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DEVELOPMENTS OF NOTE

SEC Issues Adopting Release for Advisers Act Custody Rule Amendments

The SEC issued the [adopting release](#) for amendments to Rule 206(4)-2 (the “Rule”) under the Investment Advisers Act of 1940 (the “Advisers Act”) and related changes to Form ADV, Form ADV-E and the recordkeeping requirements for registered advisers. (Rule 206(4)-2 imposes a number of requirements on an SEC-registered investment adviser that is deemed to have custody of its clients’ funds and securities.) This article summarizes the principal elements of the amendments – (a) client assets held by an adviser’s related person as a basis for custody, (b) an expanded surprise examination requirement, (c) a new internal control report requirement, (d) changes to the Rule’s requirements governing notice of custodial accounts and delivery of quarterly account statements, (e) additional conditions for exemptions from the Rule’s requirements with respect to pooled investment vehicles, and (f) changes to Form ADV. This article also describes guidance the adopting release provides regarding compliance policies and procedures for the safekeeping of client assets. Except as otherwise described below, an adviser must comply with the amendments beginning on March 12, 2010. The SEC also issued a [companion release](#) providing interpretive guidance for independent public accountants in performing the independent verification of custodied assets and providing the internal control reports required under the amended Rule.

Custody based on Client Assets held by a Related Person. In general terms, the SEC historically has viewed an adviser as having custody of client assets not only when the adviser has physical custody of those assets, but also when the adviser has the authority to obtain client assets, such as by deducting advisory fees from a client account, writing checks or withdrawing funds on behalf of a client, or by acting in a capacity that gives an adviser or its supervised person the authority to withdraw funds or securities from the limited partnership’s account, such as serving as the general partner of a limited partnership. The SEC historically has also taken the position that when a “related person” of an adviser, such as an affiliated broker-dealer, has access to client funds, the adviser may have custody of those funds if the adviser concurrently is serving as an investment adviser to the client. The SEC staff has provided no-action guidance on the considerations relevant to

determining whether or not custody ultimately exists for an adviser as result of a related person's access to client assets.

The amendments to the Rule recently adopted by the SEC incorporate this attribution of custody by a related person to an adviser by expanding the Rule's definition of custody to also provide that an investment adviser has custody of client assets if a related person of the adviser has custody (as otherwise defined in the Rule) of those client assets "in connection with" the adviser's provision of advisory services to the client. Under the amended Rule, a related person is any person directly or indirectly controlling, controlled by, or under common control with the investment adviser, with "control" generally defined to mean the power to direct the management or policies of a person. The amendments include several presumptions of control in the case of certain officers, partners and directors, certain 25 percent shareholders of corporations, partnerships and limited liability companies, and trustees and managing agents of trusts. In connection with the amendments, the SEC staff is withdrawing the abovementioned no-action letters to the extent they are not consistent with the Rule as amended.

Surprise Examination Requirement. The amendments require all registered investment advisers with custody of client assets to engage an independent public accountant to conduct an annual surprise examination of those assets. This requirement is subject to a number of exceptions:

- The surprise examination requirement does not apply to an adviser that has custody solely because it may withdraw its advisory fee from client accounts.
- The surprise examination requirement does not apply to an adviser that is (i) deemed to have custody solely because a related person has custody of client assets, and (ii) the related person and adviser are "operationally independent" of each other. For an adviser and related person to be operationally independent of each other, the following conditions must be met, "and no other circumstances can reasonably be expected to compromise the operational independence of the related person":
 - (1) client assets in the related person's custody are not subject to claims of the adviser's creditors;
 - (2) advisory personnel do not (A) have custody or possession of, or direct or indirect access to client assets in the related person's custody, (B) the power to control the disposition of those client assets to third parties for the benefit of the adviser or its related persons, or (C) otherwise have the opportunity to misappropriate client assets;
 - (3) advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision; and
 - (4) advisory personnel do not hold any position with the related person or share premises with the related person.

