of Wall Street," "Wall Street's Most Wanted," "Pure Profit," and "Mafia Trader." As alleged in the SEC's complaint, Gryphon's financial publications only served as a vehicle to attract unsuspecting clients to pay fees for personalized investment recommendations, portfolio analysis, and money management services that Gryphon purportedly provided.

According to the SEC, Gryphon made numerous material misrepresentations and omissions since at least 2007 to entice unsuspecting clients to purchase investment services. The SEC specifically alleges that Gryphon falsely touted that it (1) had significant trading operations, (2) managed or advised hedge funds with holdings of over $1.4 billion, (3) had a principal who "pull[ed] in revenues that exceed $50 billion", (4) had a "self made billionaire" who is a "great stock picker", (5) had key personnel who were educated at prestigious institutions or who were affiliated with major investment banks, and (6) received an endorsement from George Soros. David Rosenfeld, Associate Director of the SEC's New York Regional Office, stated, "[Gryphon] touted offices on Wall Street and around the world while, in reality, defrauding investors from a strip mall on Staten Island."

Temporary Relief

The U.S. District Court for the Eastern District of New York granted the SEC's request for a temporary restraining order and asset freeze against Defendants and six others, including Marsh's wife, who each allegedly obtained in excess of $500,000 from Gryphon's bank account.

Related Criminal Action

The U.S. Attorney's Office for the Eastern District of New York announced parallel criminal charges. Marsh and four Gryphon employees were arrested on April 20, 2010 on charges of conspiracy to commit securities fraud and wire fraud.

Custody & Protection

SEC's Custody Rule Amendments and Implications for Registered Private Fund Advisers

Contributed by: Kenneth Muller, Thomas Devaney and Seth Chertok

On December 30, 2009, the Securities and Exchange Commission (SEC) published a final rule release (Release) adopting amendments (Rule Amendments) to the custody and recordkeeping provisions of Rule 206(4)-2 and Rule 204-2 under the Investment Advisers Act of 1940 (Advisers Act), respectively.[1] The SEC's stated goal for the Rule Amendments is to enhance the safekeeping of investors' assets. Registered investment advisers (RIAs) may need to update their partnership agreements, fund documentation, GAAP compliance, and compliance policies and procedures to ensure conformity with the Rule Amendments, as well as update their Form ADV disclosures. Although exemptions are available, RIAs are cautioned to carefully review their requirements before relying on them. The Rule Amendments generally took effect on March 12, 2010, with some exceptions regarding compliance dates.

Custody and Record Keeping

Who Does Rule 206(4)-2 Apply To?

Following the Rule Amendments, Rule 206(4)-2(b) applies to RIAs and their related persons that have "custody" of client funds or securities. An RIA is now deemed to have "custody" of client assets if the RIA or its related person directly or indirectly holds client funds or has any authority to obtain possession of them. "Custody" includes, among other things: (1) possession of client assets; (2) a power of attorney or other arrangement authorizing the RIA to withdraw client assets; and (3) acting in any capacity that gives the RIA legal ownership of, or access to, client funds or securities, such as acting as the general partner or managing member (or any comparable position) of a private fund.[2] It will therefore be difficult for an RIA to avoid having custody of client funds and securities unless an RIA neither holds, nor has authority to obtain possession of, client funds and securities. The effect on an RIA or its related person being deemed to have custody of client funds or assets is that it must comply with certain requirements under Rule 206(4)-2; and, unless exempt therefrom, failure to do so constitutes an anti-fraud violation by the RIA.[3]

What Does Rule 206(4)-2 Require?

Qualified Custodian Requirement

Under Rule 206(4)-2(a)(1), if an RIA or its related person has custody of a client's assets (including securities and cash), unless an exemption applies, it must use a "qualified custodian" to maintain such client assets (1) in a separate account for the client under the client's name; or (2) in accounts that contain only the client's funds and securities, under the RIA's name as agent or trustee for the client.

Exemptions from Qualified Custodian Requirement

With respect to certain uncertificated privately placed securities that are transferable only with the consent of the issuer or the holders of the securities, an RIA is exempt from Rule 206(4)-2(a)(1)'s qualified custodian requirement pursuant to Rule 206(4)-2(b)(2); however, this exemption will not exempt such RIAs from the other requirements under Rule 206(4)-2. Further, the exemption will not apply to securities held for the account of pooled investment vehicles unless the vehicles are audited and the audited financial statements are distributed as described in Rule 206(4)-2(b)(4). Certain types of private equity RIAs may be able to structure their

portfolio transactions so as to fall within this exemption, but should also consider other Rule 206(4)-2 exemptions. See below for a discussion of Rule 206(4)-2(b)(4) and these other exemptions.

