIA's clients of the amount of funds and securities held by the RIA on their behalf; (iv) failed to include within one Form ADV-E the required representation that the RIA had complied with the Custody Rule since the prior surprise audit; and (v) failed to assure that a Form ADV-E was filed with respect to another year's surprise audit. The firm and named personnel were found to have both aided and abetted the RIA's violations of the Custody Rule (which, in this case and to the knowledge of the relevant personnel, were recidivist) and were also found to have violated the SEC's Rules of Practice by engaging in improper professional conduct. In its release announcing the institution and settlement of proceedings, the SEC noted that the RIA was subsequently found to have engaged in a fraud involving, among other things, "account statements . . . that materially overstated the value of assets in the client's accounts [and] to cover the existence of [t]his fraud . . . made approximately 26 unauthorized transfers between client accounts." While the SEC indicated that "[n]o evidence indicates that the Respondents knew of [the RIA's] fraudulent conduct prior to the [later] civil action," the nature of the RIA's violations was such that a well-conducted surprise audit might have prevented, or at least mitigated through earlier discovery, the effect of the RIA's fraud on clients.

Comments Requested: The SEC posed a number of issues for consideration with respect to the expanded surprise audit requirement, including:

- Whether the surprise audit requirement should apply to RIAs who would not have custody but for automatic billing arrangements[21] or in connection with a private fund.[22]
- Whether the SEC should amend the Compliance Program Rule (Rule 206(4)-7 under the Advisers Act) by requiring an RIA's Chief Compliance Officer ("CCO") to submit a certification to the SEC that all client assets are properly protected and accounted for or by imposing certain minimum required procedures with respect to safekeeping of client assets.
- Whether alternate protections would be more appropriate for dual registrants or RIAs that are also banks.[23]
- Whether the SEC should alter or clarify the procedures or guidance regarding the scope or process of the surprise audit.[24]
- Whether requiring the independent accounting firm to verify privately offered securities is feasible.

**Self-Custody or Custody by a Related Person**

Under the current Custody Rule, an RIA **may** be deemed to have custody if an affiliate of the RIA holds client assets, depending upon facts and circumstances.[25] The proposed amendments to the Custody Rule would modify the Rule in order to hold that an RIA **has** custody whenever "a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with the [RIA's] advisory services."[26] The SEC indicated that this change is appropriate because "the risks to advisory clients that arise as a result of a related person's ability to obtain client assets, regardless of the separation between the adviser and a related person, may be substantial"[27] and "the relationship between the adviser and the custodian [poses] a greater risk that the custodian could be a party to any fraud." However, the SEC **did not** propose to prohibit self-custody or the use of an affiliated

21 The SEC questioned whether automatic billing is less likely to result in the sort of abuses that the surprise audit requirement is intended to address and if restrictions on such arrangements could provide similar protections.

22 The SEC noted that the annual audit for private funds using the audit method serves a similar purpose but does not cover all funds or securities. Additionally, the timing of the annual audit is known whereas the timing of the surprise audit is not.

23 For example, "requiring these advisers to segregate custodial duties from advisory duties and implement[ing] additional internal controls to protect client assets." 2009 Proposing Release, *supra* n. 1. As a general matter, banks are excepted from the definition of an "investment adviser" except insofar as the bank provides investment advisory services to a registered fund, in which case the bank may register a separately identifiable department or division rather than the bank as a whole. As noted above, the Custody Rule does not apply to accounts managed on behalf of a registered investment company.

24 For example, by: requiring the accountant to test securities valuations; requiring the RIA to certify the list of assets examined; or allowing for sampling.

25 *See*, 2003 Adopting Release, *supra* n. 4, at note 4 (citing *Crocker Investment Management Corp.* (pub. avail. Apr. 14, 1978) ("Crocker")). If the proposed amendments are adopted, *Crocker* would be withdrawn. See 2009 Proposing Release, *supra* n. 1, at note 39.