An adviser relying on this exception must prepare and maintain a memorandum describing the relationship with its related person and explaining the adviser's basis for determining that it has overcome the presumption. The memorandum is be subject to the Advisers Act's recordkeeping requirements.

The amendments also provide an exemption from the surprise examination requirement with respect to a pooled investment vehicle that meets certain requirements regarding distribution of the pool's audited annual financial statements to its investors (which are discussed in more detail below). Under the amended Rule, privately offered securities that an investment adviser holds on behalf of its clients will be subject to the surprise examination requirement, but will continue to be excluded from the Rule's other requirements.

An independent public accountant conducting a surprise examination must be registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB"). An adviser must enter into a written agreement with the independent public accountant conducting the surprise examination, under which the accountant must (a) notify the SEC within one business day of finding any material discrepancy during the course of the examination; (b) submit Form ADV-E with an accountant's certificate to the SEC within 120 days of the time chosen by the accountant for the surprise examination, (i) stating that the accountant has examined the funds and securities and (ii) describing the nature and extent of the examination; and (c) within four business days of its resignation or dismissal, file with the SEC a statement regarding the termination that explains any problems relating to examination scope or procedure that contributed to the resignation or dismissal.

An adviser subject to the new surprise examination requirement must enter into a written agreement with an independent public accountant that provides for the examination to take place by December 31, 2010 or, for advisers that become subject to the new requirement after March 12, 2010, within six months of becoming subject to the requirement. (When an adviser or a related person maintains client assets as a qualified custodian, the adviser is also subject to an internal control report requirement regarding its or the related person's custody controls, which is discussed immediately below; because the internal control report may assist the surprise examination, the agreement with the accountant must provide for the first surprise examination to occur no later than six months after the adviser obtains its first internal control report.)

Adviser or Related Person as Qualified Custodian - Internal Control Report. When an adviser or its related person serves as a "qualified custodian" of client assets in connection with the advisory services provided by the adviser, the amendments require the investment adviser to obtain, or receive from its related person, at least annually an internal control report from an independent public accountant. The internal control report must include the accountant's opinion as to whether the adviser's or related person's internal controls have been placed in operation as of a specific date, and are suitably designed, and are operating effectively to meet control objectives related to custodial services, including the safeguarding of funds and securities of advisory clients during the year. The independent public accountant must verify that the client funds and securities are reconciled to a custodian other than the adviser or its related person. The amended Rule does not require a specific type of internal control report, but the adopting release mentions both the Type II SAS 70 Report and AT Section 610, *Compliance Attestation*, as suitable for complying with the new requirement. As with the surprise examination requirement, the independent public accountant must be a member of, and subject to regular inspection by, the PCAOB. Any internal control report produced or obtained under the Rule is subject to the Advisers Act's recordkeeping requirements. An adviser required to obtain or receive an internal control report under the Rule must do so within six months of becoming subject to the requirement.

Quarterly Account Statements. Rule 206(4)-2 currently requires delivery of quarterly account statements to clients when an adviser has custody of their assets, either by (a) a qualified custodian used to hold client assets or (b) the adviser itself (even if the adviser does not meet the definition of qualified custodian), provided the adviser undergoes surprise audits at least annually. The amendments eliminate the latter option so that in all cases where an adviser has custody of client assets, a qualified custodian holding the client assets must deliver the quarterly statements.

