

Increasing Safeguards to Protect Investors

Investment Advisers Act – Revised Custody Rule 206

Agenda

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Overview

Background

On December 30, 2009, the SEC issued an amendment to Investment Advisers Act Rule 206(4)-2 (“the Rule”). A series of fraud cases/Ponzi schemes had caused the SEC to undertake a comprehensive review of client-asset safekeeping in order to decrease the likelihood of misappropriation and increase chances for earlier detection of fraudulent activity.

The main thrust of the amended Rule is to provide more transparency to clients and regulators, improve oversight through independent testing, and increase the controls for registered advisers that maintain custody of client assets.

Overview

Summary of the Rule

The amendments to the Rule apply to investment advisers who are **registered** with the SEC and have “**custody**” of client assets (i.e., securities or funds) and are effective March 12, 2010. Advisers may reside within various types of financial services companies including asset management firms, banks, insurance companies and broker-dealers.

Key requirements of the rule include the following:

- The adviser will be subject to an annual **surprise exam** (“securities count”) to verify the existence of assets unless certain exception criteria are met (Effective date: Examination must take place by December 31, 2010)
- The adviser must obtain or receive an **internal control report** from an independent accountant who is registered with the PCAOB, if the registered adviser is the qualified custodian or if the registered adviser’s qualified custodian is a related person (Effective date: September 12, 2010)
- The adviser must perform due inquiry to ascertain that the qualified custodian is delivering **statements**, at least quarterly, directly to clients, and the registered adviser must also provide clients written notification urging clients to compare the account statements received from the registered adviser to those received from the qualified custodian (Effective date: March 12, 2010)
- Amendments to Form ADV will require registered advisers to report additional information about custody of client assets and involvement of independent public accountants to the SEC and the public
- **The adviser is not required to comply with the Rule with respect to Registered Investment Company accounts (“mutual funds”)**

Overview

Important definitions*

Custody – The adviser or related person holds client funds or securities directly or has any authority to obtain possession of them. (Examples of the latter include trustee responsibilities, power of attorney, ability to write checks).

Qualified Custodian – Bank, or savings association, broker-dealer or futures commission merchant holding assets in customer accounts, or foreign financial institution that customarily holds client assets in segregated accounts.

Control – Power to direct the management or policies of another.

Related Person – Person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser.

Operationally Independent – Client assets are not subject to claims of the adviser's creditors, advisory personnel do not have custody, control, or access, and the adviser and custodian do not share supervision, personnel, or premises. Related custodians are presumed NOT to be operationally independent; adviser must prepare written summary with support of independence.

