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A legal update from Dechert's Financial Services Group

U.S. Regulator Adopts Amendments to Advisers Custody Rule

The U.S. Securities and Exchange Commission ("SEC") released on 30 December 2009 amendments to Rule 206(4)-2 (commonly referred to as the "Custody Rule") under the U.S. Investment Advisers Act of 1940, as amended (the "Advisers Act"), and related forms.[1] The Custody Rule imposes certain safekeeping and disclosure requirements on U.S. registered investment advisers ("RIAs") who are deemed to have custody of client assets. In light of recent high-profile asset management frauds (e.g., the Madoff Ponzi scheme), the recent amendments to the Custody Rule (the "Final Rule") are designed to strengthen the controls and safeguards over the custody and use of client assets by RIAs and their affiliates.

While the Final Rule adopted by the SEC is less burdensome than the originally proposed amendments,[2] the Final Rule imposes significant additional requirements on RIAs that are deemed to have custody of client assets. Among other things, the Final Rule requires RIAs that do not use an independent qualified custodian (i.e., RIAs that are dual-registered as broker-dealers and self-custody assets, or use an affiliate as a custodian) to undergo annual surprise examinations by independent accountants, and to obtain annual reports from such accountants assessing internal controls relating to the custody of client assets.

Although certain aspects of the Final Rule may prove challenging to implement for non-U.S. RIAs (as highlighted below), the SEC confirmed in the adopting release that the "regulation lite" regime remains available to non-U.S. RIAs with respect non-U.S. pooled investment vehicles and other non-U.S. clients.[3] Accordingly, those RIAs are not required to comply with certain substantive rules under the Advisers Act, including the Custody Rule, with respect to those non-U.S. clients.[4] However, non-U.S. RIAs are subject the full requirements of the Advisers Act and regulations, including the Final Rule, with respect to any U.S. clients.

Background

Under the Custody Rule, an RIA is deemed to have custody in circumstances where it holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them. Because RIAs that have custody must ensure that client assets are held by a "qualified custodian" (such as a bank or broker-dealer), few RIAs (other than RIAs that are dual-registered as broker-dealers) self-custody, or otherwise have actual, physical custody of client assets. However, the SEC deems many RIAs to have custody of client assets because the RIA retains access to client accounts through direct billing arrangements, powers of attorney, or by virtue of an RIA (or an affiliate) serving as a general partner or managing member of a private fund. Under the Final Rule, RIAs also may be deemed

1 *See Final Rule: Custody of Funds or Securities of Clients by Investment Advisers*, Rel. No. IA-2968 (30 Dec. 2009) (the "Final Rule Release"), available at http://www.sec.gov/rules/final/2009/ia-2968.pdf.

2 *See* DechertOnPoint: SEC Proposes Significant Additional Burdens on Registered Advisers Who Have Custody of Client Assets (July 2009/Issue 14), available at http://www.dechert.com/library/FS_14_07-09_SEC_Proposes_Significant_Additional%20Burdens.pdf.

3 *See* Final Rule Release at note 123 and accompanying text.

4 *See Uniao de Banco de Brasileiros S.A.*, (pub. avail. 28 July 1992) and related letters. Under these letters, a registered non-U.S. adviser that advises non-U.S. clients is generally not subject to the full regulatory regime of the Advisers Act.

to have custody when an affiliate or "related person"[5] acts as the qualified custodian of client assets.

Amendments to the Custody Rule

Surprise Examinations

Subject to certain exceptions, the Final Rule requires RIAs with custody of client assets to undergo annual surprise examinations by an independent public accountant. In cases where the RIA or its affiliate serve as custodian, these surprise examinations must be performed by an independent public accountant registered with, and regularly examined by, the Public Company Accounting Oversight Board ("PCAOB" and such an independent public accountant, a "PCAOB Firm"). Notably for non-U.S. RIAs, the Final Rule does not provide an exception from the requirement that the annual surprise examination be conducted by a PCAOB Firm.[6]

Accountants conducting the surprise examination are required to verify the existence of client assets (including privately offered securities[7]), and to check the consistency between the books and records of the RIA and the custodian.[8] If the accountant discovers any missing assets or material discrepancies,[9] the accountant must notify the SEC within one business day. The accountant must also file with the SEC a certificate describing the nature and extent of the examination within 120 days of the time chosen by the accountant for the surprise examination, and must also make additional filings in the event of the accountant's resignation or termination of the audit engagement. Importantly, the SEC determined not to require that the surprise examination include testing of valuation, citing comments submitted by Dechert LLP to the proposed amendments.[10]

Exceptions

The Final Rule contains some significant exceptions to the surprise examination requirement, which are summarized below.

First, the surprise examination requirement does not apply to RIAs to pooled investment vehicles (e.g., hedge funds and private equity funds) that obtain annual audits of these funds and distribute, or cause to be distributed, the audited financial statements to the pools' investors.[11] These annual audits must be conducted by PCAOB Firms, and audited financial statements must be prepared in accordance with generally accepted accounting principles.[12]

In order to prevent RIAs from using layers of funds to avoid meaningful application of the Custody Rule's protections, the Final Rule provides that

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5 Under the Final Rule, a "related person" is defined as a person directly or indirectly controlled by or under common control with the RIA.

