The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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May 22, 2009

SEC Proposes Amendments to Investment Adviser Custody Rule; Conference Call Scheduled for June 4

[23481]

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TO: ACCOUNTING/TREASURERS COMMITTEE No. 9-09
INVESTMENT ADVISERS COMMITTEE No. 2-09
SEC RULES COMMITTEE No. 26-09 RE: SEC PROPOSES AMENDMENTS TO INVESTMENT ADVISER CUSTODY RULE; CONFERENCE CALL SCHEDULED FOR JUNE 4

The Securities and Exchange Commission has proposed amendments to Rule 206(4)-2 under the Investment Advisers Act of 1940, which governs custody arrangements for registered investment advisers. [1] The amendments, which are designed to provide additional safeguards under the Advisers Act, were proposed in response to several recent enforcement actions alleging fraudulent conduct, including misappropriation or other misuse of investor assets. The additional safeguards 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, when an adviser or an affiliate maintains client assets (rather than an independent qualified custodian), the adviser or affiliate must obtain, at least yearly, 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, the proposal would provide the SEC with more information about the custodial practices of registered investment advisers.

Comments on the proposal, which is briefly summarized below, are due to the SEC on or before July 28, 2009.

We have scheduled a conference call for Thursday, June 4, at 3:00 p.m. Eastern time to discuss the Institute's comment letter on the proposal. The dial-in number for the

conference call is 1-866-541-3298 and the passcode for the call is 6501781. If you plan to participate on the call, please contact Jennifer Odom by email at jodom@ici.org or by phone at 202-326-5833.

Annual Surprise Examination of Client Assets

The SEC proposes to require that all registered investment advisers with custody of client assets engage an independent public accountant to conduct an annual surprise examination of client assets 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 limited partners (or other investors) within 120 days of the end of its fiscal year. Specifically, the Release states that the independent public accountant conducting a surprise examination would independently verify all client funds and securities of which an adviser has custody, including those maintained with a qualified custodian and those that are not maintained with a qualified custodian, such as certain privately offered securities and mutual fund shares.

The proposal would require investment advisers subject to the rule 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. It also would 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 proposal would 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 under which the accountant was terminated.

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

Custody by Adviser and its Related Persons—Additional Requirements

The proposal 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. The Release explains that the proposed amendments would deem advisers whose “related persons” hold client assets to have custody under the rule if those assets are held by the related person in connection with the advisory services provided by the adviser. According to the Release, the “in connection with” limitation of the proposed rule is designed to prevent an adviser from being deemed to have custody of client assets held by a related person broker-dealer (or other qualified custodian) with respect to which the adviser does not provide advice.

The proposal also would require that when an adviser or a related person serves as a qualified custodian for client funds or securities in connection with advisory services

provided by the adviser to its clients, the adviser must obtain, or receive from the related person, at least yearly, a written report ("internal control report"), which 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 or its staff upon request. The Release explains that requiring advisers to obtain an internal control report would provide an additional check on the safeguards relating to client assets held by the adviser or the related person qualified custodian. The Release also explains that an internal control report could strengthen the utility of the surprise examination when the adviser or a related person custodian maintains client assets because the independent public accountant performing the surprise examination could obtain additional comfort that confirmations received from the qualified custodian in the course of the surprise examination are reliable.

In addition, the proposal would require that when an adviser or a related person serves as a qualified custodian for the adviser's clients' funds or securities, the surprise examination 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 Release explains that it is proposing this requirement because the SEC believes PCAOB registration and inspection will provide it greater confidence in the quality of the examination performed by the independent public accountant, which is even more important when an adviser or its related person, rather than an independent custodian, maintains client funds or securities.

The Release requests comment on all aspects of the proposal relating to when an adviser or a related person serves as a qualified custodian for the adviser's clients' funds or securities. In particular, the SEC requests comment on whether, as an alternative, it should simply amend Rule 206(4)-2 to require that an independent qualified custodian hold client assets. The Release states that the use of a custodian not affiliated with the adviser would address the conflict, and potentially greater risks to client assets, that may be presented when an adviser or its related person acts as custodian for client assets.

Delivery of Account Statements and Notice to Clients

The proposal would amend Rule 206(4)-2 to require registered advisers with custody of client funds or securities 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 amendment would eliminate the alternative, currently provided in the rule, under which an adviser can send reports to clients if it undergoes a surprise examination by an independent public accountant at least annually. The Release suggests that direct delivery will provide greater assurance of the integrity of those account statements. The proposal also would require that advisers relying on the qualified custodian to send account statements directly to clients form their reasonable belief that such account statements are sent after "due inquiry." The Release notes that there are a number of ways advisers could satisfy the "due inquiry" requirement, including if the qualified custodian provides the adviser with a copy of the account statement that was delivered to the client or if the qualified custodian confirms in writing each quarter that it has sent account statements to the adviser's clients.

The proposal also would revise the content of the notice advisers are currently required to

send to clients upon opening a custodial account on their behalf. Specifically, the proposal would require advisers to include a statement in the notice urging clients to compare the account statements they receive from the custodian with those they receive from the adviser. The Release suggests that client review of periodic account statements from the qualified custodian can enable clients to discover improper account transactions or other fraudulent activity.

Amendments to Form ADV

The SEC also is proposing several amendments to Part 1A and Schedule D of Form ADV. According to the Release, the amendments are designed to provide more complete information about the custody practices of registered advisers, and to provide the SEC with additional data to improve its ability to identify compliance risks.

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endnotes

[1] *See Custody of Funds or Securities of Clients by Investment Advisers,* SEC Release No. IA-2876 (May 20, 2009) (the "Release"), available on the SEC's website at http://sec.gov/rules/proposed/2009/ia-2876.pdf.