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Adoption of Amended Rule 206(4)-2 Under the Investment Advisers Act

The Securities and Exchange Commission (the "SEC") has adopted amendments to rule 206(4)-2 (as amended, the "Rule") under the Investment Advisers Act of 1940 (the "Advisers Act") thereby updating the rule to reflect modern custodial practices and to require custodians of client funds or securities to maintain such assets with broker-dealers, banks, or other qualified custodians. The Rule regulates the custody practices of advisers registered under the Advisers Act and requires advisers with custody of client securities or funds to implement controls to protect client assets from being lost, misused, misappropriated or subject to the adviser's financial reverses. The Rule also provides a definition of "custody" and illustrates circumstances under which an adviser has custody of client funds or securities.

The SEC's amendment is designed to enhance protections for client assets and reduce the burden on advisers that have custody of client assets, in particular by relieving an adviser from sending its own account statements and from undergoing an annual surprise examination as long as the "qualified custodian" sends quarterly account statements directly to an adviser's clients, and by removing the Form ADV requirement that advisers with custody include an audited balance sheet in their disclosure brochure to clients.[1]

The effective date of the Rule is November 5, 2003. Advisers must comply with the Rule by April 1, 2004.[2]

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[1] See "Final Rule: Custody Funds or Securities of Clients by Investment Advisers," Release No. IA-2176, September 25, 2003 (the "Adopting Release").

[2] The SEC is withdrawing a number of no-action letters as a result of the Rule, which, after April 1, 2004, may no longer be relied upon (Investment Counsel Association of America, Inc., SEC Staff Letter (June 9, 1982); John B. Kennedy, SEC Staff Letter (June 5, 1996); Securities America Advisers Inc., SEC Staff Letter (Apr. 4, 1997); Bennett Management Co., SEC Staff Letter (Feb. 26, 1990); PIMS, Inc., SEC Staff Letter (Oct. 21, 1991); Canyon Management Co., SEC Staff Letter (Oct. 15, 1991); Pacific Management, Ltd., SEC Staff Letter (Oct. 29, 1991); Lee Capital Management, SEC Staff Letter (Oct. 29, 1991); Eichler Magnin, Inc., SEC Staff Letter (Nov. 4, 1991); GBU, Inc., SEC Staff Letter (Apr. 22, 1993)).

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I. Definition of Custody

The Rule defines custody as holding directly or indirectly, client funds or securities or having any authority to obtain possession of them.[3] Under the Rule, custody includes:

- Possession of client funds or securities, (but not of checks drawn by clients and made payable to third parties) unless they are received inadvertently and returned to the sender promptly but in any case within three business days of receiving them;

- Any arrangement (including a general power of attorney) under which an adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the adviser's instruction to the custodian; and

- Any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives an adviser or its supervised person legal ownership of or access to client funds or securities.

The Adopting Release clarifies that an adviser who is authorized to deduct advisory fees or other expenses directly from a client's account has access to, and therefore custody of, the client funds and securities in that account and that an adviser's possession of a check drawn by the client and made payable to a third party is not possession of client funds for the purposes of the custody definition.[4] These investment advisers may not have possession of client assets, but they have authority to obtain possession.

II. Use of Qualified Custodians

Advisers with custody of client funds and securities must maintain them with qualified custodians who must hold the funds or securities in an account either under the client's name or under the adviser's name, as agent or trustee. Under the Rule, a "qualified custodian" means:

- A bank as defined in Section 202(a)(2) of the Advisers Act or a savings association as defined in Section 3(b)(1) of the Federal Deposit Insurance Act that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act;

- A broker-dealer registered under Section 15(b)(1) of the Securities Exchange Act of 1934, holding the client assets in customer accounts;

- A futures commission merchant registered under Section 4f(a) of the Commodity Exchange Act, holding the client assets in customer accounts, but only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; and

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[3] Section (c)(1) of the Rule.

[4] See Part II, A of the Adopting Release.