6 The SEC recognized that there may be a limited number of PCAOB Firms in certain foreign jurisdictions. However, based on discussions with accounting firms, the SEC notes that advisers generally should not have significant difficulty in finding a local auditor that is eligible under the rule. Many PCAOB Firms currently have practices in those jurisdictions in which most non-U.S. RIAs and funds are domiciled. (*See* Final Rule Release at page 38).

7 Under the current Custody Rule, certain assets need not be held with a qualified custodian, such as certain privately offered securities. However, the Final Rule expands the surprise examination requirement to include these securities.

8 The SEC has published a separate companion release that provides interpretive guidance to assist accountants in the verification of client assets and in the performance of other requirements under the Final Rule. *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*, Rel. No. IA-2969 (30 Dec. 2009).

9 A material discrepancy is material non-compliance with the provisions of either Rule 206(4)-2 or Rule 204-2(b) under the Advisers Act.

10 Comments of Dechert LLP (28 July 2009) *available at* http://www.sec.gov/comments/s7-09-09/s70909-807.pdf. In our comment letter, Dechert LLP noted that, although valuation is a very important issue closely related to client assets, it covers an area that goes beyond custody.

11 However, the SEC notes that an adviser that relies on this annual audit exception must nonetheless undergo an annual surprise examination of non-pooled investor assets (e.g., separate account clients) of which it has custody.

12 It is important to note that the adopting release did not withdraw prior SEC guidance allowing deviations from U.S. generally accepted accounting principles ("U.S. GAAP") in annual audits of a private fund that is organized outside of the U.S. or whose general partner has its principal place of business outside of the U.S. if, among other things, the related financial statements contain information substantially similar to financial statements prepared in accordance with U.S. GAAP and any material differences are reconciled. *See, Final Rule: Custody of Funds or Securities of Clients by Investment Advisers*, Rel. No. IA-2176 (25 Sept. 2003), at note 41; *see also* Staff Responses to Questions about Amended Custody Rule, (10 Jan. 2005), at VI.5., *available at* http://www.sec.gov/divisions/investment/custody_faq.htm.

distributing audited financial statements to investors will *not* meet the requirements of the Final Rule if all investors in the pooled investment vehicle to which statements are sent are themselves funds that are advised by the RIA or an affiliate. Under the Final Rule, RIAs that use a "special purpose vehicle" ("SPV") to facilitate investment by one or more funds (e.g., master-feeder fund structures or trading subsidiaries) must: (i) treat the SPV as a separate client and distribute, or cause to be distributed, the audited financial statements of the SPV to the beneficial owners of the investing funds; or (ii) treat the SPV's assets as assets of the investing funds, and ensure that such assets are examined within the scope of the investing funds' financial statement audit.

A second notable exception to the surprise examination requirement is available in situations where an RIA is deemed to have custody of client assets solely as a result of its affiliate acting as custodian. In such cases, a surprise examination is not required if the RIA can demonstrate that it is "operationally independent" of the affiliated custodian. An RIA may be deemed operationally independent from its affiliates where the RIA and an affiliate operate as distinct entities with no overlap of personnel, office space or common supervision. An RIA must create and maintain a memorandum explaining the relationship with its affiliate, and the basis for a determination of independence.

A third exception is available for RIAs who use independent custodians, but are deemed to have custody as a result of their ability to deduct advisory fees from client accounts.[13] While such RIAs are not subject to surprise examinations, the Final Rule Release identifies controls and procedures related to fee deductions that RIAs should consider in order to ensure that client investor assets are properly protected. Such controls might include, among other things, periodic sampling of the accuracy of fee calculations and segregating duties of employees responsible for billing clients and those personnel responsible for reviewing the invoices and listings for accuracy.

Internal Control Reports

In addition to surprise examinations, all RIAs with custody of client assets are required to obtain (or receive from each affiliate that has custody of client assets) an annual internal control report that demonstrates that the RIA (or its affiliate) has established appropriate custodial controls. An independent public account must perform the review and prepare the report, which must contain an opinion from the accountant as to whether the internal controls are implemented, suitably designed, and are operating effectively to meet control objectives related to custodial services. As part of its review, the accountant must verify that client funds and securities are reconciled to an unaffiliated depository. In cases where the RIA or its affiliate serve as custodian, these reports must be prepared by a PCAOB Firm.

An RIA to a pooled investment vehicle that self-custodies the pool's assets must obtain an internal control report even though the RIA avoids the surprise examination requirement by obtaining an audit of the pool's financial statements and circulates the same to investors. In addition, an RIA is required to receive internal control reports from each affiliated custodian that has custody of client assets notwithstanding that a surprise examination may not be required (i.e., in situations in which the affiliated custodian is operationally independent from the RIA). RIAs must maintain these internal control reports in accordance with the recordkeeping requirements of the Advisers Act, and make such reports available to the SEC and its staff upon request.