Where the current rule requires an adviser that relies on a qualified custodian to deliver quarterly accounts statements to have a reasonable basis for believing that such delivery takes place, the amendments further require that the reasonable basis be after due inquiry. The adopting release does not specify what constitutes due inquiry, indicating that advisers have flexibility in determining how to meet the requirement, but does observe that an adviser could satisfy the due inquiry standard by receiving from the qualified custodian a copy of the quarterly account statement sent to a client. (The adopting release does not suggest, as the proposing release did, that a reasonable belief could be based on receiving a written confirmation that an account statement was sent.) In response to comments on the proposing release suggesting that advisers should be able to satisfy the due inquiry requirement by accessing account statements through the qualified custodian's website, the adopting release cautions that accessing account statements through a website merely confirms that they are available and would not be an adequate basis for forming the reasonable belief required by the Rule unless the adviser took additional steps to determine whether account statements were sent to clients, or that clients obtained statements through the website. (Because the amended reasonable belief requirement must be met beginning on March 12, 2010, the due inquiry supporting it must occur by then.)

Notice of Custodial Accounts. The Rule currently requires an adviser to provide a client certain information about a custodial account opened on the client's behalf in a written notice promptly after the adviser opens the account and subsequently when there are changes to the information required in the notice. The amendments further require an adviser that sends its own account statements to a client (which are in addition to those sent by the qualified custodian maintaining the client's assets) to include a legend in the notice and in the adviser's own account statements urging the client to compare the account statements received from the custodian with those from the adviser. Beginning on March 12, 2010 any written notices required to be sent to clients regarding their custodial accounts and any account statements they receive from the adviser are subject to the new legend requirements.

Pooled Investment Vehicles. The Rule currently exempts pooled investment vehicles from the Rule's requirements for notice to clients regarding custody of their assets and distribution of quarterly account statements if certain conditions regarding the distribution of annual audited financial statements to the pool's investors are met. The amendments expand the conditions for these exemptions to further require that (a) the audit of the financial statements be conducted by an independent public accountant registered with, and subject to regular inspection by, the PCAOB and (b) the pool conduct an audit upon liquidation, and distribute the audited financial statements to all investors promptly after the audit's completion. The expanded conditions also apply if an adviser seeks to rely on the Rule's exemption from the new surprise examination requirement with respect to a pooled investment vehicle, as discussed above. An adviser to a pooled investment vehicle may rely on the Rule's exemptions conditioned on the distribution of audited financial statement distribution to a pooled investment vehicle's investors if the adviser (or a related person)

becomes contractually obligated to obtain an audit of the pooled investment vehicle's financial statements for fiscal years beginning on or after January 1, 2010.

The amendments add a provision to the Rule that is designed to prevent an adviser from complying with the Rule simply by sending itself or a related person account statements or financial statements for a special purpose vehicle (an "SPV") that facilitates investments by a one or more pooled investment vehicles that the adviser or a related person manages. This change is designed to address the situation where an SPV is established or controlled by the adviser or a related person, *e.g.*, a related person serves as general partner of an SPV organized as a limited partnership. Under the new provision, sending an account statement or distributing audited financial statements for a pooled investment vehicle will not satisfy the relevant requirements of the Rule if all of the investors in the pooled investment vehicle to which the account/financial statements are sent are themselves pooled investment vehicles that are related persons of the adviser. The adopting release offers two options for complying with this prohibition when a pooled investment vehicle of which an adviser is deemed to have custody invests in an SPV:

- an adviser may treat the SPV as a separate client, which entails complying separately with the Rule's audited financial statement distribution or account statement and surprise examination requirements. Under these circumstances, an adviser should distribute the SPV's audited financial statements or account statements to the beneficial owners of the pooled investment vehicle(s) holding the SPV's interests; or
- an adviser may treat the SPV's assets as assets of each pooled investment vehicle that holds the SPV's interests. Under these circumstances, the SPV's assets are considered when the financial statement for the pooled investment vehicle are audited or the pooled investment vehicle undergoes a surprise examination.