Mutual Funds Can Use Transfer Agent in Lieu of Qualified Custodian

With respect to mutual fund shares, Rule 206(4)-2(b)(1) would allow an RIA to use the mutual fund's transfer agent instead of a qualified custodian for purposes of complying with Rule 206(4)-2(a). The various provisions of Rule 206(4)-2(a) are discussed below.

Notice, Account Statement and Examination Requirement

Rules 206(4)-2(a)(2), (a)(3) and (a)(4) impose certain notice, account statement, and examination requirements, unless an exemption is met. These requirements are relatively burdensome.

Under Rule 206(4)-2(a)(3), the qualified custodian must send account statements to each client for which it maintains funds or securities identifying the amount of funds and the amount of each security in the account during the applicable period and setting forth all transactions in the account during that period. With respect to pooled investment vehicles, under Rule 206(4)-2(a)(5), account statements must now be sent to all investors therein.

RIAs have the option of sending additional account statements. If an RIA sends additional account statements to investors, the statements must now contain a notice urging investors to compare the account statements from the custodian with those from the RIA.[4] An additional new feature of Rule 206(4)-2(a)(3) is that the RIA must have a reasonable basis for believing that the qualified custodian sent account statements, after due inquiry.

An RIA will also be subject to an annual surprise examination pursuant to a written agreement between the RIA and an independent public accountant under Rule 206(4)-2(a)(4).[5] Rule 206(4)-2(a)(6) requires that the accountant performing the examination be registered with, and subject to the oversight of, the Public Company Accounting Oversight Board (PCAOB). The initial surprise exam for RIAs currently subject to Rule 206(4)-2 must take place by December 31, 2010, at a time chosen by the accountant in its sole discretion.[6] Otherwise, the first examination must occur within six months of becoming subject to Rule 206(4)-2(a)(4), except that, if the RIA maintains client funds or securities pursuant to Rule 206(4)-2(a) as a qualified custodian, the first examination must occur no later than six months after obtaining an internal control report with respect to custody controls from the accountant. In addition to reporting material discrepancies, which was required under old Rule 206(4)-2, the accountant must now file a certificate on Form ADV-E with the SEC stating that it has examined the funds and securities and describing the nature and extent of the examination.[7] Upon resignation or termination, the accountant must also file an additional statement.[8]

Rule 206(4)-2(b)(4) Exemption

We recommend that RIAs advising pooled investment vehicles consider attempting to rely upon the exemption in Rule 206(4)-2(b)(4), which provides an exemption from such notice, account statement, and examination requirements. However, RIAs should also carefully evaluate whether they want to comply with the account statement requirement in Rule 206(4)-2(a)(3). The practical result of the Rule Amendments is that, generally, many RIAs will need to seek out accountants, as described below, whether or not the exemption in Rule 206(4)-2(b)(4) is relied upon.

While many RIAs currently provide GAAP financial statements audited by an independent public accountant to investors on an annual basis, Rule 206(4)-2(b)(4) will generally force RIAs to undergo an additional audit by the accountant upon liquidation, and to distribute the audited GAAP financial statements to investors promptly after completion of the audit. In addition, the accountant must be registered with, and subject to regular inspection by, the PCAOB. Currently, not all RIAs use PCAOB-registered accountants. Because GAAP compliance will now be required, RIAs should also adequately address GAAP compliance and ensure that there are no deficiencies.

Under Rule 206(4)-2(c), an RIA may not rely upon Rule 206(4)-2(b)(4) if financial statements are sent solely to limited partners (or other types of beneficial owners) that themselves are investment vehicles controlled by the RIA.

Separate Account Requirements and Exemptions

In the event that an RIA advises a separate account, the exemption in Rule 206(4)-2(b)(4) would not apply with respect to the examination required under Rule 206(4)-2(a)(4), but would nonetheless apply with respect to the notice and account statement requirements in Rule 206(4)-(a)(2) and (a)(3). If the RIA advises a separate account, the RIA could obtain an exemption from the examination requirement on the basis of Rule 206(4)-2(b)(3) provided: (1) the RIA has custody of the funds and securities solely as a consequence of its authority to make withdrawals from clients' accounts to pay the advisory fee, and (2) if the qualified custodian is a related person of the RIA, the qualified custodian is operationally independent of the RIA, and the RIA has custody solely because of the related person.[9]

If the RIA is attempting to rely upon such exemptions, the RIA must now maintain as part of its recordkeeping requirements under Rule 204-2, a memorandum describing the relationship with the related person in connection with advisory services

the RIA provides to clients. The memorandum must also include an explanation of the RIA's basis for determining that it has overcome the presumption that it is not operationally independent of the related person with respect to the related person's custody of client assets.[10]

RIAs may need to consider whether to advise separate accounts or steer separate account type clients into limited partnerships and limited liability companies. This would take advantage of the fact that Rule 206(4)-2(b)(4) provides a broader exemption for such entities with respect to the examination requirement in Rule 206(4)-2(a)(4). However, it is currently unknown whether the SEC would view a single person limited partnership or limited liability company as a circumvention of the Advisers Act's prohibition against doing indirectly what cannot be done directly.[11] To resolve this question, interpretative guidance or no-action relief from the SEC or its staff would be necessary.

