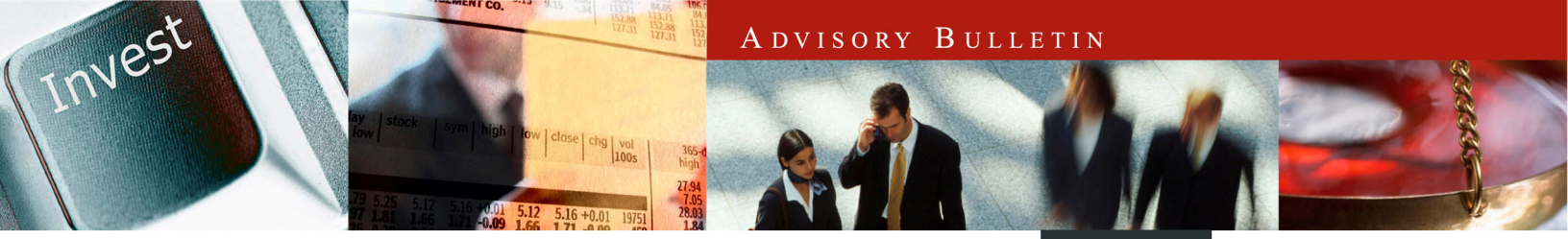

THOMPSON HINE

June 2009

INVESTMENT MANAGEMENT UPDATE

SEC Proposes Changes to the Investment Adviser Act Custody Rule

On May 20, the Securities and Exchange Commission (SEC) announced proposed amendments to Rule 206(4)-2 ("Custody Rule") of the Investment Advisers Act of 1940 ("Investment Advisers Act").[1] The comment period for the proposed amendments closes on July 28, 2009. In a press release announcing the proposed rule amendments, SEC Chair Mary Schapiro stated that the amendments "are designed to decrease the likelihood that an investment adviser could misappropriate a client's assets and go undetected."[2] The press release noted that unlike other financial institutions, investment advisers do not generally retain physical custody of their clients' assets. Rather, the clients' assets are retained by "qualified custodians," usually a bank or registered broker-dealer. However, under the Investment Advisers Act, an investment adviser may nonetheless be deemed to have custody of client assets because of its ability to withdraw client funds or because the qualified custodian is affiliated with the investment adviser and thereby the investment adviser has indirect access to the clients' assets. There is little question that the proposed amendments to the Custody Rule are a direct result of the Ponzi scheme in which Bernard Madoff was able to hide his illegal activities by using his firm as the custodian for his clients' accounts and providing limited access to information regarding the accounts to third parties. The proposed amendments seek to make independent public accountants the third-party monitors of adviser custody arrangements.

The proposed rule amendments, if adopted, would make the following changes to the Custody Rule:

- Investment advisers deemed to have custody of client assets would be subject to an annual surprise inspection conducted by an independent public accountant;
- In cases where an investment adviser has custody of client assets, the qualified custodian holding the assets would be required to deliver quarterly account statements to the investment adviser's clients directly;
- Investment advisers providing advice to clients would be deemed to have custody of a client's assets if a related person of the investment adviser has access to or custody of the client's assets; and
- In cases where the investment adviser is acting as the qualified custodian for client assets, the adviser would be required to obtain an annual internal control letter, such as a Type II SAS 70 Report, issued by an independent public accountant.

ANNUAL SURPRISE INSPECTIONS

The proposed amendments to the Custody Rule would require that all investment advisers with custody of clients' assets hire an independent public accountant to conduct an annual surprise

© 2009 THOMPSON HINE LLP. ALL RIGHTS RESERVED.

ATTORNEY ADVERTISING

inspection of the client accounts, whether maintained by a qualified custodian or not. The purpose of the surprise inspection would be to verify the existence of the assets in the client accounts, reconcile the information regarding the accounts with the books and records of the investment adviser and reconcile information contained in client account statements with the books and records of the investment adviser. Although the requirement that all investment advisers be subject to surprise inspections was part of the Custody Rule as originally adopted, amendments to the Custody Rule in 2003 created three exceptions to the surprise examination requirement.[3] The proposed changes would eliminate these exceptions.

Additionally, the investment adviser would be required to enter into a written agreement with an independent public accounting firm to perform the annual surprise inspections. The independent public accounting firm would be required to file mandated forms with the SEC regarding the inspections or in the event of termination of the accounting firm in order for the SEC to be promptly alerted in the event of any discrepancy discovered during the inspections or, in the event of any termination of an accounting firm, alerted to potential disagreements between the adviser and the independent public accountant regarding the custodial arrangements.

Quarterly Statements

The proposed amendments to the Custody Rule also require that the qualified custodians send client account statements to the investment adviser's clients directly. Furthermore, the proposed amendments require that the investment adviser must satisfy itself that the qualified custodian is sending client statements at least on a quarterly basis. The investment adviser may accomplish this task either by obtaining copies of the account statements or by obtaining a certification from the qualified custodian that such statements were sent by the qualified custodian. The proposed amendments would eliminate an existing alternative under the Custody Rule that permits an adviser to send account statements directly to clients if the adviser undergoes an annual surprise inspection by an independent public accounting firm. The SEC stated in the proposing release that direct delivery of statements to clients by the qualified custodian provides the "greatest assurance of integrity" of the information contained in the statements. In addition, investment advisers would be required to advise their clients, upon opening an account, that the clients should carefully compare account statements provided by the investment adviser (if any) with the statements provided by the qualified custodian. The SEC noted that this proposed requirement would make it more difficult for rogue investment advisers to falsify account statements and make it more likely that discrepancies, whether intentional or accidental, would be detected.

