HOW THE SEC'S NEW CUSTODY REQUIREMENTS CHANGE THE GROUND RULES FOR REGISTERED INVESTMENT ADVISERS

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To Our Clients and Friends:

As 2009 closed, the Securities and Exchange Commission (the "SEC") published its amendments to the custody rule, Rule 206(4)-2, under the Investment Advisers Act of 1940 (the "Custody Rule").[1] The Custody Rule applies to *all registered investment advisers.* The amendments were initially proposed in May 2009 in response to the revelations concerning Bernard Madoff and various other Ponzi schemes. As discussed below, the amendments impose significant new requirements on registered investment advisers, including registered advisers to certain private funds. Unregistered fund sponsors will also want to take note of these amendments in view of pending legislation that would require many private fund sponsors to be registered as advisers with the SEC.

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 adviser or one of its "related persons" 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, the general partner of a private fund is deemed to have custody of the fund's assets if it has "legal ownership of or access to client funds or securities." An adviser is also deemed to have custody if it has the authority to make withdrawals from client accounts to pay advisory fees.

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[1] *Custody of Funds or Securities of Clients by Investment Advisers, SEC Rel. No. IA-2968 (Dec. 30, 2009) (available at http://www.sec.gov/rules/final/2009/ia-2968.pdf) (the "Adopting Release"). The SEC also published interpretative guidance for independent accountants relating to certain matters under the Custody Rule. See Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940, SEC Rel. No. FR-81 (Dec. 30, 1009) (available at http://www.sec.gov/rules/interp/2009/ia-2969.pdf) (the "Accounting Guidance Release").*

In addition, under the amended Custody Rule, an adviser is deemed to have custody of client assets held by a related person "in connection with" advisory services provided by the adviser to the client.[2]

The Custody Rule also contains a quarterly client account statement requirement (the "Account Statement Requirement") and in some cases, requires an annual "surprise" examination by an independent accountant to verify the existence of client funds and securities (the "Surprise Examination Requirement").

The amendments revise these requirements in certain significant respects. The amendments also impose new requirements on advisers that maintain custody with a "related person."

THE SURPRISE EXAMINATION REQUIREMENT

General

The amended Custody Rule will subject all registered investment advisers that have custody of client assets to the Surprise Examination Requirement at least once during a calendar year. Importantly, the amended rule does contain a special accommodation for advisers to pooled investment vehicles, including private funds, if the fund provides its investors with annual audited financial statements, as discussed below.

The Surprise Examination Requirement requires an independent public accountant, which may be the auditor of the adviser or a fund that it manages, to verify all client funds and securities by actual examination of all of the funds and securities.

The Annual Audit Exception for Funds

In the case of a registered adviser to a pooled investment vehicle, including a private fund, the Surprise Examination Requirement may be satisfied by obtaining an audit and delivering the audited financial statements, prepared in accordance with generally accepted accounting principles, to fund investors within 120 days of the fund's fiscal year-end (the "Annual Audit Exception").[3] The audit must be conducted by an accounting firm registered with, and

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[2] *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.*

[3] *In 2006, the SEC staff issued a no-action letter allowing managers of funds of funds relying on the Annual Audit Exception to distribute the fund's financial statements to investors within 180 days after the end of the fund's fiscal year. The Adopting Release states that the views of the SEC staff expressed in that letter have not changed.*

subject to regular inspection by, the Public Company Accounting Oversight Board (a "PCAOB-Registered Accountant").

If the fund does not distribute audited financial statements to its investors, the fund adviser must comply with the Surprise Examination Requirement. In addition, if the fund adviser also has non-fund clients, the Surprise Examination Requirement will be applicable to those clients.

Special Purpose Vehicles

The amended Custody Rule also addresses the applicability of the Annual Audit Exception to special purpose vehicles ("SPVs"). Specifically, in the case of a private fund, this would include vehicles organized to facilitate investments in certain securities by one or more private funds ("main funds") that the adviser manages. The SEC was concerned that an investment adviser would take the view that the financial statements of an SPV need only be provided to the main fund or entities controlled by the investment adviser rather than to investors in the main fund, thus undercutting the rule's protections. The amended rule precludes this by providing the SPV's investment adviser with two options:

- the adviser may treat the SPV as a separate client, in which case the adviser will be deemed to have custody of the SPV's assets. Under this approach, the adviser could either subject the SPV to a surprise examination or distribute audited financial statements of the SPV to the beneficial owners of the main fund; or

- alternatively, the adviser may treat the SPV's assets as assets of the main fund. Under this approach, the assets of the SPV must be considered within the scope of the main fund's financial statement audit or the surprise examination.

Related Person Custody

As noted above, if a related person of the adviser has custody of client assets, the adviser is deemed to have custody, and the client's funds and securities will be subject to the Surprise Examination Requirement. In these circumstances, the surprise examination must be performed by a PCAOB-Registered Accountant.

There is a limited exception to the Surprise Examination Requirement if the related person serving as the Qualified Custodian is "operationally independent" of the adviser. The amended Custody Rule establishes a presumption that a related person is not operationally independent unless four conditions are met:

- client assets in the custody of the related person are not subject to claims of the adviser's creditors;

- advisory personnel do not have custody or possession of, or direct or indirect access to client assets of which the related person has custody, or the power to control the disposition of such client assets to third parties for the benefit of the adviser or its related persons, or otherwise have the opportunity to misappropriate such client assets;
- advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision; and
- advisory personnel do not hold any position with the related person or share premises with the related person.