PCAOB-Registered Accountant Requirement

As discussed above, Rule 206(4)-2(a)(6) requires that the accountant performing the examination required thereunder be registered with, and subject to the oversight of, the PCAOB. Funds that relied upon Rule 206(4)-2(b) would also have to use PCAOB-registered accountants when auditing their financial statements. However, the requirements in Rule 206(4)-2(a)(6) would be inapplicable if custody of client funds and securities is not maintained by the RIA or a related person. Even if Rule 206(4)-2(a)(6) does not apply, RIAs advising pooled investment vehicles will generally need to use PCAOB-registered accountants to satisfy their exemption requirements under Rule 206(4)-2(b)(4), as discussed above. Thus, the accountant will usually be subject to PCAOB oversight.

Internal Control Requirement and Exemption

Internal control requirements in Rule 206(4)-2(a)(6) apply to most RIAs, absent an exemption. Under Rule 206(4)-2(a)(6), RIAs will have to obtain copies of an accountant's internal control reports within six months of becoming subject to Rule 206(4)-2(a)(6), and thereafter on an annual basis. Internal control reports will be subject to recordkeeping requirements under Rule 204-2(a)(17)(iii). The internal control report requirements in Rule 206(4)-2(a)(6), however, will not apply if the RIA uses a non-related person to maintain custody of all funds and securities.

Compliance Policies and Procedures

In the Release, the SEC asked RIAs to update certain policies and procedures related to the Rule Amendments as part of their compliance programs. The thrust of these policies and procedures is the safekeeping of investors' assets. The SEC noted that whether policies and procedures should be implemented would ultimately depend on such factors as (1) the size and number of employees of the RIA; and (2) the type of RIA (*e.g.*, whether or not an RIA to a pooled investment vehicle). The SEC provided guidance on what such policies and procedures should include. Investment adviser compliance officers should consult the Release for more details on how to update their compliance policies.

Form ADV

The Release also made several changes to Form ADV in order to better enable the SEC to assess compliance risks associated with custody of client assets. The amendments to Form ADV require RIAs to report to the SEC more detailed information about the RIA's custody practices in their registration form and to update such information.

Effective Date

The Rule Amendments generally took effect on March 12, 2010, but there are some exceptions with regard to compliance dates.[12] Other relevant compliance dates for RIAs that are not otherwise exempt are as follows (*if applicable*):

- A PCAOB-registered accountant's initial surprise examination is required to occur no later than December 31, 2010, or, for RIAs that become subject to the rule after the effective date, within six months of becoming subject to the requirement. If the RIA maintains client assets as a qualified custodian, the engagement must provide for the first examination to occur no later than six months after obtaining the internal control report.

- The initial internal control report from any applicable qualified custodian must be obtained within six months of becoming subject to the requirement.

- The PCAOB-registered accountant's first annual audit (for fiscal year 2010) is required to occur no later than April 30, 2011. An RIA may rely on the annual audit provision in Rule 206(4)-2(b)(4) if it becomes contractually obligated to obtain an audit of the financial statements of the pooled investment vehicles for fiscal years beginning on or after January 1, 2010.

- The filing of an updated Form ADV responsive to certain updates made by the Rule Amendments is required in the RIA's first annual amendment after January 1, 2011.

Kenneth W. Muller is a partner in the San Francisco office of Morrison & Foerster and currently serves as a co-chair of its Private Equity Fund Group and Private Equity Buyout Group. Mr. Muller represents private equity funds, venture capital funds, leveraged buyout funds, real estate funds, debt funds and emerging growth companies in all aspects

of their enterprises. He has represented some of the largest and well-known sponsors of private equity, venture capital and real estate funds. Mr. Muller advises private equity clients on their business, economic, tax, securities, regulatory and compliance issues. Mr. Muller frequently writes and lectures on private equity, tax, securities and limited liability company issues.