26 Proposed Rule 206(4)-2(c)(2). The proposed amendments define a "related person" as "any person, directly or indirectly, controlling . . . controlled by . . . or under common control with" the RIA. Proposed Rule 206(4)-2(c)(6). "Control" is defined consistently with the definition of that term for purposes of Form ADV. *See*, Proposed Rule 206(4)-2(c)(1), 2009 Proposing Release, *supra* n. 1, at note 36, *Form ADV: Uniform Application for Investment Adviser Registration*, Glossary item 5, *available at* http://www.sec.gov/about/forms/formadv-instructions.pdf. The *2009 Proposing Release* notes that "[t]he 'in connection with' limitation . . . is designed to prevent an adviser from being deemed to have custody of client assets held by a related person . . . with respect to which the adviser does not provide advice." For example, if the RIA has a related person that is a bank, the RIA would not be subject to the Custody Rule as a result of (or in connection with) the client's unrelated bank accounts.

27 In this respect, the SEC noted in the 2009 Proposing Release that while such RIAs would still be subject to the surprise audit requirement, a surprise audit may be insufficient in that "the independent public accountant seeking to verify client assets may have to rely on custodial reports issued by the adviser or its related person. . . . Requiring these advisers to also obtain an internal control report would provide an additional check on the safeguards relating to client assets held by the adviser or the related . . . custodian."

custodian, though it did request comment as to whether such a prohibition would be appropriate and feasible.[28]

To further deter RIAs from self-custody or using affiliates to provide custodial services and to assure that, where used, such arrangements do not place client assets at risk, the proposed amendments would require an RIA (or its related custodian) to obtain or receive, retain[29] and make available to the SEC or its staff upon request, a written control report from an independent public accountant that is registered with and subject to inspection by the PCAOB, regarding the RIA's (or its related custodian's) custody controls.[30] Such a control report must include an opinion of the independent public accountant, issued in accordance with PCAOB standards, related to the description of controls placed in operation relating to custodial services and tests of operating effectiveness, a "description of the relevant controls, the control objectives and related controls, and the . . . accountant's tests of operating effectiveness that were performed and the results of those tests." The opinion would also be required to address control objectives relevant to custodial operations (as well as the general control environment and information systems). According to the SEC, control objectives relevant to custodial operations might include:

- safeguarding physical securities from loss or misappropriation;
- timely and accurate reconciliation of cash and security positions among the custodian, depositories and accounting systems;
- proper authorization and complete and accurate recording of client-initiated trades;
- timely and accurate processing of securities income and corporate action transactions;
- accurate performance of net settlement procedures;
- complete and accurate documentation of the account opening process; and
- accurate recording of valuations obtained from outside pricing sources.

Although not required, the 2009 Proposing Release noted that a "report on the description of controls placed in operation and tests of operating effectiveness (commonly referred to as a 'Type II SAS 70 Report') conducted in accordance with PCAOB standards would be [a] sufficient" control report.[31]

These amendments will impact RIAs who are dual registrants or banks as well as RIAs who are part of a group of financial service companies including brokers, banks, FCMs, or other persons who provide custodial functions, such as: sponsors of wrap fee programs, RIAs providing services through a wrap fee program sponsored by an affiliate, and advisers to private funds using an affiliate's prime brokerage or custody services.

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28 The SEC recognized that such a requirement could interfere substantially with wide-spread current practices of dual registrants that provide advisory services to brokerage customers or operate wrap fee programs. In this regard, the SEC requested specific comment as to whether requiring an independent custodian would: (i) be too costly for small advisory clients; (ii) result in greater costs or burdens generally, including the loss of access to services; and (iii) provide additional protection commensurate with such costs. Implicit in the SEC's review of this issue will be whether "the custodial protections afforded by the banking laws and [the SEC's] rules under the [Securities] Exchange Act [of 1934] (and the rules of the self-regulatory organizations) are sufficient to protect bank and brokerage customers, but may not be sufficient to protect custodial assets of advisory clients."

29 Proposed Rule 204-2(a)(17)(iii). Such report would be required to be retained for a period of not less than five years from the end of the fiscal year in which the report was finalized.

30 By contrast, the independent accounting firm performing the surprise audit need not be PCAOB-registered unless the RIA self-custodies or uses an affiliated custodian. The same firm can provide both the surprise audit and the control report. The SEC noted that registration with the PCAOB and "periodic inspection of an independent public accountant's control system by the PCAOB will provide . . . greater confidence in the quality of the internal control report."

31 At the Open Meeting, the SEC staff indicated its expectation that (i) most RIAs would use a Type II SAS 70 to comply with the control report requirement for U.S. custodians and (ii) most foreign jurisdictions have similar reports that would meet the requirements of the proposed amendments to the Custody Rule.