- A foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets.[5]

The Rule contains special provisions for two specific types of securities: registered open-end mutual fund shares and privately offered securities. In the situation where a client or adviser purchases shares of a registered open-end mutual fund for a client directly from the fund's transfer agent rather than through another intermediary such as a broker-dealer, the adviser may use the transfer agent in lieu of a qualified custodian. You should know that the adviser may still have custody if there is a check-writing or fee-deduction authority given to the adviser over the assets.[6]

In the case of privately-offered uncertificated securities in their client's accounts, advisers are otherwise exempted from the Rule if ownership of the securities is recorded only on the books of the issuer or its transfer agent, in the name of the client, and transfer of ownership is subject to prior written consent of the issuer or the holders of the issuer's outstanding securities. In cases such as limited partnerships where the private securities are held in the name of the limited partnerships and the adviser acts for the partnership, having apparent authority to arrange transfers of the securities, the adviser may only use the exception to the Rule with respect to the account of a limited partnership if the limited partnership is audited annually and the audited financial statements are distributed.[7]

III. Delivery of Account Statements to Clients

The Rule requires that advisers with custody of clients' funds or securities have a reasonable belief that the qualified custodian holding the assets provides periodic account statements to those clients. The Rule now requires quarterly account statements by the qualified custodians, which statements must be delivered directly to advisory clients and not through the adviser.[8] This process is designed to ensure the integrity of the account statements and to permit clients to identify any erroneous transactions or withdrawal by the adviser.[9] This arrangement may not be satisfactory in certain custodial arrangements, specifically when the adviser does not want to disclose the identity of its clients to its custodian, usually in order to prevent a potential competitor from having access to its clients or out of concern for the privacy of its clients. In these circumstances, the adviser must continue sending out quarterly account statements to its clients and undergo an annual surprise examination by an independent public accountant to verify the funds and securities of the adviser's clients. Under the Rule, the accountant must notify the Office of Compliance Inspections and Examinations within one business day of finding any material discrepancies found during the examinations.[10]

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[5] Section (c)(3) of the Rule.

[6] Section (b)(1) of the Rule.

[7] Section (b)(3) of the Rule and Part II, B of the Adopting Release.

[8] Section (a)(3)(i) of the Rule; unless the adviser wishes to continue sending quarterly account statements to clients and undergo a yearly surprise examination, see Section (a)(3)(ii) of the Rule.

[9] Part II, C of the Adopting Release.

[10] Section (a)(3)(ii)(C) of the Rule.

In circumstances where a client does not wish to receive custodial reports, a client can choose to have an "independent representative" receive account statements on its behalf.[11] Also, in situations where the adviser has legal title to the client assets under management, such as advisers that serve as general partner to investment pools in pooled investment vehicles, the Rule clarifies that account statements must be sent directly to the investors in the pool if the adviser also acts as its general partner, managing member, or in a similar capacity and has custody of client funds or securities.[12]

IV. Notice to Clients

The Rule requires that an adviser who opens an account with a qualified custodian on its client's behalf, either under the adviser's name, as agent, or the client's name, must notify the client in writing of the qualified custodian's name, address, and the manner in which the funds or securities are maintained promptly when the account is opened and following any changes in the information required by the notice.[13]

V. Exemptions

With respect to investment companies under the Investment Company Act of 1940 (the "'40 Act"), advisers need not comply with the Rule but must comply with section 17(f) of the '40 Act and the custody rules enacted thereunder. Advisers to pooled investment vehicles need not comply with the reporting requirements of the Rule (i.e. sending quarterly account statements) if the vehicle is audited at least annually and distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or members or other beneficial owners) within 120 days of the end of its fiscal year.

VI Amendments to Form ADV

Item 9 of Part 1A of Form ADV, which asks whether the adviser has custody of client funds or securities is being revised given that a large number of advisers registered with the SEC currently answer "no" to item 9 despite the fact that they deduct fees directly from client accounts and in reliance on no-action letters issued by the staff of the SEC. The new instruction to this item specifies that advisers that have custody only because they deduct fees may answer "no." The SEC is also eliminating the requirement that advisers with custody of client assets include an audited balance sheet in their disclosure statements sent to clients.

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[11] Section (b)(4) of the Rule; Section (c)(2) of the Rule defines an "independent representative" as a person that: (i) acts as agent for an advisory client, including in the case of a pooled investment vehicle, for limited partners of a limited partnership (or members of a limited liability company, or other beneficial owners of another type of pooled investment vehicle) and by law or contract is obliged to act in the best interest of the advisory client or the limited partners (or members, or other beneficial owners); (ii) does not control, is not controlled by, and is not under common control with the adviser; and (iii) does not have, and has not had within the past two years, a material business relationship with the adviser.

[12] Section (a)(3)(iii).

[13] Section (a)(2) of the Rule.

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This memorandum is not intended to provide or constitute legal advice, and no legal or business decision should be based on its contents.

Any questions concerning the foregoing should be addressed to members of the Paul Weiss Funds Group (see below). In addition, memoranda on related topics may be accessed under Funds Group publications on our web site (www.paulweiss.com).

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