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SEC AMENDS INVESTMENT ADVISER CUSTODY RULES

Changes to Advisers Act Rules and Related Forms Designed to Provide Additional Safeguards

The Securities and Exchange Commission (the "SEC") recently adopted amendments to the custody and recordkeeping rules under the Investment Advisers Act of 1940 (the "Advisers Act") and related forms. The amendments are designed to provide additional safeguards when a registered adviser has custody of client funds or securities by requiring such an adviser to, among other things: (i) undergo an annual surprise examination by an independent public accountant to verify client assets; (ii) have the qualified custodian maintaining client funds and securities send account statements directly to the advisory clients; and (iii) unless client assets are maintained by an independent custodian (*i.e.,* a custodian that is not the adviser itself or a related person), to obtain, or receive from a related person, a report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board ("PCAOB"). The SEC believes that the amended custody rule and forms will provide the SEC and the public with additional information about the custodial practices of registered investment advisers.

The full text of the final rule is located in Release No. IA-2968 (the "Release") at http://www.sec.gov/rules/final/2009/ia-2968.pdf. The SEC subsequently published interpretive guidance for independent public accountants in connection with the custody rules amendments which is located in Interpretive Release No. IA-2969 at http://www.sec.gov/rules/interp/2009/ia-2969.pdf ("Guidance for Accountants").

Compliance Dates

The effective date of the following amendments to rules 206(4)-2, 204-2, and Forms ADV and ADV-E is March 12, 2010, except as described below. Immediately upon the effective date, advisers that have custody of client assets must promptly upon opening a custodial account on a client's behalf, and following any changes to the custodial account information, as specified in rule 206(4)-2(a)(2), send a notification to the client, including a legend urging the client to compare the account statements the client receives from the custodian with those the client receives from the adviser. The Release stipulates that such legend should also be included in any account statements that advisers send to these clients after they are required to send the notification discussed above. In addition, immediately upon the effective date, each adviser that has custody of client assets must have a reasonable belief (except with respect to pooled investment vehicles the financial statements of which are audited and delivered to investors) that a qualified custodian sends account statements directly to clients at least quarterly, in accordance with rule 206(4)-2(a)(3).

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As described below, an investment adviser required to obtain a surprise examination must enter into a written agreement with an independent public accountant that provides that the first examination will take place by December 31, 2010 or, for advisers subject to the rule after the effective date, within six months of becoming subject to the requirement. If the adviser itself maintains client assets as qualified custodian, however, the agreement must provide for the first surprise examination to occur no later than six months after obtaining the internal control report. An investment adviser also required to obtain or receive an internal control report because it or a related person maintains client assets as a qualified custodian must obtain or receive an internal control report within six months of becoming subject to the requirement. An adviser obtaining an internal control report because it, rather than a related person, also serves as a qualified custodian of its clients' assets (*e.g.,* a broker-dealer) need not undergo a surprise examination until six months after obtaining the internal control report. An investment adviser to a pooled investment vehicle may rely on the annual audit provision if the adviser or a related person becomes contractually obligated to obtain an audit of the financial statements of the pooled investment vehicle for fiscal years beginning on or after January 1, 2010 by an independent public accountant registered with, and subject to regular inspection by, the PCAOB. Registered investment advisers must provide responses to the revised Form ADV in the first annual amendment after January 1, 2011. Until the Investment Adviser Registration Depository ("IARD") system is upgraded to accept Form ADV-E, accountants performing surprise examinations should continue paper filing of Form ADV-E. Investment advisers will be notified as soon as the IARD system can accept filings of Form ADV-E.

Overview

Under Advisers Act rule 206(4)-2, advisers, in most cases, must maintain client funds and securities with a "qualified custodian." Qualified custodians include the types of financial institutions to which clients and advisers customarily turn for custodial services, including banks, registered broker-dealers, and registered futures commission merchants, whose custodial activities are subject to regulation and oversight. An adviser has "custody" under the rule when it holds client funds, either directly or indirectly, or has any authority to obtain possession of them. Under the rule, advisers must have a reasonable belief that the qualified custodian sends account statements directly to advisory clients. The rule also permits advisers (rather than custodians) to send account statements if the adviser is subject to annual surprise verification of client assets by an independent public accountant.

