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SEC Provides Guidance on Amended Custody Rules

Last month the Securities and Exchange Commission (“SEC”) published a series of staff responses (the “Staff Responses”) to clarify issues regarding Rule 206(4)-2 under the Investment Advisers Act of 1940 (the “Custody Rule”). These staff responses clarify questions raised from the adopting release to the 2009 Custody Rule amendments and supersede responses related to the Custody Rule that were issued by the SEC in 2003. To view the adopting release and a detailed summary of the 2009 Custody Rule amendments, please refer to the S&G Private Investment Funds Alert entitled Amendments to the Custody Rule: New Controls on Custody of Client Assets [<http://www.shipmangoodwin.com/publications/detail.aspx?pub=632>].

The Staff Responses are divided into a number of categories, including, among other things, compliance dates, clarification on the definition of custody and scope of the Custody Rule (e.g., compliance guidance for independent accountants), pooled investment vehicles, and privately offered securities. Select Staff Responses are provided below.

Custody and Scope of Custody Rule

- Investment advisers that inadvertently receive securities from a client should not return such securities to the client’s qualified custodian; rather, the adviser must return such securities to the sender

within three business days to avoid being deemed to have custody of such securities and violating the Custody Rule by maintaining client assets in a non-qualified custodian account. See *Question II.1*.

- For purposes of complying with the Custody Rule, an independent public accountant engaged by an investment adviser must be registered with, and subject to, regular inspection by, the Public Company Accounting Oversight Board (“PCAOB”) if it is engaged to:
 - (i) perform an annual audit of a pooled investment vehicle; (ii) perform an annual surprise examination of an adviser that maintains assets with a qualified custodian that is the adviser or a related person; and (iii) prepare an internal control report. See *Question II.5*.

Compliance

- The surprise examination to verify client assets and securities must commence on or before December 31, 2010; however, the surprise examination does not need to be completed until 120 days after the date chosen by the accountant. Advisers that subsequently become subject to the Custody Rule must commence a surprise examination

by the later of six months after becoming so subject and December 31, 2010. See *Question I.3*.

- For purposes of compliance with the Custody Rule, an accountant performing annual audits on a pooled investment vehicle must be registered with, and subject to, regular inspection by the PCAOB for fiscal years beginning on or after January 1, 2010. See *Question I.4*.
- Investment advisers must provide responses to the additional questions in amended Form ADV in their first annual updating amendment after January 1, 2011. See *Question I.10*.

Pooled Investment Vehicles

- Financial statements for pooled investment vehicles must be prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) in order to use the “audit provision” under the Custody Rule (i.e., an exception from compliance with certain investment adviser requirements under the Custody Rule, including, the annual surprise examination). Pooled investment vehicles organized outside the U.S. or with general partners or managers located outside the U.S. may have their financial statements prepared with an accounting standard other than GAAP so long as (i) the information contained therein is substantially similar to what is required under GAAP and (ii) material differences between GAAP and such other accounting standards are reconciled. In addition, offshore advisers registered with the SEC are not subject to the Custody Rule with respect to offshore funds that they manage. See *Question VI.3*.
- Failure to distribute the audited financial statements of a pooled investment vehicle within 120 days after the end of such

vehicle’s fiscal year would likely not result in enforcement by the SEC so long as (i) certain unforeseen circumstances arose and (ii) the adviser had a reasonable belief that the statements would have been delivered otherwise. See *Question VI.7*.

- The “audit provision” for pooled investment vehicles, which requires audited financial statements to be delivered to investors within 120 days of fiscal year end, does not require a minimum number of investors, and accordingly, single-limited partner limited partnerships and single-member limited liability companies would be required to deliver audited financial statements within 120 days to the sole investor. See *Question VI.9*.
- Advisers may not rely on the audit provision in lieu of a surprise examination for clients that are not pooled investment vehicles, even if the client co-invests alongside an audited pooled investment vehicle. See *Question X.1*.

Privately Offered Securities

- Investment advisers cannot utilize the exception for privately offered securities (i.e., exemption from the surprise examination) for pooled investment vehicle clients that do not rely on the audit provision in lieu of a surprise examination. See *Question VII.1*.
- A registered investment adviser that manages a pooled investment vehicle that does not undergo an annual audit may still fulfill its obligation to hold the securities with a qualified custodian for uncertificated securities so long as (i) the qualified custodian keeps the originally-signed subscription agreement or (ii) the qualified custodian acts as a nominee for the pooled investment vehicle. See *Question VII.2*.



- An investment adviser that advises a client in respect of the purchase of privately offered securities will have custody of such securities when such adviser has legal authority to obtain possession of such securities (e.g., a general partner of a limited partnership). For example, if a client must sign a subscription agreement to purchase a privately offered security, and the adviser has no authority to transfer or redeem those securities without client consent, the investment adviser would not be deemed to have custody under the Custody Rule. *See Question VII.3.*

The Division of Investment Management staff expects to release updates to these responses periodically. We will continue to monitor any future releases and update you with any new developments.

To view the Staff Responses, please see the following link: http://www.sec.gov/divisions/investment/custody_faq_030510.htm.

Questions or Assistance

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