

ClientAlert

Investment Funds

June 2009

Proposed Amendments to Advisers Act Custody Rule

On May 20, 2009, the Securities and Exchange Commission (the "SEC") issued a release proposing amendments to Rule 206(4)-2 (the "Proposed Rule") of the Investment Advisers Act of 1940 (the "Advisers Act") to improve the safekeeping of client assets. Of the estimated 11,000 investment advisers that are registered with the SEC, the Proposed Rule would apply to approximately 9,600 advisers that are deemed to have custody of client assets, either directly or through an affiliate, or because they have the authority to access client funds, for example, by deducting advisory fees. The Proposed Rule is part of a larger package of regulatory reforms designed to respond to the recent revelations of widespread fraud and misappropriation of assets in the investment industry, most closely associated with disgraced investment manager Bernard Madoff. It is expected that the number of investment advisers affected by the Proposed Rule would significantly increase beyond 9,600 if pending federal legislation requiring the registration of most unregistered investment advisers, specifically the Hedge Fund Transparency Act or the Hedge Fund Adviser Registration Act, becomes law.

The Proposed Rule would increase scrutiny of assets entrusted to investment advisers to detect potential misappropriations. Most significantly, the Proposed Rule would require:

- **all** registered investment advisers deemed to have custody of client assets to undergo an annual surprise examination by an independent public accountant
- any registered investment adviser who itself or through a related person acts as the qualified custodian of client assets (rather than engaging an independent qualified custodian) to hire an independent public accountant registered with and inspected by the Public Company Accounting Oversight Board ("PCAOB") to:
 - conduct the annual surprise examination
 - provide an annual internal control report, including an opinion regarding the qualified custodian's controls relating to the custody of client assets
- qualified custodians to deliver periodic account statements to clients of an investment adviser, and to the underlying investors of such clients in the case of clients that are organized as pooled investment vehicles, such as private equity funds and hedge funds (the "Fund Clients"), that do not distribute annual audited financial statements to their underlying investors

These provisions are described in further detail on the following pages.



Our global network of more than 500 lawyers in 24 countries handles cutting-edge disputes around the world and includes litigators and arbitrators licensed to represent clients before local, national, regional and international tribunals. We successfully resolve complex, cross-border and precedent-setting disputes on behalf of the world's largest corporations, leading financial institutions and sovereign governments.

White & Case LLP
 1155 Avenue of the Americas
 New York, NY 10036
 United States
 + 1 212 819 8200

Annual Surprise Examination and Reporting by Independent Public Accountant

The Proposed Rule would require all registered investment advisers with custody of client assets to enter into a written agreement engaging an independent public accountant to conduct annual surprise examinations. The Proposed Rule additionally expands the definition of custody to include custody by a related person. The staff of the SEC has previously indicated through no-action positions that advisers **may** be considered to have custody when related persons have access to assets, depending on the circumstances. The Proposed Rule codifies the SEC's position with respect to the custody of client assets by a related person, and the existing no-action positions will be withdrawn in connection with the adoption of the Proposed Rule.

The mandatory surprise examination component of the Proposed Rule is a significant departure from current practice that requires surprise examinations only when an adviser, rather than a qualified custodian, distributes account statements to clients. Additionally, under current practices, the requirement to distribute client account statements does not apply with respect to Fund Clients that are subject to annual audits who distribute audited financial statements to their underlying investors. Therefore, surprise examinations do not currently apply to advisers of such Fund Clients in any case. Furthermore, under the existing rule, certain privately offered securities, including privately offered securities held for the account of Fund Clients that are audited annually and who distribute audited financial statements to underlying investors, are entirely excepted from the rule, including any surprise examination requirement. The Proposed Rule does not include any exceptions to the surprise examination requirement.