Comments Requested: The SEC posed a number of issues for consideration with respect to self-custody, custody by affiliates and the control report requirement, including:

- Whether, and under what circumstances, custody should be imputed to an RIA using a related custodian.
- Whether the control report provides protections in addition to the surprise audit and how the timing of the control report would relate to the timing of the surprise audit.
- Whether requiring a PCAOB-registered independent public accountant to prepare the control report will increase the cost or difficulty of obtaining control reports.
- Whether sufficient guidance has been provided to independent public accountants with respect to the control report.[32]
- Whether the control report requirement presents any particular difficulties or issues with respect to assets held in custody outside of the U.S.
- Whether requiring that surprise examinations for RIAs that self-custody or use an affiliated custodian be conducted by a PCAOB-registered independent public accountant is beneficial.
- Whether there is a disparate impact on smaller accounting firms or RIAs.
- Whether a PCAOB-registered independent public accountant should be required to perform the audit where an RIA to a private fund relies on the audit method.[33]

**Delivery of Account Statements and Related Notice Requirements**

Under the current Custody Rule, an RIA can avoid surprise audits if it has a reasonable basis for believing that clients receive quarterly account statements from a qualified custodian.[34] Under the proposed amendments, delivery of account statements by the custodian for the accounts will no longer permit an RIA to avoid the surprise audit requirement. In addition, the proposed amendments would eliminate the ability for an RIA to send account statements directly to clients (without duplicate account statements being provided by the qualified custodian).[35] Rather, except with respect to pooled vehicles using the audit method, each RIA would be required to "have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement, at least quarterly, to each of [the RIA's] clients for which it maintains funds or securities."[36]

Under the current Custody Rule, an RIA that relies on a qualified custodian to deliver account statements to its clients must have a reasonable basis for believing that the custodian is sending such account statements to clients (or the client's independent representative, if the client does not wish to receive such reports directly); by contrast, the proposed amendments to the Custody Rule would impose a "due inquiry" requirement on

32 In particular, the SEC requested comment as to whether (and which) specific control objectives should be required to be addressed in the control report.

33 In addition, the SEC asked whether such a revision would be workable for RIAs to offshore pools.

34 The proposed amendments would not alter the content of these quarterly account statements from what is currently required by the Custody Rule. Additionally, as under the current Custody Rule, clients who do not wish to receive account statements may designate an independent representative to receive statements (from the RIA and/or custodian) on their behalf.

35 The *2009 Proposing Release* notes that this "alternative delivery option [was permitted] because some advisers did not wish to disclose the names of their clients to custodians to prevent a potential competitor from having access to their lists of clients, or to protect the privacy of some well-known clients." The SEC noted that privacy and competitive concerns could be adequately addressed through contractual provisions and, with respect to individuals, applicable laws and regulations with respect to consumer privacy.

Additionally, some advisory clients may prefer not to receive statements from the qualified custodian. If the proposed amendments are adopted, clients not wishing to receive custodial statements directly will be required to arrange for such statements to be provided to an independent representative.

36 Proposed Rule 206(4)-2(a)(3). The *2009 Proposing Release* notes, however, that "custodians may use service providers to deliver their account statements . . . so long as the statements are sent to the client directly and not through the adviser."

RIAs.[37] The SEC explained that the "due inquiry" standard could be satisfied by, among other things: (i) receiving duplicate statements from the custodian or (ii) requesting that the custodian confirm, in writing, that it has sent such statements.[38] While the SEC indicated that account statement delivery should be "not through the investment adviser," it did not address instances in which an RIA, that is itself a qualified custodian, has custody of client assets.

The proposed amendments would also retain the current requirement that an RIA inform clients, upon the opening of a custodial account in the client's name or subsequent changes to relevant information about the account or the custodian, of the identity and address of the custodian and the manner in which client assets are maintained. In addition, the proposed amendments to the Custody Rule would require the RIA to include, with such notice, "a statement urging the client to compare the account statements he or she shall receive from the custodian with those from the adviser."[39] The SEC believes that "the effectiveness of the [R]ule depends significantly on direct delivery of account statements by custodians" and notes, in the 2009 Proposing Release, that "[c]lient review of periodic account statements from the qualified custodian can enable clients to discover improper account transactions or other fraudulent activity. Raising client awareness of this safeguard at account opening could enhance its effectiveness."