It should, however, be noted that while other provisions of the proposed amendments apply to investment advisers of pooled investment vehicles (including hedge funds), the requirement for qualified custodian delivery of account statements would not apply to pooled investment vehicles if the pooled investment vehicle is audited annually by an independent public accounting firm and the audited financial statements are distributed to the pooled vehicle's investors within 120 days (or 180 days in the case of a pooled vehicle acting as a fund of funds) of the vehicle's fiscal year end.

Related Party Custody

Under the current Custody Rule, the SEC has stated that an investment adviser is deemed to have custody of a client's assets if it holds, directly or indirectly, client assets or has the authority to obtain possession of the client's assets. Many times an investment adviser has the authority to deduct its fees from the client's account, write checks against the client's account or otherwise has authority to withdraw funds or access securities in a client's account, such as when the adviser is a general partner in a partnership. The proposed amendment would expand what constitutes custody by including those situations where a related person of the investment adviser holds directly or indirectly, client assets for which the investment adviser provides investment advice. The proposal defines a "related person" as anyone who controls, is controlled by or is under common control with the investment adviser. This proposed amendment extends the current interpretations of the Custody Rule that establish a presumption that the investment adviser *may* be deemed to have custody of the assets held by an affiliate, to a situation where the investment adviser is *automatically* deemed to have custody of assets held by an affiliate, provided the investment adviser provides investment advice related to the assets.

Internal Control Letter

The proposed amendments to the Custody Rule would also require investment advisers (and related parties of the investment adviser) who do not maintain assets with a qualified custodian to obtain an annual report from an independent public accountant regarding the firm's internal controls. The report would be required to be prepared in accordance with the standards established by the U.S. Public Company Accounting Oversight Board (PCAOB). According to the proposed amendments, the report must contain a description of the controls in place related to custodial services as well as an opinion of the independent public accountant as to the effectiveness of those controls. The SEC stated in the proposing release that a Type II SAS-70 report would be sufficient for purposes of complying with the proposed amendment to the Custody Rule.

Additional Proposals and Request for Comments

The release also proposed changes to Form ADV and Form ADV-E necessary to comply with the proposed amendments. Also, the SEC proposed that with regard to pooled investment vehicles that rely on the annual audit exemption for quarterly statement, that a final audit also be obtained at the time of liquidation (if other than at the end of the fiscal year) to assure the liquidated proceeds are accurate and appropriately accounted for.

As part of the proposing release the SEC specifically solicited comments on five issues. First, have the custodial practices of investment advisers changed such that the SEC should reconsider its previous guidance regarding surprise custodial inspections? Second, should the surprise inspections also assess the valuation of securities held in custodial accounts? Third, should the same independent public accounting firm be permitted to perform the surprise inspection and review the internal controls of the adviser or custodian? Fourth, do the requirements that the accounting firms register

with and issue reports consistent with PCAOB guidelines make the inspections too cumbersome or expensive? And fifth, should the Custody Rule mandate delivery of the surprise inspection certificate to investors in pooled investments?

Conclusions

As stated earlier, the comment period for the proposed amendments ends July 28, 2009. The initial comments received are mostly opposed to the proposals, specifically regarding the surprise inspections. While many of the comments are from individuals involved in financial planning or investment advisory businesses, most suggest that implementation of the proposed amendments would be unduly burdensome and costly for smaller advisers and financial planners who deduct fees from client accounts. Additionally, many note that certain qualified custodians used by a large majority of the financial planners and investment advisers report any deduction of fees in monthly statements that are sent to clients. Most of those submitting comments suggested this model as it currently exists is adequate to deter, or at a minimum, record, illegal conduct regarding client assets.

For More Information

For more information, please contact:

Michael V. Wible	614.469.3297	**Michael.Wible@ThompsonHine.com**
Richard S. Heller	212.908.3907	**Richard.Heller@ThompsonHine.com**
James P. Jalil	212.908.3976	**James.Jalil@ThompsonHine.com**
Donald S. Mendelsohn	513.352.6546	**Don.Mendelsohn@ThompsonHine.com**
JoAnn M. Strasser	513.352.6725	**JoAnn.Strasser@ThompsonHine.com**
Marc L. Collins	513.352.6774	**Marc.Collins@ThompsonHine.com**

If you do not wish to receive future communications by email, please reply to this email with "unsubscribe" in the subject line.

This advisory bulletin may be reproduced, in whole or in part, with the prior permission of Thompson Hine LLP and acknowledgement of its source and copyright. This publication is intended to inform clients about legal matters of current interest. It is not intended as legal advice. Readers should not act upon the information contained in it without professional counsel.

This document may be considered attorney advertising in some jurisdictions. Some of the design images and photographs in this document may be of actors depicting fictional scenes.

© 2009 THOMPSON HINE LLP. ALL RIGHTS RESERVED.

---

[1] The text of the proposed rule changes can be found on the Securities and Exchange Commission's web site at www.sec.gov/rules/proposed/2009/ia-2876.pdf.

[2] See Securities and Exchange Commission Press Release 2009-109, *SEC Proposes Rule Amendments to Strengthen Safeguards of Investor Funds Controlled by Investment Advisers.*

[3] The exceptions from the private inspection requirement include those investment advisers that have a reasonable basis to believe that the qualified custodian that has custody of their client's assets is providing account statements directly to the clients; investment advisers to pooled investment vehicles that have an annual audit and distribute the annual audit results to investors; and investment advisers holding accounts that contain private placement securities (although the exception applies only to the private placements).