



Regulatory Practice Letter

ADVISORY

RPL Number 09-20

Proposed Amendments Relating to Custody of Funds or Securities of Clients by Investment Advisers

Executive Summary

On May 20, 2009, the Securities and Exchange Commission ("SEC") proposed several revisions to Rule 206(4)-2 ("Custody Rule" or "Rule") under the *Investment Advisers Act of 1940* that are designed to improve the safekeeping of client assets. Comments on the proposed amendments must be received by the SEC on or before July 28, 2009.

Background

In 2003 the SEC finalized significant amendments to the Custody Rule in an effort to more clearly define custody, modernize the Rule to be more consistent with contemporary custody practices and enhance client protections by requiring those advisers with custody to maintain the client's assets with a "qualified" custodian.

The significant growth in the investment management industry and recent fraudulent conduct have prompted the SEC to revisit the Custody Rule with proposed changes that the SEC believes will improve the safekeeping of client assets.

Description

Annual Surprise Examination of Client Assets

1. Application to All Advisers with Custody

The SEC proposes to require that all registered investment advisers with custody of client assets engage an independent public accountant to conduct an annual surprise examination of client assets in the hope that "another set of eyes" may result in the earlier detection of fraudulent activities. Additionally, the SEC proposal requires that the independent public accountant must be registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB"). The SEC believes that PCAOB registration and inspection will provide for greater confidence in the quality of the examination performed by the independent public accountant.

The annual surprise examination would apply to all registered investment advisers who have been deemed to have custody of client assets. This contrasts with the 2003 amendments which did not require advisers, who

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were deemed to have custody, to engage an independent third party when the adviser had reasonable expectations that the “qualified” custodian was providing statements directly to clients.

Advisers that are also registered as broker-dealers and thus are permitted to act as qualified custodians for their clients’ assets would also be subject to an annual surprise examination though such advisers are already subject to an annual audit of their financial statements by a registered public accounting firm.

2. *Commission Reporting*

The proposal would require investment advisers to enter into a written agreement with an independent public accountant to conduct the surprise examination requiring the accountant to, among other things, notify the SEC within one business day of finding material discrepancies, and to submit a filing with the SEC within 120 days of the surprise examination, stating that it has examined the funds and securities and describing the nature and extent of the examination. The information on the nature and extent of the examination is intended to assist the SEC’s examination staff in identifying and assessing risks raised by the investment adviser’s custodial practices and in determining the scope of the SEC’s examination of that investment adviser. The SEC would also be made aware of a possible problem with the investment adviser’s custodial practices if the independent public accountant provides the SEC with notice of a material discrepancy.

The SEC is also proposing that the written agreement require the

independent public accountant to notify the SEC within four business days of its resignation, dismissal, or other termination from the engagement, or upon removing itself or being removed from consideration for being reappointed. The accountant would have to provide the SEC with a statement that includes (i) the date of such resignation, dismissal, removal, or other termination, and the name, address, and contact information of the accountant, and (ii) an explanation of any problems relating to examination scope or procedure that contributed to such resignation, dismissal, removal, or other termination. This information is intended to help the SEC compare information provided by the adviser with the perspective of the accountant, and to further evaluate the need for an examination of the adviser to determine whether client assets are at risk.

3. *Privately Offered Securities*

Currently, privately offered securities are excluded from all aspects of the Custody Rule. The SEC’s proposal would amend the Rule to make privately offered securities that investment advisers hold on behalf of their clients subject to the annual surprise examination because the SEC is of the opinion that subjecting these securities to the surprise examination would provide greater assurance that such securities are properly safeguarded.

Custody by Adviser and its Related Persons

1. *Custody by Related Persons*

The SEC is proposing to change the definition of custody to include advisers who have custody of client securities or funds that are directly or indirectly held by a “related person” in connection

with advisory services provided by the adviser to its clients. A “related person” would be a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser. This change would extend the protections of the Rule to clients when their funds and securities are not held with an independent custodian, but rather with the adviser itself or indirectly through a related person. The “in connection with” limitation of the proposed rule is designed to prevent an adviser from being deemed to have custody of client assets held by a related person broker-dealer or other qualified custodian with respect to which the adviser does not provide advice.

