

January 13, 2010

SEC Adopts Amendments to Custody Rule

On December 30, 2009, the Securities and Exchange Commission (the "SEC") formally published amendments to Rule 206(4)-2 of the Investment Advisers Act of 1940, as amended (the "Custody Rule"). The Custody Rule is designed to increase protections for clients and investors who turn their assets over to an investment adviser registered with the SEC, and it imposes significant new regulatory requirements on advisers with custody of client assets.

Surprise Examination Requirement. Subject to certain exceptions (described below), all SEC registered investment advisers with "custody" of client assets are required to undergo annual surprise examinations by independent public accountants registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (the "PCAOB"). As with the prior Custody Rule, "custody" is broadly defined as "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them," including access to client or investor funds by virtue of an adviser's dual role as both general partner and investment adviser to a pooled investment vehicle or other entity. The amendments provide that an adviser will be deemed to have "custody" of any client assets held directly or indirectly by an affiliate of such adviser and, thus, will be subject to the surprise examination requirement (except in cases where the adviser is "operationally independent" of the affiliated custodian, as described below).

Each independent public accountant who performs surprise examinations must do so pursuant to a written agreement with such adviser which provides that the accountant must, among other things, (i) notify the SEC within one business day of discovering any material discrepancies during a surprise exam; (ii) file a Form ADV-E and a certificate with the SEC describing the nature and extent of the surprise examination within 120 days of its start date; and (iii) file a Form ADV-E within four business days of the accountant's dismissal, resignation, or voluntary or involuntary removal. The agreement must also provide that the first exam takes place before December 31, 2010, or, for advisers becoming subject to the rule after the effective date, within six months of becoming subject to the rule.

Exceptions to Surprise Examination Requirement:

- **Authority to Deduct Fees.** Advisers having custody *solely* because of their authority to deduct advisory fees from client accounts are not subject to the surprise examination requirement. This exception is not available, however, to an adviser that has custody under the Custody Rule for other reasons (e.g., because the adviser is the general partner of a limited partnership client or has a general power of attorney over client assets).
- **Hedge Funds and Other Pooled Investment Funds.** Advisers to hedge funds and other pooled investment vehicles that obtain an independent audit by a PCAOB-registered accountant, and distribute audited financial statements to investors in the pool, are not subject to the surprise examination requirement.
- **Operationally Independent Related Persons.** An adviser is not subject to the surprise examination requirement if it is (i) deemed to have custody of client assets solely because of custody by a related person and (ii) "operationally independent" from the related person.

Internal Control Report. In addition to the surprise examination, all entities that actually hold client assets – be they advisers, affiliates or even operationally independent affiliates – are required to undergo an annual review of the controls they have in place regarding custody (the “Custody Controls Review”). This Custody Controls Review must be conducted by an independent accountant that is registered with the PCAOB.

Reasonable Belief that Statement has been Delivered. The Custody Rule also requires that advisers reasonably believe that the client’s custodian has delivered account statements directly to the client (or, in the case of pooled investment vehicles, its investors). This requirement is intended to provide greater assurance of the integrity of account statements, and operate so clients can compare the account statement they receive from their adviser with the custodian’s statement to determine whether account transactions are proper.

Investment Advisers in Texas. Investment advisers registered with the Texas State Securities Board are not subject to the Custody Rule (unless also registered with the SEC). The State Securities Board continues to take the position, however, that advisers should comply with the federal Custody Rule as a “best practice.” Accordingly, we recommend that such advisers work with their auditors and compliance personnel to monitor custody issues as if they were subject to these rules.

For additional information regarding the amendments to the Custody Rule, please contact one of the attorneys listed below:

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