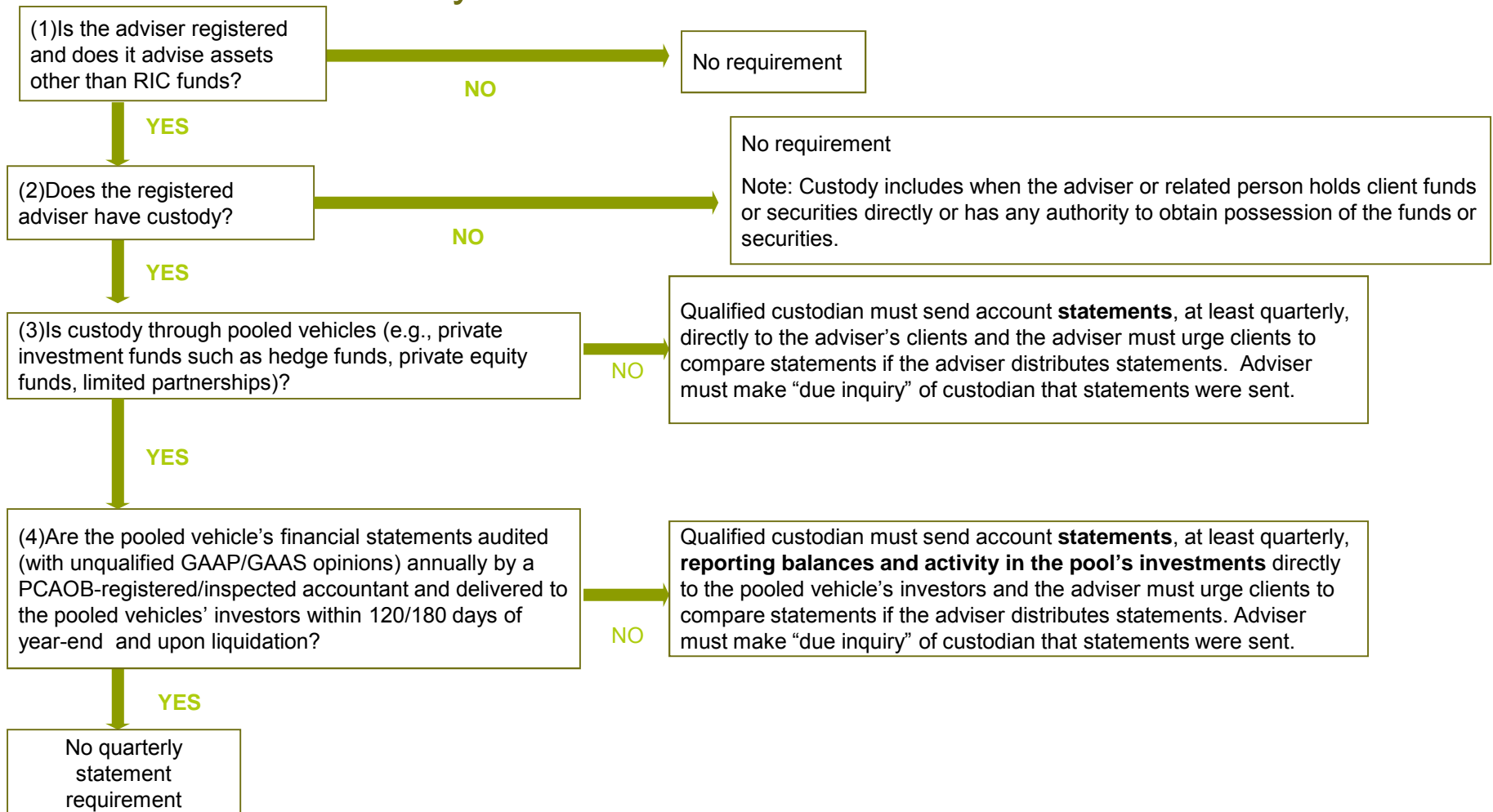
Independent Public Accountant – Accountant subject to SEC independence standards.

*Note: The above definitions are summarized versions of those referenced in the Rule. Refer to Rule 206(4)-2 for complete definitions.