The newly adopted amendments eliminate certain exemptions in the rule in order to expand the protections afforded advisory clients and to strengthen controls over the custody of assets by registered investment advisers and to encourage the use of independent custodians. In addition to the amendments to rule 206(4)-2, the SEC has also adopted related amendments to rule 204-2, Form ADV, and Form ADV-E. The SEC believes that these amendments, together with the interpretive Guidance for Accountants, will provide for a more robust set of controls over client assets designed to prevent those assets from being lost, misused, misappropriated or subject to advisers' financial reverses. Although it acknowledges that no set of regulatory requirements will prevent all fraudulent activities by advisers or custodians, the SEC believes that this rule, together with its examination program's increased focus on the safekeeping of client assets, will help deter fraudulent conduct and increase the likelihood that fraudulent conduct will be detected earlier so that client losses will be minimized. The

SEC continues to review additional potential recommendations to enhance the oversight of broker-dealer custody of customer assets. The Release cautions that these newly adopted rules changes represent a “first step” in the effort to enhance custody protection, and additional enhancements of the rules are likely to follow.

Delivery of Account Statements and Notice to Clients

Existing rule 206(4)-2 requires advisers that have custody, with certain limited exceptions, to maintain client funds or securities with a “qualified custodian,” which the adviser must have a reasonable basis for believing sends an account statement, at least quarterly, to each client for which the qualified custodian maintains funds or securities. The requirement was designed so that advisory clients would receive a statement from the qualified custodian to compare with any statements or other information they received from their adviser in order to determine whether account transactions, including deductions to pay advisory fees, were proper. The newly adopted amendment to the rule eliminates an alternative to the requirement under which an adviser can send quarterly account statements to clients if it undergoes a surprise examination by an independent public accountant at least annually. The SEC believes that direct delivery of account statements by qualified custodians will provide greater assurance of the integrity of account statements received by clients. The Release notes that any privacy concerns that might arise can be addressed through custodial contracts or other agreements that restrict the custodian’s use of confidential information.

The amended rule requires that an adviser’s reasonable belief that the qualified custodian sends account statements directly to clients must be formed by the adviser after “due inquiry.” The SEC prescribes no single method for forming this belief, choosing instead to provide advisers with the flexibility to determine how best to meet this requirement. The Release suggests that an adviser could form a reasonable belief after “due inquiry” where the qualified custodian provides the adviser with a copy of the account statement that was delivered to the client.

Rule 206(4)-2 also requires investment advisers to notify their clients promptly upon opening a custodial account on their behalf and when there are changes to the information required in that notification. The newly adopted amendment requires advisers to include a legend in the notice urging clients to compare the account statements they receive from the custodian with those they receive from the adviser. In order to avoid customer confusion, and because advisers may not (and are not required by rule 206(4)-2 to) send statements separate from the ones the custodian delivers, the SEC modified the notice requirement so that the cautionary legend must be included only if the adviser elects to send its own account statements to clients. In addition, because the SEC believes that providing regular notice will serve to more effectively remind clients to take steps to protect their assets, the amendment requires those investment advisers, in any subsequent statements they deliver to clients after the initial notice, to urge clients to compare the adviser’s statements with the account statements they receive from the custodian.

Annual Surprise Examination of Client Assets

The SEC also amended rule 206(4)-2 to require registered advisers with custody of client assets to undergo a surprise examination (or an audit, if applicable) of those assets by an independent public accountant. Several amendments to the custody rule and related forms were also adopted to strengthen the utility of the surprise examination as a means of deterring misuse of client assets and improve the SEC's ability to identify potential misuse of those assets. The Release also revises the guidance provided to accountants engaged to perform these examinations in order to modernize the surprise examination and make it more effective.

