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SEC PROPOSES AMENDMENTS TO THE INVESTMENT ADVISER ACT CUSTODY RULE TO PROVIDE ADDITIONAL SAFEGUARDS TO CLIENT ASSETS

On May 20, 2009, the Securities and Exchange Commission (the "SEC") published proposed amendments to the Investment Advisers Act of 1940 (the "Advisers Act"), and Rule 206(4)-2 thereof, commonly referred to as the "custody rule."

The SEC proposed three significant changes to the custody rule that, if adopted, would require:

- All registered investment advisers with custody of client assets to undergo an annual surprise examination by an independent public accountant to verify client assets.

- All registered investment advisers (or their affiliates) who maintain client assets as qualified custodians to obtain from an independent accountant, who is registered with and inspected by the Public Company Accounting Oversight Board ("PCAOB"), an annual internal control report (a Type II SAS 70 Report) attesting to controls and safekeeping of client assets.

- All qualified custodians holding client assets to deliver account statements directly to advisory clients. (Registered investment advisers who have custody of assets of private pooled investment vehicles would continue to be exempt from this requirement if the pooled investment vehicle satisfied certain audit requirements.)

The proposed amendments are in response to the recent string of highly publicized Ponzi schemes and other fraudulent conduct, and they strive to provide additional safeguards to protect client assets within an adviser's custody from loss, misuse, or misappropriation.

Comments on the proposed amendments are due by **July 28, 2009**.

BACKGROUND

The custody rule regulates practices of registered investment advisers who have, or who are deemed to have, custody of client funds or securities by virtue of authority to obtain possession of such funds or securities, or to withdraw funds or deduct advisory fees on behalf of a client. The custody rule aims to protect such assets from misappropriation or other misuse by a registered investment adviser by requiring that registered investment advisers maintain client funds or securities with a qualified custodian. "Qualified custodians" include registered broker-dealers, banks, savings associations, registered futures commission merchants, and foreign financial institutions that typically hold financial assets for their customers.

The current custody rule also requires that registered investment advisers with custody of client assets maintained with a qualified custodian have a reasonable belief that the qualified custodian sends to those clients account statements itemizing the funds or securities in custody and all transactions for that account, at least on a quarterly basis. A registered investment adviser to a pooled investment vehicle is not subject to the custody rule's account statement delivery requirement as long as the pooled investment vehicle is audited on an annual basis and distributes its audited financial statements to investors in the pool within 120 days following the end of its fiscal year.

Currently, in instances where the registered investment adviser knows that the qualified custodian does not send account statements directly to the adviser's clients, the adviser must provide quarterly account statements to each client and undergo an annual surprise examination by an independent public accountant. The surprise examination is designed to verify all client assets over which an adviser has custody and to reconcile all cash and securities to the books and records of client accounts maintained by the adviser. The results of the surprise examination must be reported to the SEC within 30 days of completion—or within one business day if any material discrepancies are found during the surprise examination. The current rule does not subject privately offered securities to these requirements.

SEC PROPOSED AMENDMENTS

Surprise Examination. The proposed amendments, if adopted, would require *all* registered investment advisers with custody of client assets (including advisers who are deemed to have custody through fee payment arrangements, advisers holding privately offered securities, and advisers to pooled investment vehicles) to undergo an annual surprise examination by an independent public accountant, regardless of whether a qualified custodian sends account statements directly to the adviser's clients or a pooled investment vehicle distributes its audited financial statements to its investors annually. The proposed amendments would eliminate the current rule's provision whereby an adviser may avoid an annual surprise examination if a qualified custodian sends account statements to the adviser's clients.

The proposed amendments would also require registered investment advisers to enter into a written agreement with an independent public accountant to conduct the surprise examination. The accountant would have 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 he or she has examined the funds and securities held in custody, and describing the nature and extent of the examination. In addition, the proposal would require that the written agreement require the accountant to submit Form ADV-E to the SEC within four business days of its resignation, dismissal, or other termination of the engagement, or upon removing itself or being removed from consideration for being reappointed, in each case accompanied by a statement explaining any problems relating to the examination, scope, or procedure that contributed to the event. The proposed rule would still require the accountant to report to the SEC within one business day any material discrepancies found.

Internal Control Report. The proposed amendments would require that where a registered investment adviser or an affiliate serves as the qualified custodian (as opposed to an independent qualified custodian), the registered investment adviser or the affiliate would have to obtain an internal control report (commonly known as a Type II SAS 70

Report) at least once per fiscal year from an independent public accountant that is subject to inspection by PCAOB. The report would require an opinion from the independent accountant with respect to the description of the internal controls of the registered investment adviser or the affiliate relating to the custody of client assets, including tests of operating effectiveness. Furthermore, the proposed amendments would require the registered investment adviser to retain such report for five years.

It should be noted that while the proposed amendments intend to promote the use of independent qualified custodians in an effort to prevent any conflict of interest when an adviser or its affiliate acts as custodian for client assets, the SEC's proposal does not require that all custodians be independent qualified custodians.

Account Statement Delivery. The proposed amendments would also require that all qualified custodians send account statements directly to the adviser's clients at least quarterly. Private pooled investment vehicles would be exempt from this requirement (as is currently the case) if the pooled investment vehicle satisfies certain audit requirements. The proposal would eliminate the current rule's alternative, under which an adviser with custody can send its own account statements to clients if the adviser is subject to an annual surprise examination. In an effort to ensure that account statements are sent out by qualified custodians, advisers would be required to conduct "due inquiry" in order to have a reasonable basis for believing that the qualified custodian is sending the account statements.

Further, where a registered investment adviser opens a custodial account for a client, it would be required to not only notify the client of the custodial arrangement but, under the proposals, also include a statement urging the client to compare the account statements provided by the custodian with those provided by the adviser.

Form ADV. The SEC proposals also affect Form ADV. Specifically, the amendments would require, among other things, that registered investment advisers (1) identify all affiliates that are broker-dealers and identify which, if any, serve as custodians for the adviser's clients, and (2) disclose the amount of client assets and the number of clients for which it or its affiliate has custody.

DISCUSSION

The proposed amendments are designed to provide more stringent safeguards for registered investment adviser and broker-dealer clients and their assets from being lost, misappropriated, or misused as demonstrated by the recent SEC enforcement actions alleging fraudulent conduct by registered investment advisers and broker-dealers.

The proposed amendments raise the following significant issues:

- Whether the independent accountant retained to conduct the surprise examination can be the same accountant that audits the accounts of the registered investment adviser's clients or the accountant that prepares the internal control report.

- Whether the term "material discrepancy" should be defined with respect to the surprise examination.

- Whether registered advisers should be subject to the proposed amendments simply because they deduct fees from client assets.

- Whether registered advisers should be required to disclose the names of their clients to custodians (resulting in the loss of client privacy) in connection with the delivery of account statements.

Jones Day will continue to monitor the proposed amendments and provide updates on any further SEC action taken on this topic.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Anthony L. Perricone
1.212.326.7871
aperricone@jonesday.com

John M. Saada
1.216.586.7089
johnmsaada@jonesday.com

Randall B. Schai
1.415.875.5803
rschai@jonesday.com

Stuart J. Chasanoff
1.214.969.3753
sjchasanoff@jonesday.com

David M. Mahle
1.212.326.3417
dmmahle@jonesday.com