These amendments will impact RIAs that currently send account statements directly to clients. In some cases, RIAs choose to send statements directly in order to limit contact between clients and the qualified custodian because, for example, the qualified custodian may be a competitor in providing advisory services. In other cases, RIAs send statements directly to accommodate their clients' desire to suppress custodial statements in order to minimize the amount of paper that crosses their desks. If the proposed amendments are adopted, RIAs that have competitive concerns could negotiate confidentiality protections or non-disclosure/non-use agreements, while those who are accommodating clients' desire to minimize paperwork could request that their clients appoint an independent representative to receive account statements on their behalf. These amendments may also impact RIAs that self-custody client assets, though it is hoped that, if the amendments to the Custody Rule are adopted, the SEC will clarify that such RIAs can, in their role as qualified custodian, continue to provide quarterly account statements directly to their clients. Finally, RIAs that previously relied on a qualified custodian to deliver account statements, based on a reasonable belief that was formed in absence of the receipt of duplicate account statements or quarterly delivery confirmations, now will need to determine what additional inquiry will be required to assure the "due inquiry" standard is met.

Comments Requested: The SEC posed a number of issues for consideration with respect to account statement delivery and notice requirements, including:

- Whether the alternate method (of allowing RIAs to deliver account statements) should be retained.
- Whether there are securities with respect to which qualified custodians will not send account statements (due to legal, tax or practical limitations).
- Whether other means could provide greater assurance of the integrity of account statements.
- Whether the Custody Rule (or SEC guidance) should specify particular steps to be taken to assure that custodians deliver account statements.
- Whether RIAs should be required to send their own account statements in addition to the custodian's statements and whether such statements should be required to include a legend urging clients to compare them to the custodian's statements.
- Whether additional disclosures should be required.

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37 *Compare*, current Rule 206(4)-2(a)(3)(i) *with* Proposed Rule 206(4)-2(a)(3).

38 RIAs choosing the latter method are warned that "such confirmations would need to cover each quarter during which the qualified custodian is expected to send account statements to the clients." 2009 Proposing Release, *supra* n. 1, at note 61.

39 Proposed Rule 206(4)-2(a)(2). Although the proposed language would seem to suggest that the RIA also would send account statements, the 2009 Proposing Release notes that RIAs "are not required by the Advisers Act or rules to send their own account statements to clients."

**Disclosure and Reporting Requirements**

As noted above, the proposed amendments would include a broader surprise audit requirement. As with the current Custody Rule, each surprise audit must be reported to the SEC on Form ADV-E. However, unlike the current regime, Form ADV-E would be available to the public on the IAPD.

Further, the proposed amendments would impose additional reporting and disclosure requirements for RIAs that have custody of client assets. First, and perhaps most importantly, if an RIA dismisses its independent accounting firm (or the firm resigns from the engagement), the firm would be required to file with the SEC a Form ADV-E within four business days of such termination or resignation, including a statement setting forth: (i) the date of the termination or resignation; (ii) the name and contact information for the independent accounting firm and (iii) explanation of any problem relating to the examination scope or procedures that may have contributed to the termination or resignation. Such a termination statement might likely trigger an examination of the RIA by the SEC staff, which could discourage RIAs from terminating their independent accounting firm.[40]

The proposed amendments would also include several important amendments to Form ADV, Part 1 that would require RIAs to disclose additional information about their custodial arrangements.[41] In particular, RIAs would be required to, as applicable: (i) identify all related broker-dealers (currently RIAs may, but are not required to, identify related broker-dealers) and indicate which, if any, provide custodial services to the RIA's clients; (ii) report the amount of client assets and number of clients for which the RIA (or an affiliated custodian) has custody (currently, RIAs must disclose whether they, or an affiliate, has custody but need not provide further information as to the amount of assets or number of clients);[42] (iii) indicate how the RIA complies with various Custody Rule requirements with respect to pooled vehicles and other client accounts;[43] (iv) disclose the names of all related persons who act as qualified custodians; (v) disclose the names, locations and regulatory status (*e.g.*, bank, FCM, foreign financial institution) of all other related persons who serve as qualified custodians for the RIA's clients; (vi) disclose the name and location of each firm engaged to provide (a) an annual audit for a pooled vehicle relying on the audit method, (b) a surprise audit or (c) a control report, and indicate, for each such firm, whether it is registered with the PCAOB and subject to regular inspection by the PCAOB and, for each independent public accountant providing an annual audit to a pooled vehicle or a control report, disclosure as to whether the relevant audit or report contains an unqualified opinion; and (vii) provide the date of the most recent surprise audit. Most of this information (other than the amount of assets and accounts custodied and most recent audit date, which are annual update items) would need to be updated promptly in the event of **any** change.[44]