Applicability. The newly adopted amendments require advisers with custody of client assets to obtain a surprise examination (or an audit, if applicable in the case of a pooled investment vehicle) of client assets by an independent public accountant, other than as discussed below. An investment adviser required to obtain a surprise examination must enter into a written agreement with an independent public accountant that provides that the first examination will take place by December 31, 2010 or, for advisers that become subject to the rule after the effective date, within six months of becoming subject to the requirement. If the adviser itself maintains client assets as qualified custodian, however, the agreement must provide for the first surprise examination to occur no later than six months after obtaining the internal control report.

Advisers with Limited Custody Due to Fee Deduction. When the adviser has custody of client assets solely because of its authority to deduct advisory fees from client accounts, no surprise examination is required. Nevertheless, the Release cautions that appropriate controls should be in place regarding fee deduction.

Pooled Investment Vehicle Audit. The amended rule provides that an adviser to a pooled investment vehicle that is subject to an annual financial statement audit by an independent public accountant, and who distributes the audited financial statements prepared in accordance with generally accepted accounting principles to the pool's investors within 120 days of the pool's fiscal year-end is deemed to have satisfied the annual surprise examination requirement. The amendments limit the rule's recognition of such audits as satisfying the surprise verification requirement to those audits performed by an independent public accountant registered with, and subject to regular inspection by, the PCAOB.

An investment adviser to a pooled investment vehicle may rely on the annual audit provision if the adviser or a related person is contractually obligated to obtain an audit of the financial statements of the pooled investment vehicle for fiscal years beginning on or after January 1, 2010 by an independent public accountant registered with, and subject to regular inspection by, the PCAOB.

If the pooled investment vehicle does not distribute audited financial statements to its investors, the adviser must obtain an annual surprise examination and must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement of the pooled investment vehicle to its investors in order to comply with the custody rule. The rule requires the accounting firm performing the surprise examination to verify privately offered securities, along with other funds and securities, held by a pool that is not subject to a financial statement audit. Regardless of whether an adviser to a pooled investment vehicle obtains a surprise examination or satisfies that requirement by

obtaining an audit, if the pooled investment vehicle's assets are maintained with a qualified custodian that is either the adviser to the pool or a related person of the adviser, the adviser to the pool would have to obtain, or receive from the related person, an internal control report. Finally, the rule requires advisers to pools complying with the rule by distributing audited financial statements to investors to also obtain an audit upon liquidation of the pool when the liquidation occurs prior to the fund's fiscal year-end.

SEC Reporting. Under amended rule 206(4)-2, each investment adviser subject to the surprise examination requirement must enter into a written agreement with an independent public accountant to conduct the surprise examination. The agreement must require the accountant, among other things, to notify the SEC within one business day of finding any material discrepancy during the course of the examination, and to submit Form ADV-E accompanied by the accountant's certificate within 120 days of the time chosen by the accountant for the surprise examination, stating that the accountant has examined the funds and securities and describing the nature and extent of the examination. The agreement also must provide that, upon resignation or dismissal, the accountant must file within four business days a statement regarding the termination along with Form ADV-E. Accountants will file Form ADV-E electronically, through the IARD.

Privately Offered Securities. Amendments were adopted to rule 206(4)-2 to no longer permit the accountant conducting the annual verification of client assets to forego examining certain privately offered securities. As a result, advisers that maintain custody of privately offered securities on behalf of clients will be subject to the surprise examination requirement. The SEC believes that although privately offered securities may present little risk with respect to transferability, they present significant risks in other regards. To mitigate these risks and to provide assurance that privately offered securities are properly safeguarded, the SEC now requires an independent third-party to verify client ownership with the issuers of the securities by requiring that these securities be subject to the surprise examination requirement under the amended rule.

Guidance for Accountants. The Release notes that existing guidance for accountants, which was published in 1966, was inadequate because it neither reflected today's custodial practices nor adequately recognized certain commonly accepted auditing practices. In the companion Guidance for Accountants release, the SEC provides updated guidance that addresses the surprise examination, as well as the internal control report required under amended rule 206(4)-2 and the relationship between them. It also discusses the relevant auditing and attestation standards that apply to these engagements, and, among other things, the nature and extent of the accountant's procedures with respect to the surprise examination. The revised guidance modernizes the procedures for the surprise examination and includes information for accountants regarding conducting a surprise examination of client assets, including privately offered securities.