Account Statement Delivery Requirements

The Custody Rule requires an RIA to ensure that clients receive account statements no less frequently than quarterly. An RIA has had the option of complying with this requirement by permitting a qualified custodian to send account statements directly to clients or by sending account statements itself if it submitted to an annual surprise audit. However, except with respect to pooled investment vehicles using the audit method, the Final Rule eliminates the latter option, and qualified custodians will be required to send account statements directly to advisory clients. Under the Final Rule, RIA must have a reasonable belief after "due inquiry" that the qualified custodian delivered the account statements. In the adopting release, the SEC did not attempt to definitively articulate the acceptable methods for forming this belief, but did indicate that receiving duplicate copies of client account statements provided a sufficient basis.

While RIAs continue to have the option to send their own statements to clients in addition to statements sent by a qualified custodian, the Final Rule requires that these statements contain a cautionary legend encouraging clients to compare the statements sent by the RIA with those sent by the qualified custodian.

[13] This exception does not apply to RIAs that act as trustees on behalf of clients in most circumstances.

With respect to pooled investment vehicles, to the extent an RIA obtains annual audits and distributes, or causes to be distributed, the audited financial statements to the underlying investors, the RIA will not be required to comply with these account statement delivery and legend provisions.[14]

If an RIA to pooled investment vehicles does not distribute, or cause to be distributed, audited financial statements to the pools' investors, the RIA must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends the account statements of the pooled investment vehicle to the investors in the fund. We note that some RIAs have historically resisted the direct delivery of account statements by custodians to fund investors due to privacy concerns.[15] Under the Final Rule, these RIAs presumably would be required to disclose to the custodian their lists of investors in order to facilitate direct delivery of the account statements.

Effective and Compliance Dates

The Final Rule becomes effective on 12 March 2010 (the "Effective Date"). The following provides the compliance dates for certain provisions discussed above:

- RIAs subject to the annual surprise examination must enter into a contract with an independent public accountant providing that the first examination will take place before 31 December 2010 (or, for RIAs that become subject to the new rules after the Effective Date, within six months of becoming subject to this requirement). If the RIA self-custodies client assets, the first surprise examination must occur no later than six months after the RIA obtains its first internal control report. [16]
- RIAs subject to the requirement to obtain (or receive from an affiliated qualified custodian) an internal control report must obtain such report within six months of becoming subject to the requirement.
- With respect to the client notifications and account statement delivery requirements, RIAs must comply with these requirements immediately upon the Effective Date and, if applicable, have a reasonable belief that a qualified custodian sends account statements to clients in accordance with the Final Rule.
- An RIA to a pooled investment vehicle may rely on the annual audit provision if the RIA (or affiliate) becomes contractually obligated to obtain an audit of the financial statements of the pooled investment vehicle for fiscal years beginning on or after 1 January 2010 by a PCAOB Firm.

In order to meet these compliance deadlines, RIAs should begin implementing the following changes:

- By the Effective Date, RIAs should include cautionary legends on account statements sent to clients if the RIA plans to send its own account statements in addition to those to be provided by the custodian. In addition, RIAs should ensure that, by this date, custodians have the information they need to directly deliver account statements to clients in a manner that is verifiable by the RIA. RIAs may wish to revisit their custodial contracts to ensure that proper restrictions are placed on the custodian's use of confidential information.
- As soon as reasonably practicable, RIAs that will be subject to the surprise examination requirement should begin the process of entering into written agreements with independent public accountants.
- Form ADV custody disclosure should be amended as part of the first annual update after 1 January, 2011.
- RIAs should amend their recordkeeping policies to comply with the new

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14 As a consequence of this exemption, the SEC notes that investors to pooled investment vehicles will not have the benefit of regularly receiving reports that the assets underlying their investments are properly held. The SEC has directed its staff to explore ways in which this potential shortcoming can be remedied while respecting the confidential nature of proprietary information. *See* Final Rule Release at page 18.

15 As noted in the proposing release, some RIAs 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 well-known clients.

16 An RIA with multiple affiliates that serve as qualified custodians must undergo a surprise examination within six months of receiving the last internal control report it is required to receive. *See* Final Rule Release, at note 160.

requirements. In addition, although not legally required, RIAs should consider the SEC's compliance recommendations found in the adopting release. Where implementing these recommendations would be practicable and reasonably low-cost, RIAs may wish to revise their compliance policies and procedures accordingly.

Conclusion

As noted by Mary L. Schapiro, Chairperson of the SEC, the Final Rule is designed to encourage the use of fully independent custodians, as certain of the new measures (i.e., surprise examinations and internal control reports) may not be required if an independent custodian is used. The costs and burdens associated with compliance with the Custody Rule, as amended, may increase significantly for RIAs that self-custody assets or use affiliated custodians. Accordingly, these RIAs may wish to consider amending their advisory contracts and custody arrangements, if possible, to avoid being deemed to have custody of client assets.

Even where the requirements of the Final Rule are not literally applicable, advisers (registered or unregistered) may wish to consider implementing some or all of the Final Rule's requirements (and SEC guidance with respect to compliance policies and procedures found in the adopting release) as a matter of "best practice" and in anticipation of the potential impact of the Final Rule on industry practices and investor expectations.

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