Scope of Amended Rule

Decision tree for applicability of requirements

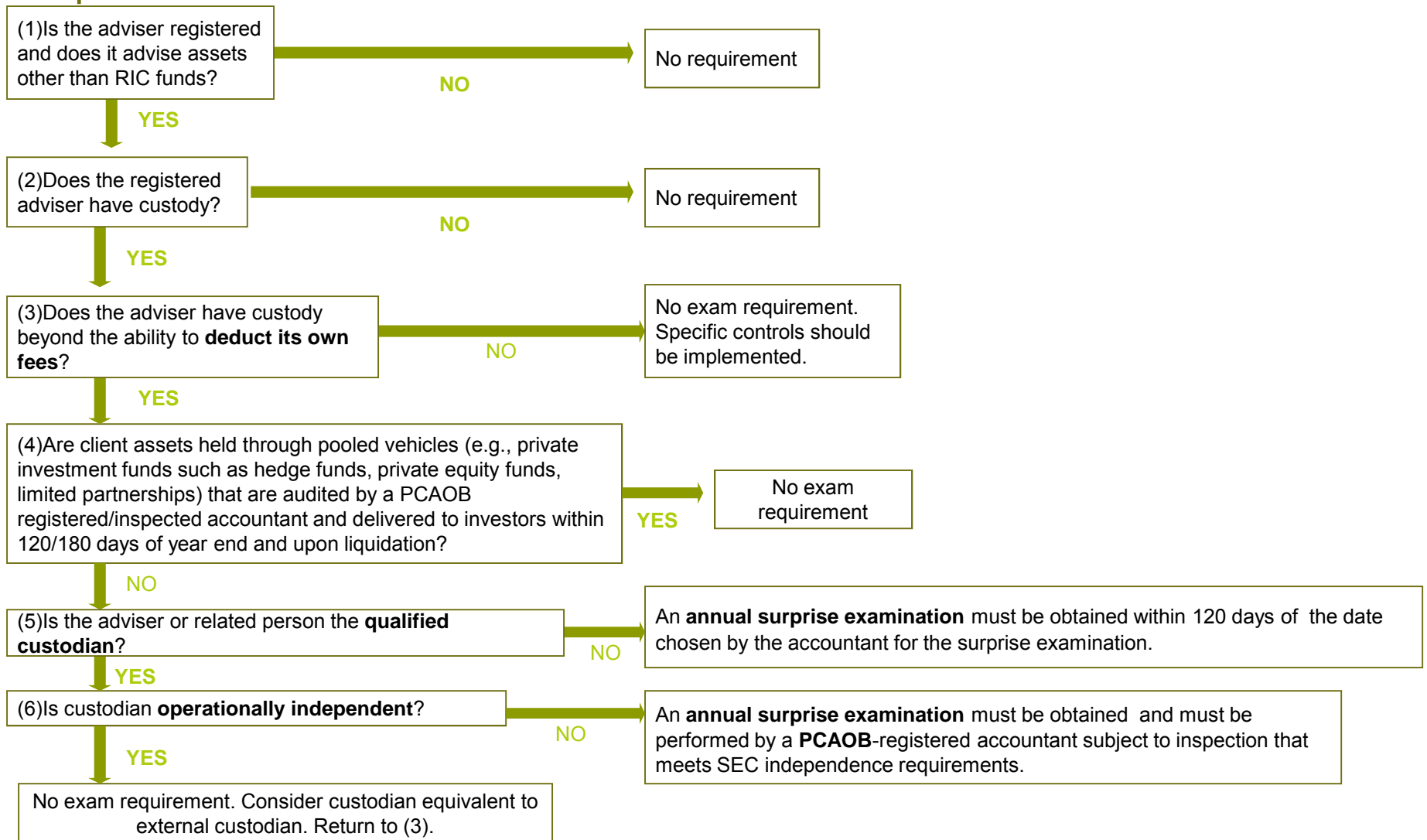
Notification and delivery of account statements



Scope of Amended Rule

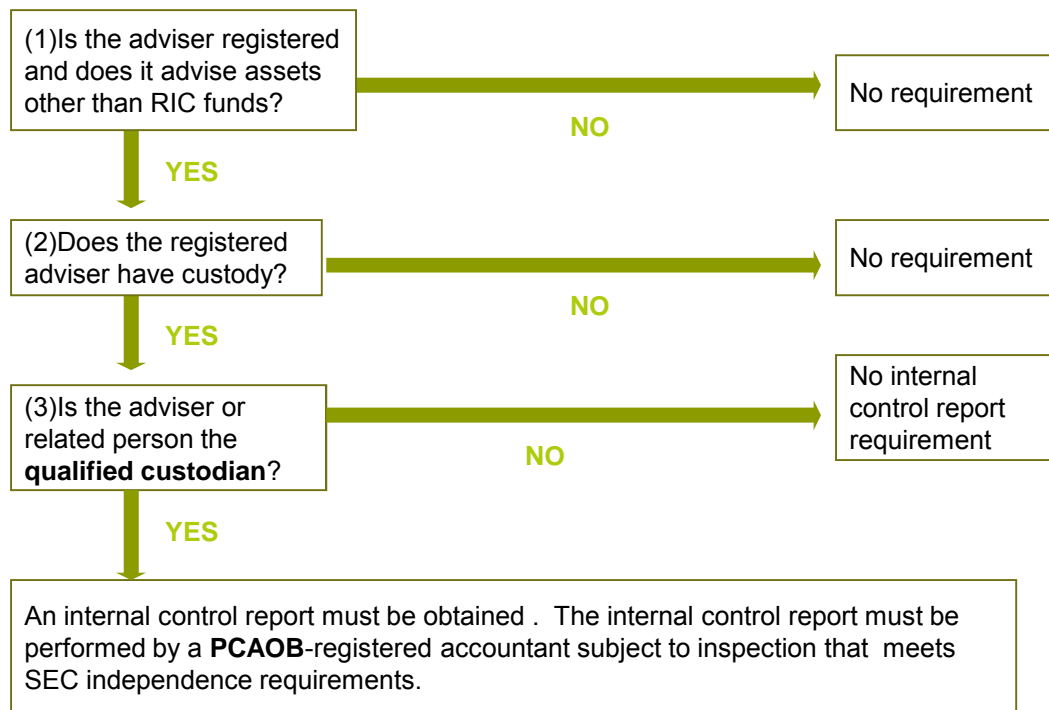
Decision tree for applicability of requirements

