SEC Proposes Amendments to Enhance Custody Rules for Investment Advisers

May 18, 2009

THE FOLEY ADVISER - MAY 18, 2009

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On May 14, 2009, the Securities and Exchange Commission ("SEC" or the "Commission") proposed rule amendments which are intended to substantially increase protections for investors who allow investment advisers to have custody over their assets. The SEC's proposed rule amendments would promote independent custody and enable independent public accountants to act as third-party monitors. The SEC is seeking public comment on the proposals.

As background, investment advisers generally do not have physical custody of their clients' funds or securities. Instead, client assets are typically maintained with a broker-dealer or bank (the "**Qualified Custodian**"), but the adviser still may be deemed to have custody because the adviser has authority to withdraw its clients' funds held by the Qualified Custodian. In other circumstances, the Qualified Custodian may be affiliated with the adviser, which may give the adviser indirect access to client funds.

One proposed rule amendment would require all registered advisers with custody of client assets to undergo an annual "surprise exam" by an independent public accountant to verify those assets exist.

Another proposed rule amendment would apply to investment advisers whose client assets are not held or controlled by a firm independent of the adviser. In such cases, the investment adviser will be required to obtain a written report, prepared by a PCAOB-registered and inspected accountant, that, among other things:

(i) describes the controls in place with respect to custody;

(ii) tests the operating effectiveness of those controls; and

(iii) provides the results of those tests.

These reports are commonly known as SAS-70 reports. This review would have to meet PCAOB standards.

The proposed rule amendments also would include reporting requirements designed to alert the SEC staff and investors to potential problems at an adviser, and provide the Commission with information for risk assessment purposes. An adviser would be required to disclose in public filings with the Commission: (i) the identity of the independent public accountant that

performs its “surprise exam;” and (ii) amend its filings to report if the adviser changes accountants. In addition, the accountant would have to report the termination of its engagement with the adviser and, if applicable, any problems with the examination that led to the termination of its engagement. If the accountants find any material discrepancies during the surprise examination, they would have to report them to the Commission.

Furthermore, the proposed rule amendments would require that all custodians holding advisory client assets directly deliver custodial statements to advisory clients rather than through the investment adviser, and that advisers opening custody accounts for clients instruct those clients to compare account statements they receive from the custodian with those received from the adviser. These additional safeguards are intended to make it more difficult for an adviser to prepare false account statements, and more likely that clients would find discrepancies.

Investment advisers with questions about the proposed rule amendments should contact Peter Rosenblum or Jeffrey Collins in Foley Hoag’s Investment Management Group at 617 832 1000.