

MEMO# 14950

July 24, 2002

SEC PROPOSES AMENDMENTS TO THE CUSTODY RULE UNDER THE ADVISERS ACT

[14950] July 24, 2002 TO: INVESTMENT ADVISERS COMMITTEE No. 13-02 RE: SEC PROPOSES AMENDMENTS TO THE CUSTODY RULE UNDER THE ADVISERS ACT The Securities and Exchange Commission has proposed for comment substantial amendments to update and modernize Rule 206(4)-2 under the Investment Advisers Act, which governs custody by investment advisers.¹ The amendments, which are summarized below, are intended to provide greater transparency to the rule by incorporating into it no-action positions of the Commission; enhance investor protection; and remove unnecessary regulatory requirements (e.g., the requirement that advisers with custody provide customers a balance sheet). Comments on the proposed amendments must be filed with the SEC by Wednesday, September 25, 2002. The Institute will hold a conference call on Tuesday, August 6th at 3 p.m. to discuss the proposed amendments. If you are interested in participating in the call, please e-mail your contact information to Deborah Washington (Deborah@ici.org) by Friday, August 2nd. If you are unable to participate in the call, please provide your comments on the proposed amendments to the undersigned no later than Monday, August 5th. Comments may be submitted by phone (202-326-5825), fax (202-326-5839), or e-mail (tamara@ici.org).

I. DEFINITION OF "CUSTODY" The Commission has proposed to add to the rule the definition of "custody" currently found in the instructions to Form ADV. As such, the proposed definition would provide that an adviser has custody of client assets when it holds "directly or indirectly client funds or securities or [has] any authority to obtain possession of them." In addition, the Commission recognizes that, as a result of its issuance of numerous no-action and interpretive letters, advisers must review a "large body of letters" in addition to the rule itself to understand what arrangements constitute

1 See SEC Release No. IA-2044 (July 18, 2002) (the "Proposing Release"). The Proposing Release is available on the SEC's website, www.sec.gov. References in the memorandum to the Proposing Release are to the version available on the SEC's website.

2 custody for purposes of the rule. To address this, the Commission has proposed to add to the rule's definition of "custody" examples (taken from these no-action letters) that illustrate the application of the definition. In particular, the Commission has proposed to include three examples in the definition. The first example would clarify that an adviser has custody when it has any possession or control of client funds or securities, even temporarily. However, in recognition that an adviser may inadvertently receive client assets (e.g., when a third party sends funds or securities to a client via the adviser), the rule would expressly exclude inadvertent receipt by the adviser of client assets so long as the adviser returns them to the sender within one business day of receiving them. This example would also clarify that an adviser's possession of a check drawn by the client and made payable to

a third party will not be considered possession of client funds for purposes of the definition of "custody." The second example would clarify that an adviser has custody if it has the authority to withdraw funds or securities from a client's account, including withdrawals by the adviser to pay the client's advisory fees or other expenses. The third example would clarify that an adviser has custody if it is the legal owner of client assets or has access to those assets (e.g., when the adviser acts as both a general partner and investment adviser to a limited partnership).

II. USE OF QUALIFIED CUSTODIANS The Commission has proposed to require that both client funds and securities maintained by an adviser be held by a "qualified custodian" in an account in either the client's name or in the name of the adviser as agent or trustee for its clients.² As with the current rule, the adviser must notify the client in writing of the qualified custodian's name, address, and the manner in which the funds or securities are maintained. As proposed to be defined, "qualified custodian" would include: (1) a bank as defined in the Advisers Act; (2) a savings association as defined in the Federal Deposit Insurance Act; (3) a broker-dealer registered under the Securities Exchange Act that holds the client's assets in customer accounts; (4) a futures commission merchant registered under the Commodity Exchange Act that holds the client's assets in customer accounts; and (5) with respect to certain foreign securities, a financial institution that customarily holds financial assets in that country and that holds the client assets in customer accounts segregated from its proprietary assets. According to the Proposing Release, many advisers that are registered with the Commission (e.g., those that are also banks and broker-dealers) would be qualified custodians under the proposed rule. As such, under the proposal these advisers could maintain their own clients' assets, subject to certain proposed account statement requirements (summarized below) and the custody rules imposed by the regulators on the advisers' custodial functions. Advisers would also be able to maintain assets with affiliates that are qualified custodians.

III. DELIVERY OF ACCOUNT STATEMENTS TO CLIENTS Rule 206(4)-2 currently requires all advisers with custody to send clients quarterly account statements and to have a surprise annual examination conducted by an independent public accountant. The Commission has proposed to revise the rule to provide an alternative to these 2 requirements if the adviser has a reasonable basis for believing that the qualified custodian sends monthly account statements directly to each advisory client.³ These monthly statements from the qualified custodian must identify the amount of funds and of each security in the account at the end of the period and set forth all transactions in the account during the period. However, in recognition that this arrangement may not work in all custodial arrangements (e.g., when the adviser wants to protect its clients' identities), the Commission has proposed to retain the existing quarterly account statement and surprise annual examination requirements. In connection with the surprise annual audit examination, the rule would be amended to require (in addition to the accountant filing a certificate on Form ADV-E regarding the examination) that notice of any material discrepancies found during the examination are reported to the Commission's Office of Compliance Inspections and Examinations by fax or e-mail within one business day of the finding.

IV. EXEMPTIONS The Commission has proposed to exempt an adviser from the custody rule with respect to the account of any (1) registered investment company or (2) limited partnership that has its transactions and assets audited at least annually and distributes its audited financial statements prepared in accordance with generally accepted accounting principals to all limited partners within 90 days of the end of the partnership's fiscal year. The Commission has not proposed to retain the current exemption from the rule for advisers that are also broker-dealers.⁴ According to the Proposing Release, most registered broker-dealers that would be qualified custodians under the rule would already be in compliance with the proposed requirement to send monthly statements to their clients. As such, the proposed rule would not impose on these

broker-dealers any additional burdens from which they need to be provided an exemption.

V. ELIMINATION OF THE BALANCE SHEET REQUIREMENT The Commission has proposed to eliminate the requirement that an adviser that has custody of client assets include in its advisory brochure a balance sheet audited by an independent public accountant. In connection with eliminating this requirement, the Proposing Release notes that Rule 206(4)-4⁵ provides ample customer protection by warning clients when their assets may be at risk, thereby obviating the need for an adviser to provide clients a balance sheet detailing the adviser's financial condition. Tamara K. Reed Associate Counsel 3 The rule would, however, permit an adviser that is a general partner of a limited partnership to send the required account statements to the independent representative of each limited partner (or member or other beneficial owner) in lieu of sending them to the limited partner directly. See proposed Rule 206(4)-2(a)(3)(A)(iii). 4 See Rule 206(4)-2(b), which exempts advisers that are also broker-dealers from the custody rule if they are subject to and in compliance with the net capital requirements under Rule 15c3-1 under the Securities Exchange Act. 5 Rule 206(4)-4 requires an adviser to disclose to clients any financial condition that is reasonably likely to impair the adviser's ability to meet its contractual requirements to clients.