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# The SEC Adopts Amendments to the Custody Rules

On December 16, 2009, the Securities and Exchange Commission (the "SEC") voted to adopt rule amendments designed to strengthen controls over client assets held by registered investment advisers or their affiliates. On December 30, 2009, the SEC published the adopting release for these amendments along with an interpretive release providing guidance to auditors.[1] These amendments modify the amendments previously proposed in May 2009 in response to approximately 1,300 comment letters.[2] The new rule will become effective on March 12, 2010.

## Rule 206(4)-2: The Current Custody Rule

Rule 206(4)-2 of the Investment Advisers Act of 1940, as amended (the "Advisers Act") regulates the custody practices of registered advisers.[3] Rule 206(4)-2 requires advisers that have custody of client securities or funds to implement controls designed to protect client assets from being lost, misused, misappropriated or subject to the advisers' financial reverses.[4]

Custody includes directly or indirectly holding clients' funds or securities or having the authority to obtain possession of them. Advisers are therefore subject to rule 206(4)-2 if they directly hold the client assets, if they have the authority to withdraw funds or securities from a client's accounts or if they have ownership of or access to client funds or securities, such as through fee deductions.[5] Currently, an adviser is not subject to rule 206(4)-2 in every instance where its affiliate has custody over client assets, but only if the nexus between the adviser and the affiliate indicates that the adviser is directing the disposition of client assets.[6]

1 *See* Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. IA-2968 (Dec. 30, 2009) (the "Adopting Release"), *available at* http://www.sec.gov/rules/final/2009/ia-2968.pdf.

2 *See* Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. IA-2876 (May 20, 2009) (the "Proposal Release"); *see also* the Skadden Client Memorandum, "The SEC Proposes Revised Custody Rules" (May 28, 2009), *available at* http://www.skadden.com/content%5CPublications%5CPublications1792_0.pdf. Approximately 1,100 comment letters were form letters or substantially similar letters submitted by smaller advisory firms. Adopting Release at 5 n.11.

3 References herein to "advisers" or "investment advisers" are to investment advisers registered or required to be registered under the Advisers Act.

4 Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. IA-2876, 68 Fed. Reg. 56629, 56692 (2003) (to be codified at 17 C.F.R. pts. 275, 279, effective Nov. 5, 2003) (the "2003 Release").

5 *See* 2003 Release at 56692-93.

6 *See* 2003 Release at 56692. Crocker Investment Management Corp., SEC No-Action Letter, 1978 WL 13242 (Apr. 14, 1978), sets forth considerations for whether an adviser should be deemed to have custody based on its affiliate's custody. This no-action letter and other letters that are inconsistent with the amended definition of "custody" will be withdrawn. "In light of our amended

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The current regulatory scheme protects against mismanagement of client assets through the requirement that assets must be held by a qualified custodian, as well as through specific delivery requirements. Advisers must maintain client assets with qualified custodians, which are defined to include banks, registered broker-dealers and registered futures commission merchants.[7] These entities are subject to rigorous regulation and oversight.[8] In addition, advisers must have a reasonable belief that the qualified custodian holding the assets is providing quarterly account statements to clients.[9]

Alternatively, the adviser may deliver the quarterly account statements to its clients directly but then must have the client assets verified by an independent public accountant in a surprise examination.[10] In making its examination, the public accountant must confirm with the custodian all cash and securities held by the custodian, verify the books and records of the client accounts maintained by the adviser and confirm with clients (on a test basis) closed accounts or securities or funds that have been returned since the last examination.[11] The accountant must report the results of such examination to the SEC and notify the SEC within one business day of finding a material discrepancy during an examination.[12]

An adviser to a pooled investment vehicle is not subject to the quarterly account statement delivery requirement if the vehicle is audited annually and the adviser sends the audited financial statements to investors within 120 days of the end of the fiscal year (or 180 days[13] for a fund of funds).[14] None of

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*(continued from page 1)*
definition of custody, our staff is withdrawing several no-action letters to the extent such letters are inconsistent with this definition including *Crocker* and *Pictet et Cie*, SEC Staff Letter (Jun. 22, 1980). Advisers, including those firms that have relied on these letters in the past, must comply with the amended rule." Adopting Release at 33 n.107.

7 Rule 206(4)-2(c)(3)(i).

8 *See* Adopting Release at 27.

9 Rule 206(4)-2(a)(3)(i). An adviser could form this reasonable belief if, for example, the qualified custodian provides the adviser with a copy of the account statement that was delivered to the client. 2003 Release at 56694 n.29.

The quarterly account statements must be delivered to each investor of a pooled investment vehicle. See rule 206(4)-2(a)(3)(ii). Clients may designate an independent representative to receive notices and quarterly account statements under the custody rule. As per rule 206(4)-2(c)(2), an independent representative is defined as a person that (i) acts as agent for an advisory client and by law or contract is obligated to act in the best interest of the advisory client; (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. The SEC amendment now defines independent representatives in rule 206(4)-2(d)(4).

