BLANK ROME LLP
COUNSELORS AT LAW

Corporate and Securities Update

www.BlankRome.com June 2009 No. 11

SEC Proposes Amendments To Investment Adviser Custody Rules

Executive Summary

On May 27, 2009, the Securities and Exchange Commission (the "SEC") proposed amendments to Rule 206(4)-2 under the Investment Advisers Act of 1940 ("Advisers Act") which governs custody arrangements for registered investment advisers ("Rule 206(4)-2"). The proposed rule, if adopted, would require registered investment advisers that have custody of client funds or securities to undergo an annual surprise examination by an independent public accountant to verify client funds and securities. In addition, unless client accounts are maintained by an independent qualified custodian (i.e., a custodian other than the adviser or a related person), the adviser or related person must obtain a written report from an independent public accountant that includes an opinion regarding the qualified custodian's controls relating to custody of client assets. Finally, if adopted, the proposed rule would provide the SEC with better information about the custodial practices of registered investment advisers. The proposed rule is designed to provide additional safeguards under the Advisers Act when an adviser has custody of client funds or securities. Comments on the SEC's proposal are due to the SEC on or before July 28, 2009.

Annual Surprise Examination of Client Assets

Under the proposed rule *all* registered investment advisers with custody of client assets would be required to engage an independent public accountant to conduct an annual surprise examination of client assets. This requirement would apply regardless of whether a qualified custodian directly provides statements to clients or, in the case of a pooled investment vehicle, the pool is audited at least annually and distributes its audited financial statements to its limited partners (or other investors) within 120 days of the end of its fiscal quarter. Currently, privately offered securities are excluded from all aspects of the custody rule. However, under the proposed rule, privately offered securities that investment advisers hold on behalf of their clients would be subject to the surprise examination requirement.

Under the amendments, Rule 206(4)-2 would also be amended to require investment advisers subject to Rule 206(4)-2 to enter into a written agreement with an independent public accountant to conduct the surprise examination requiring the accountant, among other things, to notify the SEC within one business day of finding material discrepancies. The proposed rule, if adopted, would also require the accountant to submit Form ADV-E to the SEC accompanied by a certificate within 120 days of the time chosen by the accountant for the surprise examination, stating that it has examined the funds and securities and describing the nature and extent of the examination. In addition, the proposed rule, would require the written agreement to require the independent public accountant to submit FORM ADV-E to the SEC within four business days of its resignation, dismissal, removal, or other termination of the engagement, accompanied by a statement relating to the circumstances of such resignation, dismissal, removal, or other termination.

Similar to the current rule, under the proposed rule, advisers would not need to comply with Rule 206(4)-2 with respect to clients that are registered investment companies.

© 2009 by BLANK ROME LLP. Notice: The purpose of this newsletter is to review the latest developments which are of interest to clients of Blank Rome LLP. The information contained herein is abridged from legislation, court decisions, and administrative rulings and should not be construed as legal advice or opinion, and is not a substitute for the advice of counsel.

One Logan Square • Philadelphia, Pennsylvania 19103-6998 • 215.569.5500

Custody by Adviser and its Related Persons

A. Custody by Related Persons

The proposed rule, if adopted, would amend Rule 206(4)-2 to provide that an adviser has custody of any client securities or funds that are directly or indirectly held by a "related person" in connection with advisory services provided by the adviser to its clients. A "related person" would be a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser. "Control" would be defined as the power, directly or indirectly, to direct management or policies of a person, whether through ownership of securities, by contract, or otherwise. As a result, the protections of Rule 206(4)-2 would be afforded to clients when the client's funds and securities are not held with an independent custodian, but rather with the adviser itself or indirectly through a related person. Finally, under the proposed rule, advisers whose "related persons" hold client assets would be deemed to have custody under Rule 206(4)-2 if those assets are held by the related person in connection with the advisory services provided by the adviser.

B. Surprise Examination and PCAOB Registration

The proposed rule, if adopted, would require, in situations where an adviser or a related person serves as a qualified custodian for the adviser's clients' funds or securities, the surprise examination discussed above to be performed by an independent public accountant registered with, and subject to regular inspection by, the PCAOB, in accordance with the rules of the PCAOB. The SEC indicated that PCAOB registration and inspection would provide the SEC greater confidence in the quality of the examination preformed by the independent public accountant, which the SEC believes is even more important when an adviser or its related person, rather than an independent custodian, maintains client funds or securities.

C. Internal Control Report and PCAOB Registration and Inspection

Under the proposed rule, Rule 206(4)-2 would be amended to require that if an independent custodian does not maintain client assets but the adviser or a related person instead serves as a qualified custodian for client funds or securities under Rule 206(4)-2 in connection with advisory services the adviser provides to clients, the adviser must obtain, or receive from the related person, no less frequently than once each calendar year a written report (an "Internal Control Report") that includes an opinion from an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB") with respect to the adviser's or related person's controls relating to custody of client assets. The adviser would be required to maintain the Internal Control Report in its records and make it available to the SEC upon request.