Surprise Examination



Scope of Amended Rule

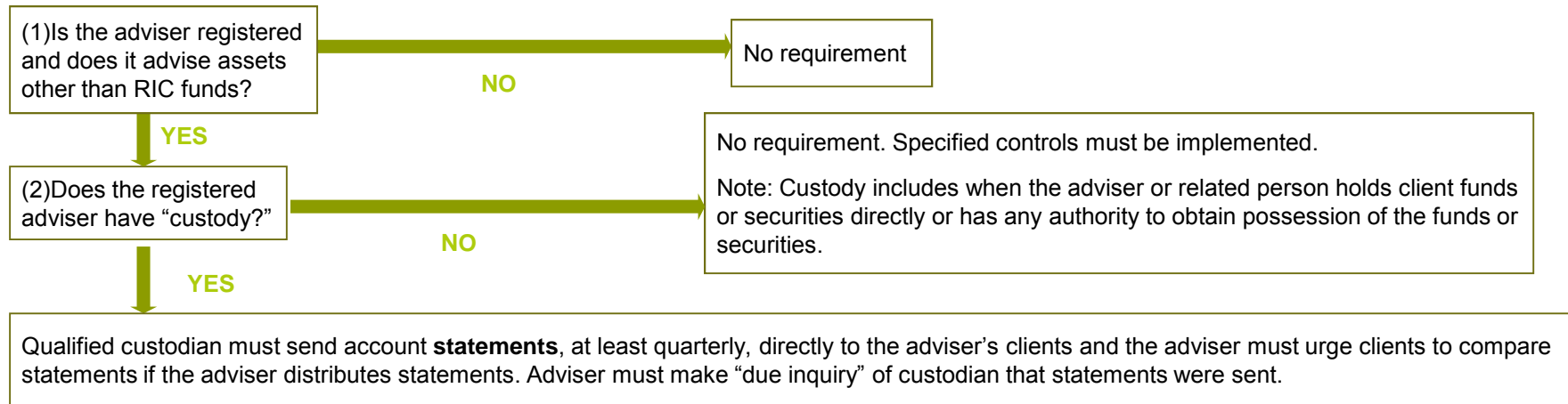
Decision tree for applicability of requirements Internal Control Report



