

## **Update on New SEC Custody Rule**

As previously discussed, the Securities and Exchange Commission (SEC) had been considering the adoption of a new set of custody rules for US registered investment advisers. The SEC has, in fact, adopted amendments to Rule 206(4)-2, the custody rule under the Investment Advisers Act of 1940, as amended (the “Advisers Act”). The new rules are intended to impose additional controls, following the recent year of fraud and scandal (read, Madoff), on registered advisers that have access to client funds or securities. Advisers now have to:

- Undergo an annual surprise examination (the big bugbear of the new rules) by an independent public accountant registered with the Public Accounting Oversight Board (PCAOB) to verify client assets;
- Have a reasonable belief after due inquiry that any qualified custodian maintaining client assets sends account statements directly to advisory clients;
- If the adviser or a related person acts as “qualified custodian” of client assets, obtain or receive from the related person, a report on internal controls relating to the custody of client assets prepared by an independent PCAOB-registered public accountant.

All SEC-registered investment advisers will be required to comply with the enhanced custody rules. The amendments will be effective **March 12, 2010**, and registered advisers must comply with the new rules as of that date, except in certain cases where other compliance dates are specified.

There is an important “exemption” for certain hedge funds. An investment adviser to a pooled investment vehicle (such as a hedge fund) that is subject to an annual financial statement audit and that distributes the audited financial statements (prepared in accordance with U.S. GAAP) to the pool’s investors is deemed to have satisfied the annual surprise examination requirement – which relieves the adviser of the additional associated costs. However, the audit must be performed by an independent PCAOB-registered accountant and the financial statements must be distributed to investors within 120 days of the end of the pooled investment vehicle’s fiscal year end (or 180 days for a fund of funds). However, if the hedge fund is liquidated it has to be *audited upon liquidation* and the audited financial statements must be distributed to all investors “promptly” after completion of the audit.

## **House of Representatives Passes Reform Bill**

On December 11, 2009, The US House of Representatives passed a Wall Street reform bill – H.R. 4173, “The Wall Street Reform and Consumer Protection Act” – which requires, among other things, hedge fund managers to register as investment advisers under the Advisers Act. It also would require a new regulatory framework for derivatives. All standardized swap transactions between dealers and “major swap participants” would have to be cleared and traded on an exchange or electronic platform. A “major swap participant” is an entity that maintains a substantial net position in swaps, exclusive of hedging for commercial risk, or whose positions create significant risk exposures so as to warrant monitoring. The bill also contains a controversial provision that would make brokers fiduciaries (under certain circumstances), requiring that they act “solely in the interest of” their clients. Finally, a provision that would have given the Financial Industry Regulatory Authority (FINRA) power to regulate investment advisers was beaten back – to the glee of the investment adviser community, and the considerable consternation of FINRA, which had been trying to get into the investment adviser space for years. [Track the bill at www.opencongress.org](#).