Custody by Adviser and Related Person

Amended rule 206(4)-2 imposes additional requirements when advisory client assets are maintained by the adviser itself or by a related person rather than with an independent qualified custodian. In addition to the surprise examination, the amended rule requires that when an adviser or its related per-

son serves as a qualified custodian for advisory client funds or securities under the rule, the adviser obtain, or receive from its related person, no less frequently than once each calendar year, a written internal control report, which includes an opinion from an independent public accountant with respect to the adviser's or related person's controls relating to custody of client assets, such as a Type II SAS 70 report. The amended rule also requires, in these circumstances, that the accountant issuing the internal control report, as well as the accountant performing the surprise examination, be registered with, and subject to regular inspection by, the PCAOB. The adviser must maintain the internal control report in its records and make it available to SEC staff upon request.

Internal Control Report. To address the custodial risks associated with an affiliated custodial relationship, the amended rule includes an internal control report requirement. The elements of the required internal control report are set forth in the Guidance for Accountants companion release. The internal control report must include the accountant's opinion as to whether the qualified custodian'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. In order for the accountant to be able to form this opinion, the internal control report should address control objectives and associated controls related to the areas of client account setup and maintenance, authorization and processing of client transactions, security maintenance and setup, processing of income and corporate action transactions, reconciliation of funds and security positions to depositories and other unaffiliated custodians, and client reporting.

The rule was amended to state that, for the internal control report to satisfy the rule's requirements, the independent public accountant preparing the report must verify that the client funds and securities are reconciled to a custodian other than the adviser or its related person. Internal control reports regarding custody, such as Type II SAS 70 reports, however, may not necessarily include specific procedures performed by the accountant that are designed to verify the reconciliation of funds and securities of unaffiliated custodians.

As described in the Guidance for Accountants, the accountant's verification that client funds and securities are reconciled to an unaffiliated custodian (*e.g.,* the Depository Trust Corporation) can be accomplished in one of two ways: (i) the accountant may either obtain direct confirmation, on a test basis, with unaffiliated custodians; or (ii) perform other procedures designed to verify that the data used in reconciliations performed by the qualified custodian is obtained from unaffiliated custodians and is unaltered. Certain minimum control objectives are identified within the revised Guidance for Accountants. The SEC is not requiring that a specific type of internal control report be provided under the rule as long as the objectives noted above are addressed, but believes that flexibility should permit accountants of qualified custodians to leverage audit work they have performed to satisfy existing regulatory requirements to which these custodians are subject, or work currently performed as part of internal control reports prepared to meet client demand. The Release notes that a Type II SAS 70 report would be sufficient to satisfy the requirements of the internal control report. A report issued in connection with an examination of internal control conducted in accordance with AT Section 601, Compliance Attestation under the standards of the American Institute of Certified Public Accountants would also be sufficient, provided that such examination meets the objectives set forth in the Guidance to Accountants.

An investment adviser required to obtain or receive an internal control report because it or a related person maintains client assets as a qualified custodian must obtain or receive an internal control report within six months of becoming subject to the requirement. An adviser obtaining an internal control report because it, rather than a related person, also serves as a qualified custodian of its clients' assets (e.g., a broker-dealer) need not undergo a surprise examination until six months after obtaining the internal control report.

Related Persons. The amended rule 206(4)-2 provides a limited exception from the surprise examination requirements in circumstances when the adviser is deemed to have custody solely as a result of a related person having custody. A related person is defined by the rule as a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser. The exception is available to an adviser that is: (i) deemed to have custody solely as a result of certain of its related persons holding client assets; and (ii) "operationally independent" of the custodian. Under the amended rule, a related person that holds, or has authority to obtain possession of, advisory client assets would be presumed not to be operationally independent of the adviser unless the adviser can meet the rule's conditions, which are similar to the factors that the SEC has used to evaluate whether an adviser has custody of client funds and securities indirectly under the rule as a consequence of the custody of a related person, and no other circumstances exist that can reasonably be expected to compromise the operational independence of the related person. An adviser that is able to satisfy these conditions and overcome the presumption that it is not operationally independent of its related person would not have to obtain a surprise examination of client assets held by a related person, including a related person that is a qualified custodian. The adviser would, however, have to comply with the other provisions of the rule (unless an exception is available), including notifying the client where the assets are maintained, forming a reasonable belief after due inquiry that the qualified custodian sends the client account statements, and obtaining an internal control report from a related person that is a qualified custodian.

