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Securities and Exchange Commission Votes to Amend the Custody Rule

January 13, 2010

On December 16, 2009, the Securities and Exchange Commission (the **"SEC"**) voted unanimously to amend Rule 206(4)-2 (the **"Custody Rule"**) under the Investment Advisers Act of 1940, as amended. The amendments approved by the SEC are intended to address recently disclosed misappropriations of client assets by registered investment advisers and restore public confidence in the investment advisory industry and the SEC. We previously analyzed the SEC's proposed amendments to the Custody Rule in an O'Melveny & Myers Client Alert dated June 2, 2009 (Click to read "SEC Proposes Changes to the Custody Rule that Go Too Far; Impose Significant Costs and Fail to Address Shortcomings in the Existing Rule," a June 2009 O'Melveny Client Alert) (the **"Proposed Amendments"**).

Although the SEC has not yet published the adopting release for the Custody Rule, it appears based on the open Commission meeting on December 16, 2009 that the following will be included in the Custody Rule. We will update this alert once the adopting release is available.

Surprise Annual Audit

Under the Proposed Amendments, all registered investment advisers with custody[1] of client funds or securities (including advisers that are dually registered as broker-dealers and may act as qualified custodians for their client assets) would have been required to engage an independent public

accountant to conduct an annual surprise audit of client accounts. If the investment adviser or a related person (e.g., an affiliate of the adviser) maintains client assets as a qualified custodian, the surprise audit would have to have been performed by an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (**"PCAOB"**).

Based on the discussion of the amendments to the Custody Rule during the SEC's meeting yesterday, it appears that the Custody Rule will provide for three exceptions to the annual surprise audit requirement, as described below:

- **Exception for Advisers that Are "Operationally Independent" from Affiliated Custodian:** The exact scope of this exception was not made clear during yesterday's meeting, but it appears to be an exception from the requirement to obtain a surprise audit. However, it appears that a rebuttable presumption would be imposed on the registered adviser to prove it is operationally independent from its affiliated qualified custodian. [2]

- **Exception for Advisers with Limited Custody:** In the event a registered investment adviser uses a third party qualified custodian and its only access to client funds and securities is the ability to deduct advisory fees, the Custody Rule may not require an annual surprise audit. However, the adopting release may identify controls and procedures related to advisory fee deduction that registered investment advisers should adopt, and the Chairman stated that review of advisory fee deduction will be a top priority during staff examinations.

- **Exception for Advisers to Pooled Investment Vehicles:** Advisers to pooled investment vehicles that obtain an audit of those vehicles from an independent public accountant registered, and subject to oversight by the PCAOB may not be subject to an annual surprise audit.

In addition, the SEC indicated that it will consider further amendments to require public disclosure by registered investment advisers regarding the use of affiliated qualified custodians and auditors performing surprise audits so the quality of custody arrangements and controls over client assets can be better monitored. It appears that the SEC will also require auditors who cease to provide services to a registered investment adviser to engage in a "noisy withdrawal" by explaining to the SEC the reason for the termination of the relationship. Finally, the SEC expects to issue an interpretive release to provide guidance to accountants on conducting surprise audits and issuing internal controls reports.

The amendments to the Custody Rule will become effective 60 days after their publication in the Federal Register.

If you have any questions, please contact Chris Salter at (202) 383-5371 or Peter Vaglio at (212) 326-2164.

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[1] The Custody Rule defines “custody” broadly and contemplates situations in which the adviser has only constructive custody over client assets. An adviser has custody over client assets (i) when it has physical possession of client assets (e.g., the adviser holds a client’s stock certificates), (ii) through an arrangement (e.g., a power of attorney) whereby the adviser is authorized to withdraw client assets maintained with a qualified custodian or deduct advisory fees or other expenses from client accounts maintained with a qualified custodian, or (iii) through a legal capacity or relationship of the adviser or a supervised person of the adviser (e.g., the general partner of a partnership).

[2] The SEC Staff indicated that a qualified custodian and an adviser would be “operationally independent” if they do not have any overlap of personnel, office space, or supervision.