Compliance Procedures. The adopting release provides guidance regarding policies and procedures for safekeeping client assets that advisers should consider including in their compliance programs, while noting that advisers should tailor their policies to their particular businesses and risks. The adopting release notes that an adviser's custody of client assets presents elevated compliance risks for the adviser and its clients, which an adviser and its CCO must accord appropriate attention in the adviser's compliance program. Specific compliance program suggestions include the following:

- requiring any problems be brought to the immediate attention of the adviser's management;
- conducting background and credit checks on adviser employees who will have access (or could acquire access) to client assets to determine whether such access would be appropriate;
- requiring the authorization of more than one employee for the movement of assets within, and withdrawals or transfers from, a client's account, and for changes to account ownership information;
- limiting the number of employees permitted to interact with custodians with respect to client assets, and rotating those employees on a periodic basis;

- if the adviser also serves as a qualified custodian for client assets, segregating the duties of advisory personnel from those of custodial personnel to make it difficult for any one person to misuse client assets without being detected;
- developing policies that address the ability of individual employees to acquire custody of client assets (*e.g.*, by becoming trustees for client assets or obtaining powers of attorney for clients separate and apart from the firm), and adopting measures to assure that any custody that is permitted complies with firm policies;
- developing procedures to periodically test the effectiveness of custody controls, *e.g.*, by periodically reviewing the reconciliation of the adviser's account statements with each qualified custodian's account statements or by comparing, on a sample basis, the client addresses to which a qualified custodian sends account statements with those in the adviser's records to look for inconsistencies or patterns that suggest possible manipulation of address information to conceal misappropriation by advisory personnel; and
- for advisors to pooled investment vehicles, considering whether any of the foregoing policies, or others, should be implemented to address the risk of misappropriation of pool assets through the withdrawal/redemption process.

The adopting release includes specific guidance for the situation where an adviser may deduct its fee from client accounts. Under this guidance, an adviser's procedures should take into account how and when clients are billed; be reasonably designed to ensure that the amount of assets under management on which the fee is billed is accurate and has been reconciled with the assets under management reflected on the statements provided by the client's qualified custodian; and be reasonably designed to ensure that each client is billed accurately in accordance with its advisory contracts. The SEC also suggests advisers consider the following policies and procedures:

- periodically sampling fee calculations to test their accuracy;
- reviewing the reasonableness of advisory fees deducted from client accounts in light of the adviser's aggregate assets under management; and
- segregating duties so that the personnel responsible for producing the invoices or listings of client advisory fees due that are provided to custodians for use in deducting fees are not the personnel responsible for reviewing the invoices and listings for accuracy or reconciling those invoices and listings with the advisory fees received by the adviser.

Form ADV. The amendments make related changes to the disclosure requirements of Form ADV Part 1 that are primarily designed to provide the SEC staff with additional information about an adviser's custody practices, particularly in terms of compliance with certain aspects of the amended Rule. An adviser must provide the new disclosures in its first annual amendment after January 1, 2011.

FRB Issues NPR under which FRB would Sell Term Deposits to Depository Institutions to Absorb Excess Liquidity in U.S. Banking System

The FRB issued a Notice of Proposed Rulemaking (“NPR”) that would amend the FRB’s Regulation D to establish a program under which the FRB would offer and sell term deposits to eligible depository institutions (“Eligible DIs”). Under the NPR, term deposits would generally bear maturities of from one month to one year. The interest rate paid on a term deposit would be set either through an auction process or through application of a formula. The maximum allowable interest rate set through an auction would not be higher than the general level of short-term interest rates. Short-term interest rates are defined by the NPR to mean:

“the primary credit rate and rates on obligations with maturities of up to one year in which eligible institutions may invest, such as rates on term federal funds, term repurchase agreements, commercial paper, term Eurodollar deposits and other similar rates.”

The FRB issued the NPR establishing term deposits to help the FRB manage and absorb excess liquidity in the U.S. banking system resulting from the extraordinarily high level of funding provided by the FRB over the past two years to combat the unprecedented economic and financial crisis. The FRB stated that term deposits would be one of several tools the FRB could use “to drain reserves to support the effective implementation of monetary policy.”