The Release emphasizes that an adviser with custody due to reasons in addition to, or other than, a related person having custody cannot rebut the presumption contained in the rule. For example, an adviser with custody because it serves as a trustee with respect to client assets held in an account at a broker-dealer that is a related person could not rely on the exception from the surprise examination on the grounds that the broker-dealer was operationally independent and that the factors discussed above were met. Such an adviser would be subject to the surprise examination requirement and would be required to receive an internal control report from the related person qualified custodian. Rule 204-2 was also amended to require an adviser whose client assets are held by a related person but does not undergo a surprise examination to make and keep a memorandum describing the relationship with the related person in connection with advisory services the adviser provides to clients and including an explanation of the adviser's basis for determining that it has overcome the presumption that it is not operationally independent of the related person with respect to the related person's custody of client assets.

PCAOB Registration and Inspection. Pursuant to the newly adopted amendments, the surprise examination and internal control report required when the adviser or its related person serves as quali-

fied custodian for client assets may be satisfied only when performed or prepared by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB. While PCAOB inspection is focused on public company audit engagements, the SEC believes that requiring that the accountant not only be registered with the PCAOB but subject to its inspection can provide indirect benefits regarding the quality of the accountant's other engagements.

Liquidation Audit

The newly amended rule requires that advisers to pooled investment vehicles that distribute the pool's audited financial statements to investors under the rule's annual audit provision must, in addition to obtaining an annual audit, obtain a final audit of the pool's financial statements upon liquidation of the pool and distribute the financial statements to pool investors promptly after the completion of the audit.

Layering of Pooled Investment Vehicles

A newly adopted provision in rule 206(4)-2 precludes advisers from using layers of pooled investment vehicles to avoid meaningful application of the protections of the rule. Specifically, new paragraph (c) provides that sending an account statement (paragraph (a)(5)) or distributing audited financial statements (paragraph (b)(4)) will not meet the requirements of the rule if all of the investors in a pooled investment vehicle to which the statements are sent are themselves pooled investment vehicles that are related persons of the adviser. Investment advisers to pooled investment vehicles may from time to time use special purpose vehicles ("SPVs") to facilitate investments in certain securities by one or more pooled investment vehicles that the advisers manage. The Release notes that these SPVs are typically established or controlled by the investment adviser or its related persons who often serve as general partners of limited partnerships, or managing members of limited liability companies, or persons who hold comparable positions for another type of pooled investment vehicle. As a result, the Release notes that a literal application of the rule could result in account statements and financial statements designed to permit investors to protect their interests being sent to the adviser itself, rather than to the parties the rule was designed to protect. To comply with the rule, as amended, the investment adviser could either treat the SPV as a separate client, in which case the adviser will have custody of the SPV's assets, or treat the SPV's assets as assets of the pooled investment vehicles of which it has custody indirectly. If the adviser treats the SPV as a separate client, rule 206(4)-2 requires the adviser to comply separately with the custody rule's audited financial statement distribution or account statement and surprise examination requirements.

Accordingly, the Release provides that advisers should distribute the audited financial statements or account statements of the SPV to the beneficial owners of the pooled investment vehicles. If, however, the adviser treats the SPV's assets as assets of the pooled investment vehicles of which it has custody indirectly, such assets must be considered within the scope of the pooled investment vehicle's financial statement audit or surprise examination.

Compliance Policies and Procedures

Advisers Act rule 206(4)-7 requires registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules. As the SEC stated in 2003 when the rule was adopted, these policies and procedures must address, among other things, the safeguarding of client assets from conversion or inappropriate use by advisory personnel. The SEC believes that an adviser's maintenance of strong policies and procedures, in addition to the newly adopted measures, is an essential component of a comprehensive approach to addressing the potential risks raised by an adviser's custody of client assets. Compliance with rule 206(4)-7 requires an adviser with custody to adopt controls over access to client assets that are reasonably designed to prevent misappropriation or misuse of client assets, develop systems or procedures to assure prompt detection of any misuse, and take appropriate action if any misuse does occur.

