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SEC Adopts Amendments to Rules Under the Advisers Act

On December 30, 2009, the SEC adopted amendments to Rule 206(4)-2 under the Investment Advisers Act of 1940, which governs custody arrangements for registered investment advisers. The amendments are designed to provide additional protection to investors when a registered adviser maintains custody of client funds or securities and to "deter custody-related violations from occurring in the first place, and detect them as early as possible when they do occur." The amendment provides several noteworthy changes with respect to Rule 206(4)-2.

Annual Surprise Examination: All SEC-registered advisers with custody of client assets must undergo an annual surprise examination. Advisers must enter into an agreement with an independent accountant that requires the accountant to (1) conduct the surprise examination and report to the SEC any material discrepancies found in the examination within one business day of the examination; (2) file a certificate on Form ADV-E within 120 days of the surprise examination; and (3) file a termination statement with the SEC within four days of resignation or cancellation of the contract. Two exceptions to this rule exist.

The first exception applies to those advisers who only have "implied" custody due to their authority to automatically debit fees from client accounts. The rule exempts this category of custodians because the purpose of the surprise examination is to verify assets as opposed to the accuracy of fees. However, SEC Chairman Schapiro recently indicated that the SEC staff has been directed to focus on fee deduction issues as they conduct investment adviser examinations.

The second exception applies to advisers of pooled investment vehicles that are subject to an annual financial statement audit by an independent public accountant that is registered with and inspected by the Public Company Accounting Oversight Board (PCAOB), and distributes the audited financial statements prepared in accordance with generally accepted accounting principles to the vehicle's investors.

Internal Controls: The amendments require an adviser with custody to adopt internal controls over access to client assets, develop systems or procedures to assure prompt detection of any misuse, and take appropriate action if any misuse occurs. The release accompanying the amendment discusses the value of instituting these various policies and procedures. Related rule 204-2 was also amended to require advisers to maintain copies of (1) internal control reports and (2) the memorandum describing the basis upon which an adviser determined that the presumption that any related persons are not operationally independent has been overcome for five years.

SAS-70 Audit for Advisers that Self-Custody: In addition to the annual surprise examination, the amendments require all advisers that self-custody to undergo an audit by a PCAOB-registered and inspected accountant and produce a Type II SAS-70 or similar report. The report should include a discussion and analysis of the custody controls including their suitability and effectiveness, and detailing the results of any tests performed against the controls.

Form ADV Reporting and Tracking: The amendments to Form ADV Part 1 require that advisers provide additional information concerning custody practices and the name of the accounting firm used in the surprise exam or SAS-70 audit to the SEC. In addition, if the adviser and the independent accountant sever their relationship, both parties are required to report the termination to the SEC. If the client and the adviser are in disagreement over the scope or procedures of the exam, the accountant is required to make a "noisy withdrawal" by raising the issues in its termination report to the SEC.

Direct Delivery of Account Statements: The amendments require all custodians to deliver custodial statements directly to an adviser's clients as opposed to through the adviser. The requirement is designed to assure the integrity of the account statements by making it difficult for an adviser to falsify the statements. It replaces the previous option that allowed the adviser to send an account report to clients only after the adviser underwent a surprise examination by an independent

public accountant. The amendment further requires that the adviser form a reasonable belief that the account statements are sent after “due inquiry.” Due inquiry may be satisfied in several ways such as receiving a copy of the account statement delivered to the client by the qualified custodian. Finally, advisers are required to encourage their clients to compare the account statements they receive from the custodian with those they receive from the adviser at the time the advisor opens a custodial account on the client’s behalf or when information concerning the account changes.

The amendments are effective March 12, 2010. An adviser that is required to obtain a surprise examination must enter into a written agreement with an independent public accountant to complete the first examination by December 31, 2010. Advisers that become subject to the rule after the effective date must contract for the examination to take place within six months of becoming subject to the requirement. If the adviser or a related person is the qualified custodian, the agreement must require that the surprise examination occur no later than six months after the adviser receives the internal control report, which must be obtained within six months of an adviser becoming subject to the rule. Advisers must respond to the revised Form ADV in their first annual amendment after January 1, 2011.

What This Means to You

The amendments will impact investment advisers who maintain client assets on several fronts, the most significant of which include the need to (1) identify and engage an independent accountant to perform a surprise examination by the end of the year; (2) review current ADV disclosures for compliance with the new rules; and (3) review existing internal controls and prepare for an audit of those controls by an accountant registered with the PCAOB.

Contact Info

For additional information on this topic and assistance with the new requirements, please contact your Husch Blackwell Sanders attorney.

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