PROPOSED AMENDMENTS TO THE SEC'S INVESTMENT ADVISER CUSTODY RULE

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To Our Clients and Friends:

Recent revelations concerning a number of Ponzi schemes involving investment advisers (the most notorious, of course, being Bernard Madoff) spurred the Securities and Exchange Commission (the "SEC") to announce a number of initiatives to fill perceived gaps in the regulation of investment advisers. The SEC focused in particular on Rule 206(4)-2 under the Investment Advisers Act of 1940 (the "Custody Rule"), which addresses custody of client assets by registered investment advisers.

The SEC identified three issues: infrequency of third-party examinations to ensure that the client assets are actually held by the custodian; potential for fraud when the custodian is a related person of the investment adviser; and oversight of the accountants who may be called upon to conduct certain examinations required by the Custody Rule.

On May 20, 2009, the SEC proposed amendments to the Custody Rule that would address these issues. Among other things, the proposed amendments would subject *all* registered investment advisers that are deemed to have custody of client assets to a "surprise" examination of the custodied assets by an independent public accountant. *This proposal will directly impact private fund sponsors who are registered investment advisers.*

The amendments would also require a registered investment adviser that has custody, or that is affiliated with the custodian, to obtain an "SAS 70" report with respect to the custodian's internal controls from an accountant registered with, and subject to regular inspections by, the Public Company Accounting Oversight Board (a "PCAOB-Registered Accountant").

The Custody Rule applies only to *registered investment advisers*. If Congress moves forward to eliminate the exemption from Investment Advisers Act registration that many private fund sponsors currently rely on, the impact of the amendments could be much broader.

THE CUSTODY RULE: BACKGROUND

Generally, the Custody Rule requires that a registered investment adviser having custody of client funds or securities maintain them with a "qualified custodian" such as a bank, registered broker-dealer, registered futures commission merchant or foreign financial institution that customarily holds financial assets for its customers (the "Qualified Custodian Requirement"). The adviser or one of its affiliates may serve as a qualified custodian if it falls into one of these categories.

The term "custody" is itself subject to interpretation and its definition for purposes of the rule is quite broad. An adviser has custody if "it holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them." For example, a general partner that is a registered adviser would have custody of assets held by a private fund if it has "legal ownership of or access to client funds or securities."

In addition to the Qualified Custodian Requirement, the Custody Rule requires that quarterly account statements be provided to the client. There are two means to satisfy this requirement (the "Account Statement Requirement"):

- The adviser must have a reasonable basis for believing that the qualified custodian sends an account statement, at least quarterly, to each client for which the custodian maintains funds or securities.
- The adviser must send the account statements itself.

If a private fund is subject to the Account Statement Requirement, the account statement must be sent directly to the investors in the fund.

If the adviser sends the account statements itself, the adviser must be subject to an annual surprise examination by an independent public accountant (the "Surprise Examination Requirement").

The Custody Rule currently excuses many registered private fund sponsors from the Account Statement and Surprise Examination Requirements if the private fund (i) is audited at least annually and (ii) distributes audited financial statements, prepared in accordance with generally accepted accounting principles, to its limited partners within 120 days (or 180 days, in the case of a fund of funds) of the end of its fiscal year (the "Annual Audit Exception").

The amendments would subject every registered private fund sponsor to the Surprise Examination Requirement, even if it takes advantage of the Annual Audit Exception.

THE SURPRISE EXAMINATION REQUIREMENT

The proposed amendments would subject *all* registered investment advisers that have custody of client assets to the Surprise Examination Requirement. The Surprise Examination Requirement requires an independent public accountant (which may be the auditor of the advisor or a fund that it manages) to verify all client funds and securities by actual examination of all of the funds and securities that are in the adviser's custody at least once during each calendar year at a time that is chosen by the accountant without prior notice or announcement to the adviser and that is irregular from year to year. The accountant must report the results of its examination to the SEC on Form ADV-E. In

addition, if the accountant finds any "material discrepancies" during the course of the examination, it must notify the SEC within one business day of the finding.

The SEC proposed that when an adviser or a related person serves as the qualified custodian for the adviser's clients' funds or securities, the surprise examination must be performed by a PCAOB-Registered Accountant and that the retention be memorialized by a written agreement. The SEC believes that PCAOB registration and inspection will provide greater confidence in the quality of the examination, which the SEC views as particularly important when an adviser or its related person, rather than an independent custodian, maintains client funds or securities.

The proposed amendments will, for the first time, subject "privately offered securities" to the Surprise Examination Requirement. Privately offered securities, which are currently exempted from all provisions of the Custody Rule, are securities that are (i) acquired from the issuer in a transaction or chain of transactions not involving any public offering, (ii) uncertificated and (iii) transferable only with the prior consent of the issuer or of the holders of the outstanding securities of the issuer. The proposing release does not specify the means by which the accountant will verify the existence of such securities.