The Release provides that advisers with custody of client assets should therefore consider the value of instituting the following policies and procedures as part of their compliance programs:

- Conduct background and credit checks on employees of the investment adviser who will have access or could acquire access to client assets to determine whether it would be appropriate for those employees to have such access;
- Require the authorization of more than one employee before the movement of assets within, and withdrawals or transfers from, a client's account, as well as before changes to account ownership information;
- Limit the number of employees who are permitted to interact with custodians with respect to client assets and rotating them on a periodic basis; and
- If the adviser also serves as a qualified custodian for client assets, segregate the duties of its advisory personnel from those of custodial personnel to make it difficult for any one person to misuse client assets without being detected.

The Release notes that advisers should consider including in their policies and procedures a requirement that any problems be brought to the immediate attention of the management of the adviser. Advisers should also consider developing policies regarding the ability of individual employees to acquire custody of client assets, because their custody may be attributable to the firm, which will thereby acquire responsibility for those assets under the rule. The Release notes that many firms preclude employees from acquiring custody by prohibiting them from, for example, becoming trustees for client assets or obtaining powers of attorney for clients separate and apart from the advisory firm. Advisers that permit employees to serve in capacities whereby the firm acquires custody of client assets should take steps to assure themselves that their employees' custodial practices conform to the firm's policies and procedures, and that the adviser's chief compliance officer ("CCO") has access to sufficient information to enforce those policies and procedures. The adviser's custody of client assets presents elevated compliance risks for the adviser and its clients. Advisers and their CCOs therefore must accord these risks appropriate attention in the adviser's compliance program. Accordingly, the Release notes that the adviser should consider developing procedures by which the CCO periodically tests the effectiveness of the firm's controls over the safekeeping of client assets. For example, the

Release notes that the CCO could periodically test the reconciliation of account statements prepared by advisers with account statements as reported by qualified custodians. In addition, the CCO could compare, on a sample basis, client addresses obtained from the clients' qualified custodians to which the custodian sends client statements, with client addresses maintained by the adviser, to look for inconsistencies or patterns that suggest possible manipulation of address information as a means for concealing misappropriation from these accounts by advisory personnel.

The Release stipulates that advisers with custody as a result of their authority to deduct advisory fees directly from client accounts held at a qualified custodian should have policies and procedures in place that address the risk that the adviser or its personnel could deduct fees to which the adviser is not entitled under the terms of the advisory contract, which would violate the contract and which may constitute fraud under the Advisers Act. Policies and procedures of the adviser, the Release notes, should: (i) take into account how and when clients will be billed; (ii) 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 statements of the client's qualified custodian; and be reasonably resigned to ensure that clients are billed accurately in accordance with the terms of their advisory contracts.

Examples provided in the Release of policies and procedures such adviser should consider include:

- Periodic testing on a sample basis of fee calculations for client accounts to determine their accuracy;
- Testing of the overall reasonableness of the amount of fees deducted from all client accounts for a period of time based on the adviser's aggregate assets under management; and
- Segregating duties between those personnel responsible for processing billing invoices or listings of fees due from clients that are provided to and used by custodians to deduct fees from clients' accounts and those personnel responsible for reviewing the invoices and listings for accuracy, as well as the employees responsible for reconciling those invoices and listings with deposits of advisory fees by the custodians into the adviser's proprietary bank account to confirm that accurate fee amounts were deducted.

Because different controls may be appropriate for different advisers in designing effective compliance programs, the Release does not suggest a single set of policies and procedures. As the SEC noted in 2003 when it adopted rule 206(4)-7, there is recognition that advisers are too varied in their operations and size for such an approach to work. As the Release notes, advisers with only a few employees may, for example, find segregation of duties impractical, but for advisers with a large number of employees such a control may be highly effective. Advisers to pooled investment vehicles should consider whether these practices, or others, should cover investor accounts in the pool, for example, to prevent an employee from misappropriating assets from the pool by processing false investor withdrawals. The guidance set out in the Release is provided, the SEC notes, primarily in the form of examples to be tailored by advisors to fit the size and particular risks raised by their particular business model.

