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## Amendments to the Investment Advisers Act Custody Rule Will Impact Registered Timberland Investment Managers

In December 2009, the Securities and Exchange Commission (“SEC”) amended Rule 206(4)-2 (the “Custody Rule”) and related rules under the Investment Advisers Act of 1940, as amended (the “Advisers Act”), to strengthen controls over the custody of client assets by registered investment advisers. Under the Custody Rule, a registered investment adviser must, in most cases, maintain client funds and securities with a “qualified custodian,” such as a bank or a registered broker-dealer. While the amendments to the Custody Rule and related provisions will impact all timberland investment managers (“TIMOs”) that are registered investment advisers under the Advisers Act, TIMOs that advise “separate account” clients on their timberland investments will be more significantly impacted by these amendments than TIMOs that advise only pooled investment funds.

### Effect on Separate Account Business

The amendments require a TIMO that has custody of separate account client funds or securities (1) to undergo an annual surprise examination by an independent public accountant to verify client assets and (2) to have the qualified custodian maintaining the client funds or securities send account statements directly to the client.

### Annual Surprise Examination of Client Assets

The amended Custody Rule requires a TIMO having custody of separate account client funds or securities to undergo an annual surprise examination of those assets by an independent public accountant, subject to a limited exception in the case of a TIMO having custody of separate account client assets *solely* because it has the authority to deduct advisory fees from the client account. Any TIMO subject to the annual surprise examination requirement must enter into a written agreement with an independent public accountant to provide that the first examination will take place no later than December 31, 2010. The agreement must require the accountant to notify the SEC within one business day of discovering any material discrepancy during the course of the examination and to submit Form ADV-E to the SEC within 120 days of the time chosen by the accountant for the surprise examination, accompanied by the accountant’s certificate stating that the accountant has examined the separate account client’s funds and securities and describing the nature and extent of the examination.

### Delivery of Account Statements and Notice to Client

The amended Custody Rule requires a TIMO having custody of separate account client funds or securities maintained by a qualified custodian to reasonably believe, after due inquiry, that the custodian sends an account statement, at least quarterly, *directly* to each client for which the custodian maintains funds or securities. The SEC declined to specify a single method for satisfying the “due inquiry” requirement; however, the SEC did indicate that a TIMO could form a reasonable belief after due inquiry if the custodian provides the TIMO with a copy of the account statement that was provided to the client.

Currently, the Custody Rule requires a TIMO to notify a separate account client promptly upon the TIMO’s opening of a custodial account on the client’s behalf and upon any change in the information set out in the initial notice. The amendments to the Custody Rule require a TIMO, if the TIMO sends its own account statements to the client, to include a legend in any such notice urging the client to compare the account statements it receives from the custodian with those that it receives from the TIMO. In addition, if a TIMO sends its own account statements to the

client in addition to the account statements sent by the custodian directly to the client, the TIMO must include a legend urging the client to compare the two forms of statement.<sup>1</sup>

## Additional Requirements for Certain TIMOs

The amendments to the Custody Rule impose additional obligations on a TIMO if it or a related person serves as the qualified custodian for a separate account client's funds or securities. Most notably, any such TIMO must obtain an annual report on the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board (the "PCAOB"), subject to limited exceptions. For example, this requirement would be triggered if a TIMO affiliated with a bank held client funds in accounts at the affiliated bank, unless the TIMO can establish that it is "operationally independent" of the affiliated custodial bank.

## Effect on Pooled Investment Business

Under the amended Custody Rule, a TIMO, in its capacity as an adviser to a pooled investment vehicle, is also subject to the annual surprise examination requirement with respect to the pool's assets; however, the amended Custody Rule deems such a TIMO to have complied with the requirement if it obtains an annual audit of the pooled investment vehicle and distributes audited financial statements to the pool's investors within 120 days of the pool's fiscal year end.<sup>2</sup> The audit must be conducted by an accounting firm registered with, and subject to regular inspection by, the PCAOB. Accordingly, to benefit from this exemption from the annual surprise examination requirement, a TIMO serving in its capacity as an adviser to a pooled investment vehicle must engage a PCAOB registered accounting firm to conduct the annual audit and be vigilant in complying with the 120-day audited financial statement delivery requirement. Any TIMO that relies on the audit exemption in its capacity as an adviser to a pooled investment vehicle must also obtain an audit upon liquidation of the pool and distribute audited financial statements to the pool's investors "promptly" after completion of the audit.

## Forms ADV and ADV-E

In connection with the amendments to the Custody Rule, the SEC also adopted amendments to Form ADV to require registered investment advisers to report more detailed information about their custody practices and to Form ADV-E to conform to the changes made to the Custody Rule. Registered investment advisers must provide responses to the revised Form ADV in their first annual amendment after January 1, 2011.

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<sup>1</sup> In the typical case, a TIMO will send a separate account client a quarterly statement/report that sets forth the current fair market value of the client's timberland holdings, as well as cash balances held by the TIMO in the custodial bank accounts. In that case, the TIMO would be required to include the specified legend in any notice relating to the opening of or change in a custodial account for that client and in any account statement that the TIMO sends to the client.

<sup>2</sup> Since the governing agreements of most pooled investment vehicles require sponsors to deliver audited financial statements to investors, for ease of illustration we previously characterized the annual surprise examination rule as applying to a TIMO only in its capacity as an adviser to separate account clients. As discussed above, this technically is not correct. If a TIMO in its capacity as an adviser to a pooled investment vehicle does not obtain the required audit or distribute audited financial statements to the pool's investors, the TIMO must satisfy the annual surprise examination requirement and have a reasonable basis, after due inquiry, to believe that each qualified custodian of the pool's assets sends an account statement, at least quarterly, directly to the pool's investors. Similarly, any TIMO in its capacity as an adviser to a pooled investment vehicle that itself or through a related person serves as a qualified custodian of the pool's assets must obtain an annual report on the internal controls relating to those assets.

## Effective Date

The amended Custody Rule will become effective 60 days after publication in the Federal Register, which has yet to occur; however, TIMOs should assume that the amended Custody Rule will become effective in early March 2010. After that date, TIMOs having custody of separate account client assets must comply with the account statement delivery and notice/legend requirements, and, as stated previously, must undergo a surprise examination no later than December 31, 2010.

## Compliance Policies and Procedures

Rule 206(4)-7 under the Advisers Act requires TIMOs that are registered investment advisers under the Advisers Act to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules. In connection with the adoption of the amendments to the Custody Rule, the SEC provided guidance regarding the types of policies and procedures relating to the safekeeping of client assets that advisers should consider including in their compliance programs. Attached as [Annex A](#) are policies and procedures that the SEC suggested registered investment advisers consider as part of their compliance programs. The SEC also urged advisers to develop procedures by which each adviser's chief compliance officer periodically tests the effectiveness of the adviser's controls over the safekeeping of clients assets.

## Application

This Legal Alert is a brief summary of the amended Custody Rule and its potential affect on TIMOs that are registered investment advisers under the Advisers Act generally, and does not address the application of the amended Custody Rule to any particular TIMO or set of facts. In particular, certain pooled investment structures, to the extent they employ parallel investment vehicles or REIT subsidiaries, will have to be reviewed carefully to ensure that the TIMO complies with the audit exemption to the annual surprise examination requirement, assuming that is desired.



*If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.*

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