

# Investment Adviser Newsletter

July 2009

## Proposed Amendments to Custody Rule

The fallout from the Bernard Madoff scandal continues. On May 14, 2009, the Securities and Exchange Commission ("SEC") proposed additional safeguards designed to minimize the potential for abuse of client funds by investment advisers with custody. Typically, advisers do not have physical custody but are deemed to have custody if they have the authority to withdraw client funds held by the qualified custodian or if they are affiliated with the qualified custodian. The proposed amendments are summarized below. The SEC is requesting comments by July 28, 2009.

### ✓ Audit Requirements.

For all advisers with custody, the SEC has proposed an annual examination by an independent public accountant conducted on a surprise basis to verify client assets. This requirement would apply to advisers who have custody solely because they are authorized to deduct advisory fees directly from clients' account, or to advisers that act as general partners to pooled investment vehicles in which clients invest. Under the proposed regulations, where advisers or their affiliates act as "qualified custodians" for a client's assets under management, the adviser must be examined by a PCAOB-registered accountant, who will issue a SAS-70 report. A SAS-70 report describes the adviser's controls, the tests conducted to evaluate the effectiveness of those controls, and the results of those tests.

### ✓ New Reporting Obligations.

Under the proposal, the adviser would be required to disclose in public filings the identity of the independent public accountant performing the surprise examination and amend its filings to report if the adviser changes accountants. The accountant also would have to report the termination of its engagement with the adviser and any problems with the examination that led to the termination. Also, if the accountants find any material discrepancies during the surprise examination, they would have to report them to the SEC.

### ✓ New Operational Requirements.

The proposed amendments would require that custodians holding advisory client assets deliver custodial statements directly to advisory clients. Advisers opening custodial accounts for clients would be required to instruct those clients to compare account statements they receive from the custodian with those received from the adviser.

## NEW EXAM PRACTICE

The SEC's Office of Compliance Inspection and Examinations ("OCIE") has stated that the OCIE's staff will verify the existence of client assets managed by the adviser as part of its standard adviser examination. OCIE examiners will focus on smaller firms, advisers that are engaged in riskier ventures, and advisers with improperly segregated accounts. To verify assets, the staff will test a sample of client accounts on a specific date by requesting confirmation of assets and transactions from independent third parties including, but not limited to, banks, broker-dealer custodians, administrators, auditors, the adviser's clients, and investors in hedge funds managed by the adviser. Earlier this month, John Walsh, OCIE's Chief Counsel announced that the SEC staff may contact advisory clients directly to verify account information. A copy of the verification letter that the SEC staff sends to clients is available online at: [http://www.sec.gov/about/offices/ocie/routine\\_account\\_information\\_confirmation.pdf](http://www.sec.gov/about/offices/ocie/routine_account_information_confirmation.pdf)

## Information about our attorneys

Our Investment and Financial Services Group represents various financial services companies, including investment advisers, financial planners, broker/dealers, and registered investment companies with respect to federal and state regulations, FINRA and SEC registration, compliance and enforcement issues. We also represent investment advisers and institutional investors in connection with investments in private equity, venture capital, real estate and hedge funds.

Please contact the Investment and Financial Services Group with any questions you may have related to topics discussed in this newsletter.

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