10 *See* rule 206(4)-2(a)(3)(ii). The examination must be performed at a time chosen by the accountant without prior notice or announcement to the adviser, and the timing of the examination must be irregular from year to year, so that the adviser will be unaware of the date on which it will take place.

11 *See* rule 206(4)-2(a)(3)(ii)(B).

12 *See* rule 206(4)-2(a)(3)(ii)(C).

13 The amended rule does not affect the views of the staff relating to the timing of delivery of the audited financial statements to fund of funds investors. Adopting Release at 17 n.45.

14 *See* rule 206(4)-2(b)(3). There are also exemptions for (1) shares of open-end mutual funds, in which case the adviser may use the mutual fund's transfer agent rather than a qualified custodian for purposes of maintaining custody, and (2) privately offered securities. However, in the case of privately offered securities held for the account of a pooled investment vehicle, the exemption only applies if the vehicle is audited annually and the audited financial statements are distributed as described above. *See* rule 206(4)-2(b)(1), (3).

the custody rules under the Advisers Act apply if the client is a registered investment company because section 17(f) of the Investment Company Act of 1940, as amended, and the strict custody rules adopted thereunder apply to such accounts.[15]

## The Adopted Amendments

The SEC's goal is to strengthen controls over the custody of client assets and to encourage the use of independent custodians. The SEC believes the amended rules will help deter fraudulent conduct and increase the likelihood that any fraudulent conduct will be detected earlier so that client losses will be minimized.[16]

The amended rule as adopted includes the following. Surprise examinations by a public accountants will be required for advisers with custody of client funds or securities, subject to certain exceptions. The SEC now requires more stringent reporting and delivery procedures. The definition of "custody" has been expanded to include custody by any related person. An independent public accountant will be required to review custodial controls unless the client assets are maintained with an independent custodian. There also is a clarification requiring an audit on liquidation for certain advisers to pooled investment vehicles. The SEC has adopted rules that prevent advisers from creating layers of pooled investment vehicles to avoid meaningful application of the protections of the amended rule. The SEC provides guidance on compliance policies and procedures relating to custody issues. Finally, there are amendments to Form ADV that require disclosure of additional information about custodial arrangements. The amendments do not modify the scope of client funds or securities subject to the rule, even though some commenters requested clarification of what securities are covered by the rule.[17]

The SEC's companion release provides guidance for accountants performing surprise examinations and preparing internal control reports and includes guidance relating to privately offered securities. The SEC is considering additional enhancements of the rules governing custody of customer assets by broker-dealers.[18]

## Surprise Examination

Under amended rule 206(4)-2(a)(4), registered investment advisers with custody of client assets must engage an independent public accountant to conduct an annual surprise examination of all client assets, whether maintained with a qualified custodian or not, subject to the exceptions described below. This surprise examination is required notwithstanding the delivery of quarterly account statements or an exemption from the delivery of quarterly account statements requirement. Currently, a surprise examination is required only when a qualified custodian fails to deliver the account statements to the client and when an exemption from such delivery requirements does not apply. However, recent levels of fraudulent activity have prompted the SEC to strengthen the surprise examination portion of the rule based on the belief that the delivery requirement, in itself, is an insufficient deterrent. If the adviser or a related person is also the qualified custodian, then

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15 Rule 206(4)-2(b)(4); see 2003 Release at 56995. This exception is not affected by the amended rules.

16 Adopting Release at 6.

17 Adopting Release at 3 n.2, 21 n.61.

18 Adopting Release at 3-4.

the independent public accountant must be registered with, and subject to regular inspection by, the Public Company Accounting and Oversight Board (the "PCAOB").[19] Furthermore, privately offered securities, which were heretofore excluded from all aspects of the custody rule, and mutual fund shares, will be subject to the surprise examination procedures as client assets, even though these assets are not required to be maintained with a qualified custodian.[20] Although the SEC acknowledged that privately offered securities do not present much risk with respect to transferability, they do present other risks, such as difficulty verifying that the securities actually exist.[21] The SEC revised its guidance to accountants in an effort to modernize and make the surprise examination more effective.[22]

The SEC was persuaded by commenters that the surprise examination will not provide materially greater protection to advisory clients in certain circumstances.[23] One exemption applies to a registered investment adviser deemed to have custody of client assets solely as a result of its authority to deduct fees from its client's account.[24] The SEC determined that the risk to the client of losses arising from overcharging does not warrant surprise examinations. The amended rule addresses this risk by allowing the client to monitor the deduction of fees by reviewing the account statements from the qualified custodian.[25] The SEC also determined that the surprise examination will not materially benefit investors in pooled investment vehicles that are subject to an annual financial statement audit and that distribute audited financial statements prepared in accordance with generally accepted accounting principles, so long as such audit is conducted by an auditor registered with, and subject to regular inspection by, the PCAOB.[26] The SEC determined that audits that meet these requirements offer comparable protection to surprise examinations.[27] However, the SEC is concerned that investors in pooled investment vehicles subject to this audit requirement will not have the benefit of regularly receiving reports that the assets are properly held and has directed its staff to consider ways to remedy this potential shortcoming.[28]

Another exemption applies to registered investment advisers that are: (i) deemed to have custody solely as a result of certain of their related persons holding client assets, and (ii) "operationally independent" of the custodian.[29] The SEC determined that the risk of collusion between two

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19 Amended rule 206(4)-2(a)(6)(i). The SEC has greater confidence in these accountants. Adopting Release at 36.