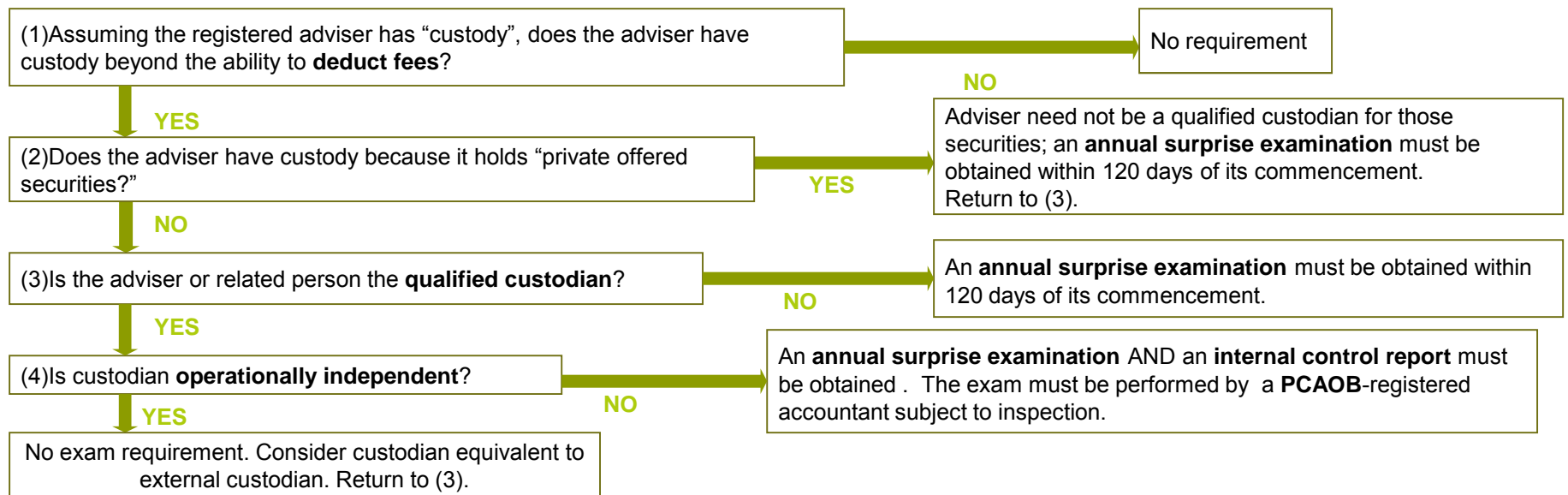
Scope of Amended Rule

Scenario: Assets held through managed accounts

Step #1: Statements

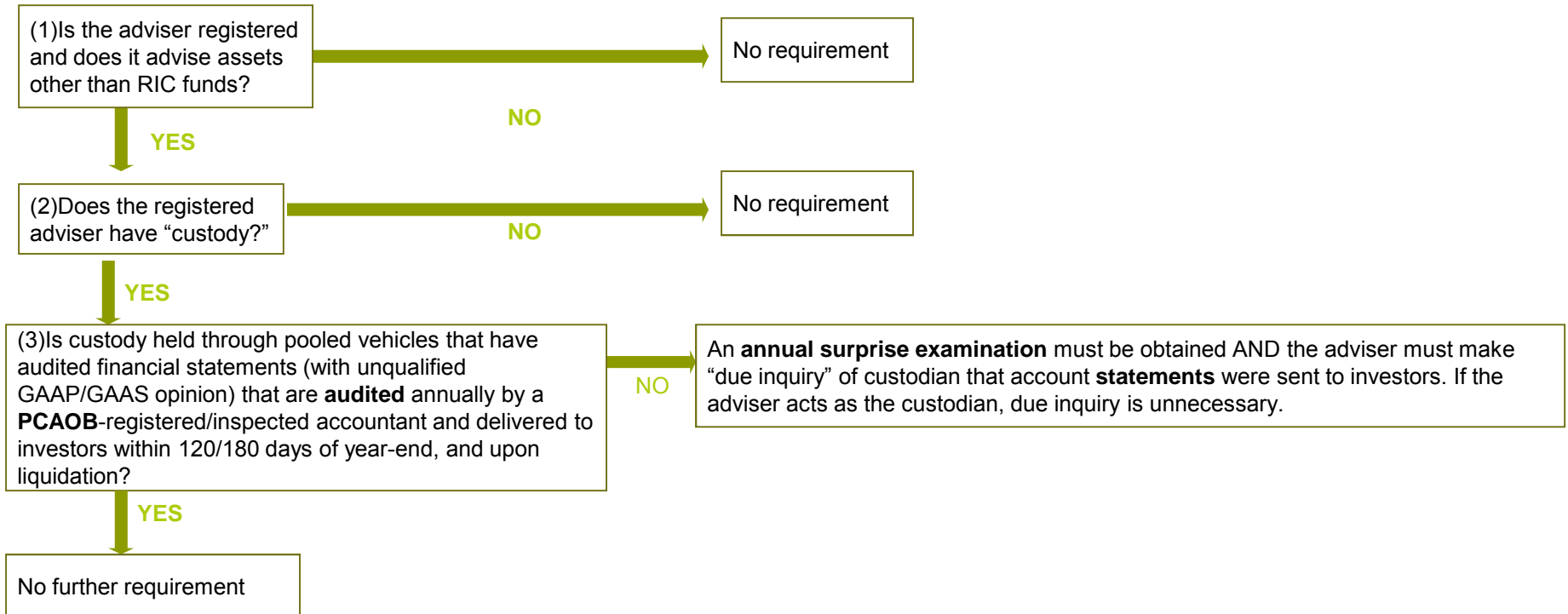


Step #2: Surprise exam and internal control report



Scope of Amended Rule

Scenario: Privately offered securities are the ONLY assets held



Reporting requirements

- Form ADV reporting requirements substantially expanded
 - Report number of accounts and AUM where “custody” is deemed to exist (in total and for related-person custody)
 - Identify related person custodians and whether “operationally independent”
 - Identify accountant performing surprise examination, control examination, audits of private investment funds, including PCAOB status; for control examination and private investment fund audit, report if opinion was qualified
 - All included in Form ADV Part 1, thus public and to be part of database
- Report accountant resignations and dismissals (Form ADV-E) within 4 business days of event
- “Written agreements” (engagement letters) with independent accountants required, with certain provisions specified

Scope of Amended Rule Qualified Custodian – Impact Analysis

Relationship with registered investment adviser	Location of client assets	Statements from qualified custodian to clients of adviser	Internal control report on custody (1)	Surprise exam (2)	Definitions
Adviser uses an independent qualified custodian	Private investment funds(3)	n/a	n/a	n/a	
	Other (e.g., separate account)	✓	n/a	✓	
Adviser is the qualified custodian or is a “related person” to the qualified custodian and is NOT “operationally independent”	Private investment funds(3)	n/a	✓	n/a	Related person - Person directly or indirectly controlling or controlled by the adviser and any person under common control of the adviser
	Other (e.g., separate account)	✓	✓	✓	
Adviser is a “related person” to the qualified custodian and is “operationally independent”	Private investment funds (3)	n/a	✓	n/a	Operationally independent: - Client assets are not subject to the claims of the adviser - Advisory personnel do not have custody, control or access - The adviser and the custodian do not share supervision, personnel or premises
	Other (e.g., separate account)	✓	✓	n/a (4)	

