

SEC AMENDS CUSTODY RULE FOR INVESTMENT ADVISERS

By James G. Smith



The Securities and Exchange Commission, concerned with adviser misappropriation of clients' funds, adopted amendments to the Investment Advisers Act custody rule that became effective on March 12, 2010. These amendments apply to an investment adviser who is, or is required to be, registered under the Investment

Advisers Act.

In summary, these changes now require an investment adviser with custody of client funds or securities to undergo an annual surprise examination by an independent public accountant to verify client assets; to have the qualified custodian maintaining client funds and securities send account statements directly to the advisory clients; and, unless client assets are maintained by an independent custodian, to obtain a report of the internal controls relating to the custody of those assets from an independent public accountant registered with the Public Company Accounting Oversight Board (PCAOB).

CHANGES TO THE CUSTODY RULE

What is custody? The changes expand the definition of custody to treat an investment adviser as having custody of client assets whenever any person controlling, controlled by or under common control with the investment adviser holds client funds or securities or has any authority to obtain possession of them.

What is a surprise examination? Client funds and securities that are in the custody of the investment adviser must be verified by actual examination at least once during each calendar year by a PCAOB-registered independent public accounting firm. The accounting firm must report to the SEC any material discrepancies within one business day and report the results of the surprise examination on Form ADV-E within 120 days.

When must the accounting firm be engaged? Investment advisers must engage the accounting firm so that the first surprise inspection shall occur prior to December 31, 2010. Upon resignation or dismissal, the accounting firm must file a

statement regarding the termination on Form ADV-E within four business days.

Who delivers account statements? Under the custody rule, most investment advisers must maintain client funds and securities with a qualified custodian, a category that includes banks, broker-dealers and futures commission merchants. The changes now require that the qualified custodian must directly deliver account statements to clients. The SEC eliminated the option for investment advisers who have an annual surprise examination by an independent accountant to send account statements to clients.

Are internal control reports required? Investment advisers who hold client assets themselves or hold client assets through an affiliate must annually obtain a written internal control report from a PCAOB accountant regarding the soundness of custodial policies and procedures.

Was Form ADV revised to include new requirements? Yes. The SEC has revised Form ADV to require investment advisers, beginning with their first annual amendment after January 1, 2011, to provide detailed information about their custodial practices, including:

- Whether the adviser or its related persons serving as qualified custodians have custody of client assets;
- A list of all related persons who are broker-dealers that identifies any such broker-dealers serving as qualified custodians with respect to the adviser's client assets;
- Whether the adviser or a related person serving as a qualified custodian acts as an adviser to a pooled investment vehicle and, if so, whether the pool is audited or a qualified custodian sends account statements directly to pool investors;
- The amount of client assets and the total number of advisory clients for which the adviser has custody;
- The identity of related persons that serve as qualified custodians; and

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- The identity of the accountants that perform audits, surprise examinations and internal control reports, if any.

IMPACT ON HEDGE FUNDS AND OTHER POOLED INVESTMENT VEHICLES

An investment adviser to a hedge fund or other pooled investment vehicle will have satisfied the annual surprise examination requirement for such fund's assets and will not be required to have the qualified custodian send account statements to the fund investors provided such fund is subject to a financial statement audit by a PCAOB accounting firm, annually and upon liquidation, and distributes financial statements to fund investors within 120 days after the fund's fiscal year end.

Investment advisers to funds that comply with this exception must still maintain the funds and securities of the fund with a qualified custodian and still comply with the internal control reporting if the qualified custodian is the investment adviser or an affiliate.

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