

# SEC Amends Custody Rule

**January 7, 2010**

## **Background**

On December 16, 2009, the Securities and Exchange Commission (the “SEC”) adopted previously proposed amendments to Rule 206(4)-2 (the “Custody Rule”) under the Investment Advisers Act of 1940 in an effort “to substantially increase the protections for investors who turn their money and securities over to an investment adviser registered with the SEC.” The SEC published the final rule release on December 30, 2009, and the effective date of the amended rule is February 28, 2010. Although the Custody Rule only applies to registered investment advisers, proposed legislation is currently pending that could require many advisers to private funds to be registered.

## **Surprise Annual Examination**

The Custody Rule generally requires that any funds or securities of a client of a registered investment adviser be held by a “qualified custodian” (generally a bank or broker-dealer). Under the amended Custody Rule, a registered investment adviser who is deemed to have custody of client funds or securities will generally (subject to certain exceptions discussed below) be required to subject such funds and securities to a surprise annual examination by an independent public accountant registered with and subject to regular inspection by the Public Company Accounting Oversight Board (the “PCAOB”). The adviser’s agreement with the accountant must require that the first examination occur within six months of the effective date of the amendments and that the accountant notify the SEC within one business day of finding a material discrepancy during the course of the examination. The agreement also must require that if the accountant resigns or is dismissed, it will file a statement with the SEC regarding the termination within four business days along with Form ADV-E. The “statement” must include the date of resignation or termination of the accountant and an explanation of any problems relating to the scope or procedures of the examination that contributed to the resignation or termination. Certain “privately offered securities”[\[1\]](#) are no longer exempt from the surprise examination requirements of the Custody Rule and must now be included in an accountant’s surprise examination.

### **Annual Audit Alternative**

Registered investment advisers to private funds may avoid the surprise annual examination requirement by having an independent public accountant conduct an annual audit of each private fund that it advises and delivering audited financial statements to the private fund's investors within 120 days of the private fund's fiscal year-end (or 180 days for funds-of-funds) (the "Annual Audit Alternative"). The accountant conducting the annual audit of each private fund must be registered with and subject to inspection by the PCAOB.

### **Final Audit Upon Liquidation**

The amended Custody Rule requires that a registered investment adviser to a private fund that relies upon the Annual Audit Alternative obtain a final audit of the fund upon its liquidation and distribute the audited financial statements to the fund's investors promptly after completion of the audit.

### **Internal Control Report**

The SEC also imposed new regulatory requirements if the assets of clients of a registered investment adviser are held by the adviser or an affiliate (such as an affiliated broker-dealer) that serves as a "qualified custodian." In such instances, the registered investment adviser must obtain (or receive from its related qualified custodian) annually an "internal control report" concerning the registered investment adviser or its related qualified custodian's custody controls and procedures, which must include an independent public accountant's opinion as to whether such controls are appropriate and effective to safeguard advisory client funds and securities. The report must be issued by an accountant registered with and subject to inspection by the PCAOB and the first report must be received within six months of the effective date of the amendments.

### **Form ADV Amendments**

The SEC amended Form ADV Part I to require registered investment advisers to make certain additional disclosures that reflect changes to the Custody Rule. These new disclosures include (i) the U.S. dollar amount of client assets under custody of the adviser or a related person, (ii) the number of client accounts over which the adviser has custody, (iii) whether or not private funds managed by the adviser are audited on an annual basis, (iv) whether or not the qualified custodian of a private fund issues account statements to the fund's investors on a quarterly basis, (v) whether or not an accountant conducts an annual surprise examination of client assets, and (vi) whether or not an accountant prepares an "internal control report" with respect to the adviser or any related person concerning custody of client assets. Registered investment advisers must provide responses to the revised Form ADV Part I in their first annual updating amendment after January 1, 2011.

A copy of the release can be found at <http://www.sec.gov/rules/final/2009/ia-2968.pdf>

[1] "Privately Offered Securities" are securities that are (i) acquired from the issuer in a transaction or chain of transactions not involving any public offering, (ii) uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client, and (iii) transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer. See amended rule 206(4)-2(b)(2).

#### Related Professionals

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