THE ANNUAL AUDIT EXCEPTION

A registered private fund sponsor would continue to be excused from the Account Statement Requirement if it complies with the Annual Audit Exception, which would be largely unchanged. The SEC is proposing to clarify that the Annual Audit Exception is available to a private fund that liquidates and makes final distributions other than at year end. In addition, although not formally proposed, the SEC solicited comments as to whether the Annual Audit Exception should be conditioned on the accountant conducting the audit being a PCAOB-Registered Accountant.

THE ACCOUNT STATEMENT REQUIREMENT

As noted above, an adviser with custody may comply with the Account Statement Requirement by either sending quarterly account statements to clients itself (subject to the Surprise Examination Requirement) or having a reasonable belief that the qualified custodian has done so. The proposed amendments would eliminate the first option.

All registered advisers with custody of client assets would be required to have a "reasonable belief" that the qualified custodian delivers account statements directly to the clients (or their representatives) at least quarterly. The proposed amendments would also provide that the "reasonable belief" be formed only after "due inquiry." The proposing release suggests that a reasonable belief may be formed by obtaining a copy of the account statement that was

delivered to the client or obtaining a written confirmation from the custodian that it has sent account statements to the adviser's clients.

Custodian account statements protect the client only if the client reviews them. Thus, the SEC proposed that advisers provide clients with disclosure "urging" them to compare custodial account statements with those they receive from the adviser.

CUSTODY BY THE ADVISER OR ITS RELATED PERSONS

As under the current rule, the proposed amendments would not prohibit an adviser or a related person of the adviser (that is, a person with a control relationship with the adviser) that is a qualified custodian from holding client assets. This was a somewhat difficult issue for the SEC, since Ponzi schemes are generally successful only if client assets are held by the adviser or an affiliated custodian.

The SEC had considered this issue when it last amended the Custody Rule in 2003 and concluded that, given the level of regulation that is applicable to qualified custodians, such as brokers and banks, such a prohibition was unnecessary. The proposing release requests extensive comment on the related custodian issues and on whether custody of client asserts by related person of a registered investment adviser should simply be prohibited. In requesting comment on the issue, the SEC noted many of the practical problems associated with such a prohibition.

The proposed amendments would deem advisers whose related persons hold client assets to have custody of the client assets if those assets are held by the related person in connection with the advisory services provided by the adviser. The "in connection with" limitation is designed to prevent an adviser from being deemed to have custody of client assets held by a related person broker-dealer (or other qualified custodian) with respect to which the adviser does not provide advice. For example, an adviser would not have custody of assets that the client holds with an affiliated broker if those assets are not managed by the adviser.

In addition, the proposed amendments would establish certain additional requirements for custody involving related persons:

- As noted above, the accountant who performs the surprise examination would be required to be a PCAOB-Registered Accountant.
- The adviser would be required to obtain, or receive from the related custodian, at least annually a written report ("internal control report") that includes an opinion from a PCAOB-Registered Accountant with respect to the internal controls relating to custody of client assets. These reports are commonly referred to as Type II SAS 70 Reports.

OTHER AMENDMENTS

The proposed amendments would change the filing date of the Form ADV-E to 120 days after the time chosen by the accountant for the surprise examination. The accountant would also be required to submit a Form ADV-E within four business days of its resignation or dismissal from the engagement and in certain other events.

The SEC also proposed amendments to Form ADV, the investment adviser registration form, that are designed to provide more complete information about an adviser's custody practices and to provide the SEC with additional data to improve its ability to identify compliance risks. The proposed amendments include provisions specifically applicable to private fund sponsors. Among other things, the amendments would require a registered private fund sponsor to report:

- Whether a qualified custodian sends quarterly account statements to investors in the private funds.
- Whether the financial statements of the private funds are audited.

The proposed amendments would also require the adviser's Form ADV to contain information concerning the Surprise Examination Requirement.

THE FUTURE OF THE CUSTODY RULE

The proposing release requests comment on a wide range of issues and the final Custody Rule may not fully reflect the changes described in this memorandum or may reflect additional changes. The comment period expires on July 28, 2009. It is likely that the adoption of the proposed amendments will be a high priority for the SEC and that it will take action on the proposed amendments in the near future.

Please call us if you have any questions.

Washington, DC

Kenneth J. Berman
+1 202 383 8050
kjberman@debevoise.com

Gregory T. Larkin
+1 202 383 8064
gtlarkin@debevoise.com

New York

David J. Schwartz
+1 212 909 6631
djschwartz@debevoise.com

Frankfurt

Marcia L. MacHarg
+49 69 2097 5120
mlmacharg@debevoise.com