Thomas Devaney is a partner in the New York office of Morrison & Foerster and is a member of the firm's Private Equity Fund Group. Mr. Devaney counsels the management teams and sponsors of domestic and international private funds with respect to fundraising, securities laws and regulatory matters, and fund administration and operations generally. Mr. Devaney's experience includes representation of real estate funds, infrastructure funds, debt funds, venture capital funds, as well as hedge funds with a broad range of investment strategies. He also frequently represents institutional investors, gatekeepers and funds of private equity funds and funds of hedge funds with respect to their investments in private funds and other types of private placements. Mr. Devaney is a frequent speaker at legal and business conferences, addressing a range of issues, including fund formation basics, current market terms for fund-raising, venture capital investing and conditions and private fund investments in financial firms compliant with the Bank Holding Company Act and related regulations.

Seth Chertok is an associate in the San Francisco office of Morrison & Foerster and is a member of the firm's Private Equity Fund Group. Mr. Chertok's practice focuses on private equity, M&A, private equity real estate, hedge funds, alternative investment funds and non-profit organizations. Mr. Chertok has advised private equity clients on the general partner fund formation side and on the limited partner investor side. Mr. Chertok has also represented buyers and sellers in secondary transactions involving private equity funds. Mr. Chertok advises private equity clients on their business, economic, tax, securities, regulatory and compliance issues. Mr. Chertok has authored several publications in the area of corporate, securities and investment law. Mr. Chertok received his J.D. from University of Pennsylvania School of Law in 2005, where he received the Lefever Prize for the best paper in law and economics.

[1] SEC Release No. IA-2968 (Dec. 30, 2009).
[2] Advisers Act Rule 206(4)-2(d)(2).
[3] One notable exemption is that Advisers Act Rule 206(4)-2 does not apply with respect to mutual fund accounts of the RIA. *See* Advisers Act Rule 206(4)-2(b)(5).
[4] Advisers Act Rule 206(4)-2(a)(2).
[5] Advisers Act Rule 206(4)-2(a)(4).
[6] Release No. IA-2968, *supra* note 1; Advisers Act Rule 206(4)-2(a)(4).
[7] Advisers Act Rules 206(4)-2(a)(4)(i) and (ii).
[8] Advisers Act Rule 206(4)-2(a)(4)(iii).
[9] Advisers Act Rule 206(4)-2(b)(3) would apply with respect to limited partnerships, limited liability companies, and other pooled investment vehicles; however, the RIA would not need to use Rule 206(4)-2(b)(3) due to the availability of Advisers Act Rule 206(4)-2(b)(4) with respect to such entities.
[10] Advisers Act Rule 204-2(b)(5).
[11] Advisers Act Section 208(d).
[12] Release No. IA-2968, *supra* note 1.

Liability & Defense

State Court's Advisers Act Preemption Analysis Does not Fall within Anti-Injunction Act's "Expressly Authorized" Exception

Ellrich v. Neel, No. 09-CV-11717, 2010 BL 92884 (D. Mass. Apr. 26, 2010)

The U.S. District Court for the District of Massachusetts dismissed a complaint brought by investment adviser David Ellrich against Justice Stephen E. Neel and other justices on the Massachusetts Superior Court, Suffolk County (collectively, Justices). Justice Neel denied a motion for summary judgment filed by Ellrich and his advisory firm Morgan Financial Advisors, Inc. (MFA) after being sued in Massachusetts Superior Court by a former advisory client (Client) for allegedly violating various state securities laws. Ellrich sought an interlocutory appeal in the form of a declaratory judgment that Justice Neel's ruling was erroneous. The District Court rejected Ellrich's arguments that the Investment Advisers Act of 1940 (Advisers Act) could be used as a basis for injunctive relief against the Justices.

State Court Ruling and Preemption Analysis

The Client alleged that Ellrich and MFA, an investment adviser registered under the Advisers Act, mismanaged her investments. Among other things, the Client brought state law claims for fraud, breach of fiduciary duty, breach of contract, and violation of Mass. Gen. Laws ch. 110A, § 410. In seeking summary judgment, Ellrich and MFA argued that the Client's claims were preempted by the Advisers Act and barred by the statute of limitations. They also argued the fraud complaint was inadequately pled; no fiduciary relationship existed; and no security was sold to the Client. Justice Neel ruled that the Advisers Act does not preempt application of state securities laws, and as a result, arguments resting on that premise failed. In denying the summary judgment motion, he also ruled that the existence of a fiduciary relationship was a significant issue in dispute.

Appeal Premise

As the District Court explained, Ellrich premised his appeal on *Ex parte Young*, 209 U.S. 123 (1908), which "stands for the general principle that Eleventh Amendment immunity does not bar a plaintiff from seeking injunctive relief against a state officer in an individual capacity." He