Amendments to Forms ADV and ADV-E

Several amendments to Part 1A and Schedule D of Form ADV were adopted which require registered advisers to report more detailed information about their custody practices in their registration form and to update the information. The SEC believes such information will enhance its ability to identify compliance risks associated with custody of client assets. The Release notes that the amendments primarily affect only those advisers that have custody of client assets under rule 206(4)-2.

Item 7. Amendments to Item 7 and Section 7.A. of Schedule D require each adviser to report all related persons who are broker-dealers and to identify which, if any, serve as qualified custodians with respect to the adviser's clients' funds or securities. Section 7.A. of Schedule D was also amended to require an adviser to report whether it has determined that it has overcome the presumption that it is not operationally independent from a related person broker-dealer qualified custodian, and thus is not required to obtain a surprise examination for the clients' assets maintained at that custodian.

Item 9. Amendments to Item 9 require each registered adviser to report: (i) whether the adviser or a related person has custody of client assets, and if so, both the total U.S. dollar amount of those assets as well as the number of clients for whose accounts the adviser or its related person has custody; (ii) if the adviser, or related person, acts as an adviser to a pooled investment vehicle, whether (a) the pool is audited, and (b) the qualified custodians send account statements to pool investors; (iii) whether an independent public accountant conducts an annual surprise examination of client assets; (iv) whether an independent public accountant prepares an internal control report with respect to the adviser or its related person; and (v) whether the adviser or a related person serves as qualified custodian for the adviser's clients. In addition, Schedule D was amended to require that advisers (i) identify and provide certain information about the accountants that perform audits or surprise examinations and that prepare internal control reports; and (ii) to identify related persons, such as banks, that serve as qualified custodians with respect to their clients' funds or securities, but are not otherwise reported in Item 7. Newly amended Schedule D also requires an adviser to report whether it has determined that it has overcome the presumption that it is not operationally independent from a related person qualified custodian, and thus is not required to obtain a surprise examination for the clients' assets maintained at that custodian.

An instruction was added to clarify that an adviser must separately report the amount of assets of which it has custody, excluding those assets maintained by a related person qualified custodian, and the amount of assets of which a related person has custody, including when the related person serves as a qualified custodian.

Form ADV-E. Three amendments to the instructions to Form ADV-E were adopted. First, the form instructions now require that the form and the accompanying accountant's examination certificate be filed electronically through the IARD. Advisers will, however, continue to file form ADV on paper until the IARD system begins accepting electronic filings of Form ADV-E, which is expected to occur sometime in late 2010, whereupon investment advisers will be notified. The second and third amendments conform Form ADV-E instructions to amended rule 206(4)-(2), which requires that (i) the surprise examination certificate must be filed within 120 days of the time chosen by the accountant

for the surprise examination; and (ii) a termination statement be filed by an accountant within four business days of its resignation, dismissal, or removal.

Registered investment advisers must provide responses to the revised Form ADV in their first annual amendment after January 1, 2011. Until the IARD system is upgraded to accept Form ADV-E, accountants performing surprise examinations should continue paper filing of Form ADV-E. Investment advisers will be notified as soon as the IARD system can accept filings of Form ADV-E.

Required Records

Amendments to rule 204-2 require an adviser to maintain a copy of (i) the internal control report that such adviser is required to obtain or receive from its related person, pursuant to amended rule 206(4)-2(a)(6); and (ii) the memorandum describing the basis upon which the adviser determined that the presumption that any related person is not operationally independent, pursuant to amended rule 206(4)-2(d)(5), has been overcome, for five years from the end of the fiscal year in which, as applicable, the internal control report or memorandum is finalized.

If you would like to discuss any of the issues discussed in this Client Alert, please contact any attorney in our Corporate Finance and Securities Group or visit us online at chapman.com.

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