

SEC ISSUES FINAL AMENDMENTS TO INVESTMENT ADVISER CUSTODY RULES

On December 30, 2009, the Securities and Exchange Commission ("SEC") issued a release containing final rules with respect to its adoption on December 16, 2009 of amendments to the custody and recordkeeping rules under the Investment Advisers Act of 1940 (the "Advisers Act") and related forms (collectively, the "Amendments"). The Amendments are designed to provide additional safeguards under the Advisers Act when a registered investment adviser has custody of client funds or securities.

Background

Rule 206(4)-2 under the Advisers Act (the "Custody Rule") sets forth procedures to be followed by registered investment advisors with respect to custody of client assets. Under the Custody Rule, advisers having "custody" of client funds or securities (i.e., where the adviser holds such assets, directly or indirectly, or has authority to obtain possession of them) must maintain those funds and securities with a "qualified custodian" (e.g., a bank or brokerage firm) in segregated accounts. Prior to the Amendments, the adviser must have had a reasonable basis for believing that the qualified custodian sends quarterly account statements to the client, or, alternatively, the adviser itself could send the quarterly statements to its clients, provided that the adviser submitted to a surprise examination by an independent public accountant at least annually. However, registered investment advisers having custody of client assets by virtue of advising (as general partner of a limited partnership or managing member of a limited liability company) an investment pool that is subject to an annual audit could instead comply with the custody requirements by delivering to investors (i.e., limited partners, members or other beneficial owners) the pool's audited financial statements within 120 days (or, if the pool is a fund of funds, 180 days) of the end of the pool's fiscal year.

As a result of numerous high profile frauds perpetrated by registered advisers such as Bernard Madoff, the SEC felt compelled to tighten certain aspects of the Custody Rule. Said Mary L. Shapiro, Chairman of the SEC, "The Madoff Ponzi scheme and other frauds have caused investors to question whether their assets are safe when they entrust them to an investment advisor."

The Amendments

Set forth below is a summary of the key Amendments to the Custody Rule and related rules and forms.

(a) **Mandatory Delivery of Account Statements by Qualified Custodians.** Registered advisers having custody of client assets can no longer satisfy the quarterly statement delivery requirements by delivering the statement themselves if they undergo the surprise annual audit. Instead, the adviser must have a reasonable basis, after due inquiry, for believing that the qualified custodian will send quarterly account statements to clients. In other words, qualified custodians will be the only source of quarterly statements that satisfy the Custody Rule. Further, if a registered adviser elects to send account statements to a client (in addition to those sent by the qualified custodian), the adviser must now include, in the notification provided to that client and in any subsequent account statement

the adviser sends to that client, a statement urging the client to compare the account statements from the custodian with those from the adviser.

(b) Annual Surprise Examination by Independent Public Accountant. The client funds and securities of which registered advisers have custody must be verified by actual surprise examinations conducted at least once each calendar year by an independent public accountant, unless: (i) the adviser has custody solely because it has authority to deduct advisory fees from client accounts; (ii) the custodian of the client assets is a "related person" to the adviser, and the adviser can demonstrate that it is "operationally independent" of the custodian; or (iii) the adviser advises a pooled investment vehicle that (A) is subject to audits at least annually and upon liquidation by an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB"), and (B) distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all investors within 120 days of its fiscal year end and promptly after completion of a liquidation audit. The engagement of an accountant to perform annual surprise examinations must be set forth in a written agreement that requires the accountant to make specified filings with or give specified notices to the SEC concerning completion of examinations, findings of material discrepancies and its resignation or termination of the engagement.

(c) Internal Control Report if Qualified Custodian Not Independent. If a registered adviser, or a "related person" to the adviser, acts as the qualified custodian, rather than an independent third party, (i) the independent public accountant retained by the adviser to perform annual surprise examinations required under the Amendments must be registered with, and subject to regular inspection by, the PCAOB, and (ii) the adviser must obtain, or receive from its related party custodian, no less frequently than once each calendar year, a written report (an "Internal Control Report") prepared by and including an opinion from an independent public accountant registered with and subject to regular inspection by the PCAOB with respect to the adviser's or related custodian's controls relating to custody of client assets.

(d) Form ADV Amendments. The Amendments also include the following changes to Form ADV:

(i) Item 7 and Section 7.A. of Schedule D are amended to require disclosure of all related persons who are broker-dealers and to identify which, if any, serve as qualified custodian for client funds or securities.

(ii) Item 9 and Sections 9.C. and 9.D. of Schedule D are amended to require disclosure as to (A) whether the adviser or a related person has custody of client assets, and if so, both the dollar amount of such assets as well as the number of clients for whose accounts the adviser or its related person has custody, (B) if the adviser or a related person acts as adviser to a pooled investment vehicle, whether the pool is audited and whether the qualified custodian sends account statements to pool investors, (C) whether an independent public accountant conducts an annual surprise examination of client assets, (D) whether an independent public accountant prepares an Internal Control Report for the adviser or its related person, (E) whether the adviser or a related person serves as a qualified custodian for the adviser's clients, and (F) the identity and certain information concerning the accountants that perform audits or surprise examinations and that prepare Internal Control Reports.

Effective/Compliance Dates

The Amendments become effective 60 days from the date on which they are published in the Federal Register. Additionally, registered advisers required to obtain surprise examinations must have entered into a written agreement with an independent public accountant providing that the first surprise examination will take place by December 31, 2010 or, for advisers that become subject to this requirement after the effective date, within six months after becoming subject to the requirement. For any registered adviser required to obtain or receive an Internal Control Report, the adviser must obtain such report within six months of becoming subject to such requirement. An adviser to a pooled investment vehicle may rely on the annual audit provision, which provides an exception to the surprise examination requirement, if the adviser becomes contractually obligated to

obtain an audit of the financial statements of the pooled investment vehicle for fiscal years beginning on or after January 1, 2010.

If you have any questions regarding The Custody Rule, please contact [Scott McGinness](mailto:smcginness@millermartin.com) at smcginness@millermartin.com or any other member of Miller & Martin's [Investment Management Practice Group](#).

The opinions expressed in this bulletin are intended for general guidance only. They are not intended as recommendations for specific situations. As always, readers should consult a qualified attorney for specific legal guidance. Should you need assistance from a Miller & Martin attorney, please call 1-800-275-7303.

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