Under the Proposed Rule, the independent public accountant is required to notify the SEC within one business day of any material discrepancies found as a result of a surprise examination. The SEC has recognized that surprise examinations may continue for extended periods of time and, as such, the Proposed Rule attempts to place parameters around such time periods by revising the time frame within which the independent public accountant is required to file an ADV-E report with the SEC for the surprise examination from 30 days after the completion of the surprise examination to 120 days from the commencement of the surprise examination.

The SEC has noted the independent public accountant review would provide "another set of eyes" on client assets and is designed to provide additional protection against misappropriation of such assets. The Proposed Rule fortifies

this "watchdog" status of independent public accountants by requiring an independent public accountant no longer engaged by an adviser to file a statement with the SEC within four business days of its termination (whether voluntary or involuntary). The statement must include the date of such termination, contact information of the accountant and an explanation of any problems relating to the examination, scope or procedure that contributed to the termination.

The SEC is seeking comments specifically on the appropriateness of the scope and substance of the surprise examinations. For example, the SEC has asked whether certain advisers, including those advisers that have custody of assets solely as a result of their authority to deduct advisory fees or those advisers to Fund Clients that are audited annually and distribute financial statements to their investors within 120 days of the end of their fiscal year, should be excepted from the surprise examination requirement. The SEC has also asked whether further guidance should be provided on the procedures required to be performed as part of the surprise examination.

Adviser or Related Persons Acting as Qualified Custodian

Recognizing the increased risk of fraud and misappropriation of assets when client assets are not held by an independent qualified custodian, the Proposed Rule includes significant measures to tighten the control and oversight of related custody arrangements. Under the Proposed Rule, an investment adviser who holds client assets as a qualified custodian, or is deemed to hold custody through an affiliate that is a qualified custodian, must engage an independent public accountant registered and inspected by the PCAOB to conduct (i) the surprise examination and (ii) an internal review of the controls relating to custody of client assets similar to a Type II SAS 70 review. The investment adviser must obtain, or receive from its affiliate serving as the qualified custodian, an annual written report summarizing this review from the PCAOB accountant describing the relevant controls, including an opinion issued in accordance with the standards of the PCAOB on the operational controls in place and its "tests of operating effectiveness." The internal review also must be made available to the SEC upon request.

The SEC recognized the limited utility of relying solely on the surprise examination for related custody arrangements because the independent public accountant must rely on custodial reports issued by the related custodian, an inherent conflict of interest that increases the risk of fraud. The internal review provides an additional check on the custodial arrangements.

Investment Funds

The requirement to use an independent public accountant registered with, and subject to regular inspection by, the PCAOB for both the surprise examination and the internal control reports is designed to further strengthen the quality of the control system, which the SEC believes is particularly necessary where the risk of fraud is heightened because the adviser or a related person itself holds custody of client assets.

The SEC is seeking comment specifically on whether, as an alternative to requiring both the surprise examination and the internal control report in instances of non-independent custody, advisers who also act as qualified custodians be required to segregate custodial duties from advisory duties and implement additional controls to protect assets. The SEC has also requested comment on whether different accountants should be engaged for each of the surprise examination and the internal control report.

Delivery of Account Statements and Notice to Clients

The Proposed Rule requires that client account statements be directly delivered by a qualified custodian to an investment adviser's clients (i.e., the rule no longer permits an investment adviser to deliver such statements in lieu of the qualified custodian). The Proposed Rule requires further that the investment adviser make "due inquiry" that such delivery is being made. Under the existing rule, the option to permit advisers (rather than a qualified custodian) to distribute client accounts so long as they were subject to an annual surprise examination was originally included to address confidentiality concerns raised by advisers who were not comfortable with providing client information to qualified custodians to deliver the account statements to clients. Despite the rationale for this option, SEC data indicates that in 2008 only about 190 advisers chose to distribute account statements themselves rather than through a qualified custodian, presumably because of the additional burden of the surprise examination requirement. Since the Proposed Rule would no longer permit investment advisers to send such account statements directly to clients, certain custodial agreements may need to be amended to include confidentiality covenants with respect to client information. Because custodians will need access to client lists, the confidentiality provisions in a custodial agreement will need to explicitly provide that confidential information include client profiles, client lists and any information relating to the beneficial owners of such clients.