2. *Internal Control Report and PCAOB Registration and Inspection*

In cases where an independent custodian does not maintain client assets, the proposed amendments would require that an adviser obtain or receive from the related person, at least once each calendar year, an “internal control report” that includes an opinion from an independent public accountant regarding the adviser’s or related person’s controls around the custody of client assets. The adviser would be required to retain the internal control report in its records for five years and make it available to the SEC upon request.

The SEC believes that requiring these advisers to obtain an internal control report would provide an additional check on the safeguards for client assets held by the adviser or the related person.

The internal control report would include the description of controls

placed in operation relating to custodial services, including the safeguarding of cash and securities held by either the adviser or a related person on behalf of the adviser's clients, and tests of operating effectiveness. In addition, the internal control report would also contain a description of the relevant controls, the control objectives and related controls, and the independent public accountant's tests of operating effectiveness that were performed and the results of those tests.

Control objectives relevant to custodial operations might include:

- Physical securities are safeguarded from loss or misappropriation;
- Cash and security positions are reconciled accurately and on a timely basis between the custodian and depositories, and between the custodian and accounting systems;
- Client-initiated trades are properly authorized and recorded completely and accurately in the client account;
- Securities income and corporate action transactions are processed to client accounts in an accurate and timely manner;
- Net settlement procedures for delivery and receive transactions are performed accurately;
- Documentation for the opening of accounts is received and authenticated, and established completely and accurately on the applicable system; and
- Market values of securities obtained from various outside pricing sources have been recorded accurately in client accounts.

3. Independent Qualified Custodians

As an alternative to the proposal to impose additional conditions on advisers that serve as, or have related

persons that serve as, qualified custodians for client assets, the SEC is requesting comment on whether to require that an independent qualified custodian hold client assets. The SEC is of the opinion that the use of a custodian not affiliated with the adviser would address the conflict, and potentially greater risks to client assets, that may exist when an adviser or its related person acts as custodian for client assets.

Delivery of Account Statements and Notice to Clients

The SEC is also proposing to require that registered advisers with custody of client funds have a reasonable basis for believing that the qualified custodian sends an account statement, at least quarterly, to each client for whom the qualified custodian maintains funds or securities. This amendment would eliminate the current alternative option under which an adviser can send reports to clients if it undergoes an annual surprise examination by an independent public accountant. The SEC had given advisers the alternative delivery option because some advisers did not want to disclose the name of their clients to custodians to prevent potential competitors from gaining access to their client lists or to protect the privacy of certain clients. In light of recent frauds, the SEC believes that direct delivery will provide greater assurance of the integrity of account statements, which is of substantially greater value than adviser concerns over confidentiality. As an alternative, the SEC suggests that the confidentiality concern could be addressed in custodial contracts or agreements outside of the contract that would restrict the custodian's use of the information.

The proposal would also require that advisers relying on the qualified custodian to send account statements directly to clients must form their reasonable belief that such account statements are sent after "due inquiry." This amendment would make it explicit that the adviser is obligated under the Rule to conduct some inquiry to form a reasonable belief because the effectiveness of the rule depends significantly on direct delivery of account statements by the qualified custodian.

The SEC is also proposing to revise the content of the notice advisers are required to send to clients upon opening a custodial account on their behalf to include a statement in the notice urging clients to compare the account statements they receive from the custodian with those they receive from the adviser.

Liquidation Audit

The current provision of the Rule exempts advisers from the account statement provisions with respect to those limited partnerships or other pooled investment vehicles that are subject to an annual audit and that distribute financial statements to investors. The SEC is proposing an amendment designed to assure that the proceeds of a liquidation are appropriately accounted for so that investors can take timely steps to protect their rights. The proposed amendment would clarify the availability of the annual audit exception to pooled investment vehicles that liquidate and make final distributions other than at year end.

KPMG Commentary

The proposed changes to the Custody Rule are significant and could have far reaching implications. The SEC estimates the proposed change in the annual surprise examination requirement would potentially impact as many as 85 percent of the over 11,000 advisers currently registered with the SEC. Moreover, should the SEC move forward (although not proposed but in the SEC's Release with a request for comment) with an alternative requirement that an independent qualified custodian hold client assets, the impact to custody practices would be even more significant.

The SEC has requested comment on all aspects of the proposal and affected firms should avail themselves of the opportunity to offer feedback. It appears the SEC is still exploring alternatives to better protect customer assets and is interested in comments concerning the effectiveness of the proposed Rule amendments and/or alternatives to those ideas formulated by the SEC.

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