In addition, the presumption may only be overcome if "no other circumstances can reasonably be expected to compromise the operational independence of the related person." Such circumstances may include a situation where the management of the adviser and related person are controlled by persons with close familial relationships.

In addition, the adviser will be required to receive from the related custodian, at least annually, a written report ("internal control report") prepared by a PCAOB-Registered Accountant with respect to the custodian's internal controls. These internal control reports are commonly referred to as Type II SAS 70 Reports. An adviser that is operationally independent from the custodian will still be required to receive an internal controls report.

Fee Deduction Authority

The amendments, as originally proposed, would have imposed the Surprise Examination Requirement on an adviser that was deemed to have custody as a result of its authority to deduct fees from client accounts. In response to comments, the SEC provided an exception from the Surprise Examination Requirement for an adviser that is deemed to have custody solely because it has such authority since the changes to the Account Statement Requirement (discussed below) would provide investors with the ability to monitor the amount of the fees deducted by the adviser. The SEC also suggested that advisers implement a number of procedures to ensure that fees are calculated and deducted properly. The Adopting Release specifically notes that SEC examiners will be instructed to focus on fee deduction issues during their examinations.

Privately Offered Securities

The amendments subject "privately offered securities" to the Surprise Examination Requirement for the first time. Privately offered securities, which were formerly 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. As noted above, however, an adviser to a private fund that holds

privately offered securities will not be subject to a surprise examination if the fund satisfies the Annual Audit Exception.

Accounting Guidance

The Accounting Guidance Release provides updated guidance to independent accountants concerning the Surprise Examination Requirement. It also sets forth the elements of the required internal control report.

Form ADV-E

The accountant must report the results of its examination to the SEC on Form ADV-E. The amendments change the filing date of the Form ADV-E to 120 days after the time chosen by the accountant for the surprise examination. 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 accountant is also 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 ACCOUNT STATEMENT REQUIREMENT

The Custody Rule continues to impose the Account Statement Requirement, but the statement now must be sent to the clients directly by the Qualified Custodian at least quarterly. (Previously, the adviser itself could also send the account statements; this option has been eliminated.) In the case of a private fund subject to this requirement, the account statements must be sent to fund investors.

An adviser to a private fund that meets the requirements of the Annual Audit Exception need not comply with the Account Statement Requirement except with respect to its non-fund clients.

The amendments provide that the adviser must have a "reasonable belief" that the custodian delivers the account statements, and that that belief may be formed only after "due inquiry." The Adopting Release provides one example of the manner in which the adviser may establish that is has a "reasonable belief" – if the Qualified Custodian provides the adviser with a copy of the account statement that was delivered to the client. The Adopting Release notes that the mere availability of account statements on the custodian's website would not satisfy this requirement.

Custodian account statements protect the client only if the client reviews them. Thus, the amendments require that an adviser, in providing a client with notice that it has opened a custodial account on its behalf, or has changed the client's custody arrangements, provide clients with disclosure "urging" them to compare custodial account statements with account

statements they receive from the adviser. This requirement will apply only if the adviser sends its own account statements to clients.

AMENDMENTS TO FORM ADV

The SEC also adopted 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 amendments include provisions specifically applicable to private fund sponsors. Among other things, the amendments require a registered private fund sponsor to report whether the private fund's financial statements are audited.

CHANGES TO COMPLIANCE POLICIES AND PROCEDURES

Depending on the circumstances, currently registered fund advisers (including fund sponsors) may need to adjust their custody arrangements to satisfy the amended Custody Rule, including ensuring that their accountant is a PCAOB-Registered Accountant. The Adopting Release also contains a reminder for advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act, including the Amended Custody Rules. The Adopting Release provides guidance regarding the types of policies and procedures relating to safekeeping of client assets that advisers should consider including in their compliance programs.

The SEC's fundamental point appears to be that the adviser's custody of client assets presents elevated compliance risks, and that advisers and their Chief Compliance Officers must therefore provide appropriate attention to these risks. It is likely that the SEC staff, in its examinations, will pay particularly close attention to an adviser's implementation of the Amended Custody Rule and custody issues generally.

EFFECTIVE DATE AND TRANSITION RULES

The amendments will become effective 60 days after publication in the Federal Register and, as a general matter, an adviser must be in compliance with the amended Custody Rule by the effective date. There are certain important exceptions to this general rule:

- An investment adviser required to obtain a surprise examination must enter into a written agreement with an independent public accountant that provides that the first examination will take place by December 31, 2010. Advisers that become subject to the rule after the effective date must enter into such an agreement within six months of becoming subject to the requirement. If the adviser is subject to the internal control

report requirement, the first surprise examination need not occur until six months after the adviser obtains the internal control report.

- An investment adviser required to receive an internal control report must receive the report within six months of becoming subject to the requirement.
- An investment adviser may rely on the Annual Audit Exception if the adviser becomes contractually obligated to obtain an audit of the financial statements of the private fund for fiscal years beginning on or after January 1, 2010.

An investment adviser currently registered with the SEC must modify its Form ADV to reflect the amendments to Form ADV in its first annual amendment filed after January 1, 2011.

Please call us if you have any questions.

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