Under the NPR, term deposits would differ from balances held by Eligible DIs in their master accounts at the FRB because the term deposits could not be withdrawn prior to maturity, would not satisfy required FRB reserve balances or contractual clearing balances and would not be available to clear payments or cover daylight or overnight overdrafts. Term deposits, which the FRB characterized as “roughly analogous” to certificates of deposit issued by depository institutions to their customers, would be eligible for use as collateral at the FRB’s discount window.

Under the NPR, term deposits would be issued by the various federal reserve banks, but one of the federal reserve banks would be selected by the FRB to administer the term deposit program for the federal reserve system as a whole. Comments to the NPR are due by February 1, 2010.

Senators Dodd and Shelby Release Statement Agreeing on Certain Regulatory Reform Goals

Senate Banking Chairman Chris Dodd and ranking Republican Richard Shelby have released a [joint statement](#) signaling agreement on several goals for financial regulatory reform and voicing hopes for more progress by the time the Senate reconvenes on January 19, 2010. In December 2009, the House of Representatives passed its version of comprehensive financial regulatory reform legislation, the Wall Street Reform and Consumer Protection Act of 2009. For more on the House legislation, please see the

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[December 15, 2009 Alert](#) and the [December 8, 2009 Alert](#). The statement by Senators Dodd and Shelby outlined several goals that the Senators indicated have bipartisan support:

- Achieving an end to “too big to fail;”
- Enhancing the resolution regime for financial institutions to prevent future costs to taxpayers;
- Strengthening consumer protection;
- Modernizing and streamlining the regulatory structure while preserving the dual banking system;
- Agreeing that the FRB should be more focused on its core responsibility of conducting monetary policy; and
- Modernizing the regulation and oversight of the derivatives market.

On November 10, 2009, Senator Dodd released a draft financial regulatory reform bill (the “Dodd Bill”) which was heavily criticized by Senators from both parties and the financial services industry. For more on the Dodd Bill, please see the [November 17, 2009 Alert](#). Following the introduction of the Dodd Bill, the Senate Banking Committee broke into bipartisan pairs in order to work out agreements on particular reform issues, such as the role of the FRB, new legal authority to wind down large, systemically important financial companies, and other matters. Senators Dodd and Shelby stated that “these talks have been extremely productive, with members providing great insight and demonstrating a desire to get this done and get this done right.” They further stated that “we have made meaningful progress and we hope to resolve the remaining issues before we reconvene in January.”

The Senators’ statement that “too big to fail” should be ended may signal agreement on language in the Dodd Bill that would allow regulators to break up large financial companies. One issue that may prove to be contentious is the creation of a Consumer Financial Protection Agency (the “CFPA”), which would write, examine and enforce rules related to consumer financial products such as mortgages and credit cards. Senator Shelby has remained strongly opposed to the creation of the CFPA, though Senator Dodd has said it is key to any new regulatory overhaul. One compromise under consideration would give the CFPA the power to write rules but would leave enforcement and examination to the federal financial regulatory agencies. A final decision on this issue has not been made.

The two Senators have also split on how to regulate banks. The Dodd Bill proposed creating a single bank regulator to replace the OCC, FDIC, OTS and bank regulatory functions of the FRB. Senator Shelby has stated that it makes more sense for the FDIC to retain oversight of state-chartered banks. A compromise under consideration would allow the FDIC to supervise state-chartered banks and create a new agency to regulate all federally-chartered institutions. No final decision has been reached on that issue either. Any agreement reached between Senators Dodd and Shelby also would have to be agreeable to a majority of the members of the Senate Banking Committee and the Senate as a whole. Other Senate committees also may exercise jurisdiction over portions of the legislation and any legislation passed by those committees would have to be reconciled with the Senate Banking Committee’s legislation. If the Senate does pass financial reform legislation, Senate and House leaders would have to negotiate to reconcile the legislation passed by each chamber, which may differ significantly.