The proposed rule, if adopted, would require that the Internal Control Report include an opinion of an independent public accountant registered with, and subject to regular inspection by, the PCAOB, that is issued in accordance with the standards of the PCAOB with respect to the description of controls placed in operation relating to custodial services, including the safeguarding of cash and securities held by either the adviser or a related person on behalf of the adviser's clients, and tests of operating effectiveness. The Internal Control Report would also contain a description of the relevant controls, the control objectives and related controls, and the independent public accountant's tests of operating effectiveness that were performed and the results of those tests. Finally, the adviser would be required to maintain a copy of the Internal Control Report for five years from the end of the fiscal year in which the Internal Control Report is finalized.

Delivery of Account Statements and Notice to Clients

The proposed rule, if adopted, would also amend Rule 206(4)-2 to require registered advisers with custody of client funds to have a reasonable basis for believing that the qualified custodian sends an account statement, at least quarterly, to each client for which the qualified custodian maintains funds or securities. The proposed rule would eliminate the alternative, currently provided in Rule 206(4)-2 under which an adviser can send reports to clients if it undergoes surprise examination by an independent public accountant at least annually. Instead, all advisers with custody of client assets would have to have a reasonable belief that the qualified custodian delivers account statements to advisory clients or their representatives (and not through the investment advisor). Rule 206(4)-2 would also be amended to state that advisers relying on the qualified custodian to send the account statements directly to clients must form their reasonable belief that such account statements are sent after "due inquiry." The SEC has explained that because the effectiveness of Rule 206(4)-2 depends significantly on direct delivery of account statements by the qualified custodian, the proposed rule, if adopted,

would make it explicit that the adviser is obligated under Rule 206(4)-2 to conduct some inquiry to form a reasonable belief.

Liquidation Audit

The proposed rule, if adopted, would contain an amendment to a provision of Rule 206(4)-2 that exempts advisers from the account statement provisions with respect to those limited partnerships or other pooled investment vehicles that are subject to an annual audit and that distribute financial statements to investors. The proposed rule would clarify the availability of the annual audit exception to pooled investment vehicles that liquidate and that make final distributions other than at year end.

Amendments to Form ADV and Form ADV-E

The proposed rule also contains several amendments to Part 1A and Schedule D of Form ADV. The amendments are designed to provide more complete information about the custody practices of advisers registered with the SEC, and to provide the SEC with additional data to improve its ability to identify compliance risks. Specifically, the proposed rule, if adopted, would modify Item 7 of Part 1A to require an adviser to report all related persons who are broker-dealers and to identify which, if any, serve as qualified custodians with respect to the adviser's clients' funds or securities. In addition, the proposed rule would amend Item 9 of Part 1A to require advisers that have custody (or whose related persons have custody) of client funds or securities to provide additional information about their custodial practices under Rule 206(4)-2. Finally, the SEC also proposed to amend Schedule D of Form ADV by adding items to require additional details relevant to an adviser's response to the proposed amendments to Item 9 as previously discussed.

With respect to Form ADV-E, the SEC proposes to amend the instructions to the form to require that Form ADV-E and the accountant's examination certificate accompanying the Form ADV-E be filed electronically with the SEC. Form ADV-E's instructions would also be amended to reflect the proposed requirement that Form ADV-E and the examination certificate be filed within 120 days of the time chosen by the accountant for the surprise examination. Lastly, the SEC proposed to add an instruction regarding the accountant's obligation under the written agreement with the adviser to file Form ADV-E accompanied by a termination statement (as described above) within 4 business days of the accountant's resignation, dismissal, or removal.

Questions

Any person who has a question regarding the issues raised in this *Corporate and Securities Update* may obtain additional guidance from a member of our Public Companies Group (www.blankrome.com). ■

Public Companies and Capital Formation Group

Philadelphia Office	Telephone
Yelena Barychev	215.569.5737
Christin R. Cerullo	215.569.5744
Frank E. Dehel	215.569.5532
Barry H. Genkin	215.569.5514
Alan H. Lieblich	215.569.5693
Frederick D. Lipman	215.569.5518
Richard J. McMahon	215.569.5554
Michael J. Medveckus	215.569.5335
Melissa P. Murawsky	215.569.5732
Michael E. Plunkett	215.569.5471
Edward F. Spaniel	215.569.5521
Jane K. Storero*	215.569.5488
Jeffrey M. Taylor	215.569.5579
Larry R. Wiseman	215.569.5549

*Editor

New York Office	Telephone
Elise M. Adams	212.885.5544
Matthew K. Breitman	212.885.5479
Kathleen A. Cunningham	212.885.5175
Richard DiStefano	212.885.5372
Pamela E. Flaherty	212.885.5174
Eliezer M. Helfgott	212.885.5431
Robert J. Mittman	212.885.5555
Jeffrey A. Rinde	212.885.5335
Ethan Seer	212.885.5393
Brad L. Shiffman	212.885.5442
Jeffrey N. Siegel	212.885.5173
Thomas Westle	212.885.5239

Washington, DC Office	Telephone
Keith E. Gottfried	202.772.5887
Michael Joseph	202.772.5959
Edward L. Lublin	202.772.5933