(1) Excludes certain privately issued securities, which can be under custody of adviser who is otherwise not a qualified custodian.

(2) Surprise exam is not required if the adviser has custody only through the ability to deduct fees.

(3) N/A only if private investment fund’s financial statements are audited annually (with unqualified GAAP/GAAS opinion) by PCAOB-registered accountant subject to inspection, and delivered to fund/pool investors within 120/180 days of year-end.

(4) N/A only if the related custodian is the sole reason for being deemed to have custody.

Scope of Amended Rule

Investment Adviser - data gathering framework

- Identify all of the registered advisers within the organization
- Identify each of the accounts and the types of account (eg. managed accounts, pooled investment vehicles, etc.) the registered adviser has responsibility for managing
- Identify the types of assets contained within each of the accounts being managed
- Determine all assets for which the registered investment adviser has custody (either directly or the authority to obtain possession of them) and those where the adviser's ability to deduct fees is the sole reason for being deemed to have custody.
- Compile a list of custodians holding each of the assets within these accounts
- Identify any pooled investment vehicles not subject to annual audit or that are not distributed to investors within 120/180 days where the investment adviser has custody
- Confirm qualified custodian is prepared to send quarterly statements directly to the investment adviser's clients
- Identify funds or securities where a related person serves as qualified custodian
- Assess the operational independence where the investment adviser or a related person serves as the qualified custodian
- Evaluate whether the existing scope is sufficient given the prescribed control objectives and associated controls if an existing internal control report exists and the adviser or related person is the qualified custodian
- Confirm the investment adviser's independent accountant is registered with, and subject to inspection by, the PCAOB where applicable
- Update policies and procedures to incorporate SEC recommendations on additional controls and testing

