



## SEC Proposes Significant Changes to Strengthen the Advisers Act Custody Rule

May 14, 2009 -- The SEC today unanimously voted to propose significant changes to strengthen the protections afforded to clients of investment advisers ("advisers") under the custody requirements of Rule 206(4)-2 under the Investment Advisers Act of 1940 (the "Rule"). The proposed changes, which were recommended by the SEC's Division of Investment Management (the "Division"), include three principal new protections, as follows:

1. Expansion of Annual Surprise Examination Requirement. The proposed changes would require all advisers that maintain custody of client assets -- including those who are deemed to have custody due to their ability to deduct fees -- to receive an annual surprise examination by an independent public accountant to verify client assets. The proposed changes would require advisers to report to the SEC the identity of the independent public accountant that is engaged to perform the surprise examination and to report when the accountant is terminated. In addition, the proposed changes would require the independent public accountant to report to the SEC when the engagement is terminated and to report if it is terminated due to a disagreement with the adviser as to the scope of the examination or the examination process. The proposed changes also would subject private securities held in client accounts to the surprise examination requirement.

Observations. Currently, the surprise examination requirement applies only where client account statements are sent by the adviser itself rather than by a qualified custodian. Statements made at the SEC's open meeting suggest that the proposed changes will affect approximately 6,000 advisers, and that the Division staff expects to be able to use the SEC's IARD adviser registration system to keep track of advisers and accountants and identify compliance gaps.

2. New Custody Control Report. If an adviser or its affiliate has physical custody over client funds or securities, the proposed changes would require the adviser or its affiliate to obtain a written report (commonly known as a Type II SAS 70 report) from a reputable independent public accountant attesting to the adviser's or related person's controls relating to the safekeeping of client assets. The

independent public accountant must be registered and inspected by the Public Company Accounting Oversight Board ("PCAOB"), and the report prepared by the accountant must conform to PCAOB standards. The new reporting requirement would apply to a foreign affiliate that has custody of advisory client assets.

Observations. During the open meeting, Director Buddy Donohue noted that the Division had considered but determined not to recommend a proposal that would have prohibited advisers from maintaining client assets with an affiliate out of concerns that doing so would effectively prohibit broker-dealers from providing retail advisory services to their brokerage customers. On a separate note, Commissioner Casey raised questions regarding the estimated costs of this new requirement, which in the aggregate may approximate \$170 million according to statements made at the SEC's open meeting. The Division staff expressed the view that that estimate may be "high" given the assumptions made in deriving the estimate.

3. Mandatory Account Statement Delivery by Custodian. The proposed changes would require all custodians to directly deliver custodial statements to advisory clients, rather than through the adviser.

Observations. Commissioner Casey observed that the proposed changes significantly depart from the SEC's determination in 2003 to allow advisers to send account statements due to their desire to protect the privacy of well known clients and to prevent the disclosure of the identity of their clients to custodians who may be potential competitors. In response, the Division staff noted that privacy concerns could be addressed in contracts with custodians and that custodians were currently limited by applicable laws and regulations in their use of client information that they receive. Regarding competition, the Division staff noted that there did not appear to be significant reliance on the Rule's exception allowing advisers to deliver account statements instead of qualified custodians.

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According to Chairman Schapiro, the proposed changes are intended to address shortfalls in current custody control regulations highlighted by the Madoff case as well as series of recent allegations involving frauds that relate to Ponzi schemes and the misappropriation of client assets. The proposed changes are part of a larger package of related reforms all of which are intended to better protect investors from fraud. These reforms include:

- improvements to the SEC's exam process to better identify fraud,
- improvements to the SEC's risk assessment process,
- improvements to the SEC's ability to handle complaints and tips, and
- improvements to the SEC's enforcement program designed to ensure its enforcement cases are "strategic, swift, smart, and successful."

Chairman Schapiro expressed the belief that the use of third parties to hold client assets, to verify the existence of client assets, or to assess the custody

controls of an adviser or affiliated custodian will provide a "critical, independent layer of protection for advisory clients."

While she supported the proposed changes, Commissioner Casey stressed the importance of balancing the additional costs associated with the proposed changes against the value of the additional protections the SEC hopes to achieve. She also noted that she would have preferred to have a chance to evaluate the broader regulatory scheme of investment adviser regulation rather than work "piecemeal" through incremental changes that the SEC possibly, perhaps at the direction of Congress, may "soon" set aside in favor of entirely new regulations.

Commissioner Paredes expressed the view that the benefits of the proposed changes should be weighed against their cost, including not only out-of-pocket costs but also burdens on other entities. He also noted that in 2003, the SEC had decided against adopting changes to the Rule that were similar in "key respects" to the proposed changes, and emphasized that the SEC's earlier cost-benefit assessment, which led the SEC in a "different direction," remains "instructive." He expressed interest in receiving comments on the following four matters:

1. whether the surprise examination requirement should cover advisers with an independent qualified custodian or be targeted to instances where the adviser or a related person is the qualified custodian, given that non-affiliated custodians already serve as an important safeguard of client assets;
2. whether the rules should cover advisers who have custody only because they withdraw fees from client accounts;
3. the extent to which the new requirements could adversely impact competition if they are disproportionately costly and burdensome for smaller entities; and
4. the extent to which the new rules could foster "moral hazard" by promoting an "undue sense of security" that dissuade investors from doing their own diligence. In this regard, Commissioner Paredes suggested consideration of circumstances under which active investor diligence may do more to deter and detect misconduct than certain regulatory demands.

Commissioners Aguilar and Walter also supported the proposed changes.

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Please direct questions regarding the proposed changes to Richard Choi at [rtc@jordenusa.com](mailto:rtc@jordenusa.com) or (202) 965-8127.

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