These changes will impact all RIAs who have custody. RIAs will need to put in place procedures to assure that necessary disclosures are made timely and accurately.

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40 The 2009 Proposing Release notes that the information provided through a termination statement "would permit our staff to compare information provided by the adviser with the perspective of the accountant, and to further evaluate the need for an examination of the adviser to determine whether client assets are at risk."

41 Form ADV, Part 1 is available to the public through the IAPD website, though it is not required to be provided to clients. The SEC did not propose any changes to Form ADV, Part II, which RIAs are required to provide to prospective clients (and offer to current clients on request). Prior proposed amendments to Part II in 2008 would have included disclosure as to whether the RIA had custody, the manner in which it complied with the Custody Rule and, with respect to RIAs relying on account statement delivery by qualified custodians, that clients should review custodial statements carefully. *See Proposed Rule: Amendments to Form ADV*, Rel. No. IA-2711 (Mar. 3, 2008). The 2008 proposal (as well as an earlier proposal in 2000) has not been adopted.

42 As is currently the case, an RIA that has custody solely as a result of automatic fee deductions is not required to claim custody on Form ADV.

43 These disclosures would include, with respect to pooled vehicles, whether the RIA uses the audit method or arranges for the qualified custodian to provide quarterly statements to pool investors and, with respect to other client accounts, whether the RIA undergoes a surprise audit and/or arranges for a control report to be performed by an independent public accountant.

44 The SEC uses the information in the Form ADV to, among other things, assess an RIA's risk for purposes of determining examination frequency and scope. The SEC noted that "this information would allow our staff to better monitor compliance with [the Custody Rule], and, together with other data reported on Form ADV, would allow our staff to better assess the compliance risks of an adviser."

Comments Requested: The SEC posed a number of issues for consideration with respect to the changes to Form ADV and Form ADV-E, including:

- Whether termination or resignation is the correct standard for notification of potential problems or disagreements between an RIA and its independent accounting firm.
- Whether additional information should be included in connection with a Form ADV-E and termination/resignation report.
- Whether the termination report should be publicly available.
- Whether the information necessary to complete additional Form ADV disclosure items is readily available.
- Whether such information is proprietary or would have adverse consequences for an RIA or clients.
- Whether additional disclosures should be required.

**Liquidation Audit for Private Funds using the Annual Audit Method**

Finally, the proposed amendments to the Custody Rule would clarify that RIAs relying on the annual audit method for a private fund that liquidates and makes final distributions other than at year end must assure that a proper audit report is prepared upon liquidation and promptly provided to each investor upon completion of the related audit.[45] The SEC explained that this clarification "is designed to assure that the proceeds of liquidation are appropriately accounted for so that investors can take timely steps to protect their rights" and requested comment as to whether alternatives to a liquidation audit should be considered.

[45] *See* Proposed Rule 206(4)-2(b)(3)(ii). Currently, the Custody Rule is silent with respect to private funds that liquidate other than at a fiscal year end.

## Conclusion

While the proposed amendments to the Custody Rule may provide beneficial protections from the types of frauds that have recently been uncovered, if the proposed amendments are adopted in their current form, the costs and burdens associated with an RIA having custody of client assets will greatly increase. As a result, many RIAs will be forced to reconsider their fee billing and custody arrangements. RIAs desiring the certainty of payment associated with having the fee debited from the custodial account could adopt an alternate method (*e.g.*, having the custodian deduct fees in accordance with the FAQ) to avoid being deemed to have custody. RIAs that self-custody client assets or use an affiliated custodian, may wish to consider whether it would be feasible to use an independent custodian, which may not be the case for certain types of advisory arrangements.

We are available to discuss the proposed amendments with clients and other interested persons who may wish to respond to the SEC's requests for comment.

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