Appendix

Impact – notification and delivery of account statements

Amended Rule	<ul style="list-style-type: none">• Advisers must notify clients promptly in writing upon the opening of an account, or change of the qualified custodian, the qualified custodian’s name and address and the manner in which funds or securities are maintained.• Advisers must have reasonable belief that the qualified custodian is sending statements, at least quarterly, to clients, formed by due inquiry of the custodian.• If an adviser sends account statements, the adviser must provide written notification to clients urging them to compare such statements to custodian statements received.
Change from Prior Rule	<ul style="list-style-type: none">• The “due inquiry” provision was added to support the adviser’s reasonable belief that statements are sent to clients at least quarterly.• The exemption allowing advisers subject to a surprise examination to send quarterly statements rather than the custodian was removed.
Exemptions	<ul style="list-style-type: none">• Pooled vehicles (e.g., private investment funds) subject to an annual financial statement audit by an independent public accountant registered with, and subject to inspection by, the PCAOB where (1) the financial statements must be distributed to the pool’s investors or the limited partners within 120 days of the pool’s fiscal year-end (180 days for funds of funds), (2) the report is unqualified as to scope and compliance with GAAP, and (3) reports on audits of liquidated funds are provided to investors “promptly” after completion of the audit. <p>Note: This exemption does not apply if all the investors in the private investment funds to whom the statements are sent are themselves private investment funds related to the adviser.</p>
Timing	<ul style="list-style-type: none">• All account statement requirements are effective March 12, 2010 or the date the adviser becomes subject to the Rule thereafter. Statements must be delivered at least quarterly, and the due inquiry must be performed at least once per calendar year.

Appendix

Impact – surprise examination

<p>Amended Rule</p>	<ul style="list-style-type: none"> • Advisers must undergo a surprise examination by an independent public accounting firm. • Examination must be completed and accountant must file Form ADV-E within 120 days of the date chosen by the accountant for the surprise exam.
<p>Change from Prior Rule</p>	<ul style="list-style-type: none"> • Privately offered securities are now included in the scope of the surprise exam. • Accountants can apply sampling rather than a “wall to wall” count/confirmation of every asset in every account. Accountants should use the controls report (if applicable) in planning the surprise exam.
<p>Exemptions</p>	<ul style="list-style-type: none"> • Advisers with custody of client assets <i>solely</i> because of the authority to deduct its own advisory fees from client accounts. <i>Note: The Rule states that such advisers should have policies and procedures in place to address associated risks.</i> • Pooled vehicles (e.g., private investment funds) subject to an annual financial statement audit by an independent public accountant registered with, and subject to inspection by, the PCAOB where (1) the financial statements must be distributed to the pool’s investors or the limited partners within 120 days of the pool’s fiscal year-end (180 days for funds of funds), (2) the report is unqualified as to scope and compliance with GAAP, and (3) reports on audits of liquidated funds are provided to investors “promptly” after completion of the audit. <i>Note: This exemption does not apply if all the investors in the private investment funds to whom the statements are sent are themselves private investment funds (e.g., special purpose vehicles) related to the adviser. In such instances, further application of the Rule will be required.</i> • Advisers using a related qualified custodian deemed to be operationally independent (however, a custodian internal controls examination is required). If custody is <u>solely</u> due to a related qualified custodian deemed to be operationally independent is exempt from the examination.
<p>Timing</p>	<ul style="list-style-type: none"> • The first examination must take place by December 31, 2010 or within 6 months of the date the adviser becomes subject to the Rule. • For advisers using a related qualified custodian that is not operationally independent, the surprise examination must occur within six months of the date the adviser obtains the internal control report.

Appendix

Impact – internal control report

Amended Rule	<ul style="list-style-type: none">• Adviser acting as a qualified custodian or who utilizes a related person as a qualified custodian must obtain, or receive from the related person, an internal control report related to custodial services with an opinion from an independent public accountant registered and inspected by the PCAOB (e.g., Type II SAS 70 or AT 601 Attestation Report).• The independent accountant must verify that funds and securities are reconciled to an independent depository (e.g., DTC).• Internal control reports must address control objectives and associated controls related to the areas of:<ul style="list-style-type: none">• Client account opening, setup, and maintenance;• Authorization and processing of client transactions;• Trade authorization, settlement, and recording;• Security maintenance and setup;• Processing of income and corporate action transactions;• Physical safeguarding of securities;• Reconciliation of funds and security positions to depositories and other unrelated custodians; and• Client reporting.• Adviser must retain a copy of any internal control reports obtained and received.
Change from Prior Rule	<ul style="list-style-type: none">• No provision in prior Rule related to internal control reports for custody operations.
Exemptions	<ul style="list-style-type: none">• Advisers who utilize an independent qualified custodian that is not a related person.
Timing	<ul style="list-style-type: none">• The adviser must obtain an internal control report for custody operations by September 12, 2010 or within 6 months of the date the adviser becomes subject to the Rule. The report must be obtained annually.