The Proposed Rule would also require an investment adviser to include, in the notice provided to clients upon opening a custodial account on their behalf, a statement urging clients

to compare the account statements they receive from the qualified custodian with those they receive from the investment adviser. Nothing, however, in the Investment Advisers Act or the rules promulgated thereunder (including the Proposed Rule) requires an investment adviser to provide clients with account statements other than the account statements required from a qualified custodian. The SEC has asked for comment on whether there should be a requirement for an investment adviser to also provide account statements to its clients.

The Proposed Rule retains the exception that account statements are not required to be delivered to Fund Clients or their underlying investors if the Fund Clients are subject to an annual audit and distribute audited financial statements to their investors within 120 days of such audit. The Proposed Rule adds an additional requirement, however, that such Fund Clients also be subject to a liquidation audit and distribute such audited financial statements to underlying investors promptly upon the completion of such audit. The existing rule includes an expanded 180-day delivery time for the annual audited financial statements for Fund Clients that are fund of funds. The Proposed Rule removes this expanded time frame. The SEC did not indicate the reason for the removal, however, it did request comment on whether 120 days is reasonable for all types of advisers. We expect that funds of funds will request the reinstatement of the 180-day delivery period in comments to the Proposed Rule.

Form ADV Amendments

The Proposed Rule includes several amendments to Part 1A and Schedule D of Form ADV that seek additional information about registered advisers' custody practices. In addition, the amendments would allow the SEC to monitor compliance with the Proposed Rule by requiring disclosure of the identity of the accountants that perform audits or surprise examinations and prepare internal control reports, the purpose for which they were engaged and whether their report was unqualified.

Next Steps

The SEC has drafted the Proposed Rule, and is soliciting comment, in an attempt to effectively balance the need for increased regulation and oversight against the costs and potentially unintended consequences of compliance with such regulation. Some industry participants have noted their belief that the Proposed Rule is unnecessary because the existing regulatory oversight of qualified custodians is sufficiently robust and the recent instances of fraud result from shortfalls in the enforcement of the existing rules and not from shortfalls of the rules themselves. On the other hand, many industry participants feared that the Proposed Rule would have been more restrictive

Investment Funds

by including a flat prohibition on any adviser or affiliate acting as a qualified custodian. The SEC has, however, asked whether such a prohibition should be adopted. Additionally, the SEC has asked whether, as an alternative or supplement to the surprise examination requirement, it should require a registered investment adviser's chief compliance officer to certify to the SEC on a periodic basis that client assets are properly protected and accounted for on behalf of clients.

We expect many industry participants to provide comments that the annual surprise examination should not apply to advisers deemed to have custody solely as a result of their ability to withdraw advisory fees directly from client accounts (nearly two-thirds of all advisers subject to the Proposed Rule) given that such limited access to client assets is less likely subject to abuse and misappropriation.

The SEC is seeking comments on the Proposed Rule by July 28, 2009. We will continue to monitor the progress of the Proposed Rule and will report on further developments.

This Client Alert is provided for your convenience and does not constitute legal advice. It is prepared for the general information of our clients and other interested persons. This Client Alert should not be acted upon in any specific situation without appropriate legal advice and it may include links to websites other than the White & Case website.

White & Case has no responsibility for any websites other than its own and does not endorse the information, content, presentation or accuracy, or make any warranty, express or implied, regarding any other website.

This Client Alert is protected by copyright. Material appearing herein may be reproduced or translated with appropriate credit.

In this publication, White & Case means the international legal practice comprising White & Case LLP, a New York State registered limited liability partnership, White & Case LLP, a limited liability partnership incorporated under English law and all other affiliated partnerships, corporations and undertakings.
© 2009 White & Case LLP

NYC/0609_A_04823_v2