20 *See* Adopting Release at 13 n.36. "Privately offered securities" are defined by amended rule 206(4)-2(b)(2) as securities that are (i) acquired from the issuer in a transaction or chain of transactions not involving any public offering; (ii) uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client; and (iii) transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.

21 Adopting Release at 21-22.

22 See Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to rule 206(4)-2 Under the Investment Advisers Act of 1940, Investment Advisers Act Release No. 2969 (Dec. 30, 2009) (the "Accounting Release"), *available at* http://www.sec.gov/rules/interp/2009/ia-2969.pdf.

23 *See* Adopting Release at 14.

24 Amended rule 206(4)-2(b)(3).

25 *See* Adopting Release at 14-15.

26 *See* Amended rule 206(4)-2(b)(4).

27 *See* Adopting Release at 17.

28 *See* Adopting Release at 17-18.

29 Amended rules 206(4)-2(b)(6), 2(d)(5). The adviser must satisfy the conditions of the rule and no other circumstances can exist that would reasonably be expected to compromise the operational independence of the related person.

unaffiliated organizations, which is deemed to be the case if the adviser and custodian are deemed "operationally independent," did not necessitate the added protection of a surprise examination.[30] The SEC requires that the adviser prepare and keep a memorandum describing the relationship with the related person and the basis for its operational independence.[31]

In response to concerns raised by commenters about the impact of the surprise examination on small advisers, the SEC has directed its staff to study the impact of this requirement on such advisers. The staff will provide the SEC with the results of its review following the completion of the first round of surprise examinations.[32]

## Reporting

Rule 206(4)-2 requires a written agreement between the independent public accountant conducting the surprise examination and the investment adviser subject to the rule.[33] The agreement must require the accountant to notify the SEC of any material discrepancies found within one business day of such finding. The agreement also must require the accountant to submit Form ADV-E to the SEC with a certificate within 120 days of the time chosen by the accountant for the surprise examination. The accountant is required to state on Form ADV-E that it has examined the funds and securities and to describe the nature and extent of the examination.[34] For ease of filing, the SEC will have accountants file Form ADV-E electronically, through the Investment Adviser Registration Depository ("IARD").[35]

In addition, the SEC mandates that the written agreement require the independent public accountant to submit Form ADV-E to the SEC within four business days of its resignation, dismissal from or other termination of the engagement, or removal from consideration for reappointment, accompanied by a statement that includes (i) the date of such resignation, dismissal, removal or other termination, and the name, address and contact information of the accountant; and (ii) an explanation of any problems relating to examination scope or procedure that contributed to such resignation, dismissal, removal or other termination.[36]

## Custody

The SEC amendments have expanded the definition of "custody." Under the new definition an adviser will be deemed to have custody of any client securities or funds that are directly or indirectly held by a "related person" in connection with advisory services provided by the adviser to its

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30 *See* Adopting Release at 33-34.

31 *See* Adopting Release at 36; Amended rule 204-2(b)(5).

32 *See* Adopting Release at 13-14.

33 Amended rule 206(4)-2(a)(4).

34 Amended rule 206(4)-2(a)(4)(i).

35 The IARD does not currently have an electronic filing option, but is expected to by the end of 2010. See Adopting Release at 50. The instructions to Form ADV-E were amended to reflect the electronic filing requirement and the revised timing requirements for filing. *See id.*

36 Amended rule 206(4)-2(a)(4)(iii).

clients.[37] A "related person" is a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser.[38] As a result, an adviser will be deemed to have custody of client assets in every instance where either the adviser or a related person holds such assets.[39] Previously, advisers only had custody of client accounts held through an affiliate if it was determined that the adviser or its personnel exercised control over the affiliate. However, there is a limited exception for "operationally independent" related persons as noted above in the Surprise Examination section.

## Custodial Controls From Independent Accountants

The amendments do not mandate that client assets be maintained with an independent qualified custodian. However, the rules encourage independent custody by making it more onerous for advisers or related persons to maintain custody of client accounts.[40] The SEC considered, but declined to adopt, a requirement for independent custodians because of concerns that certain advisory relationships with smaller investors would become unavailable. The SEC recommends the use of an independent custodian as a best practice whenever feasible.[41] Under the new rules, advisers or related persons who do not maintain client assets with an independent custodian will be subject to an annual custody control examination. The SEC is requiring the internal control report requirement in an attempt to strengthen the utility of the surprise examination requirement, by providing additional assurances to independent public accountants that confirmations received from the adviser or related person when acting as custodian are reliable.[42] The investment adviser will be required to obtain or receive from the related person a written report (the "internal control report") prepared by an auditor registered with, and subject to regular inspection by, the PCAOB that will describe the custody controls being used and the tests conducted to determine the effectiveness of their operation.[43] In order to satisfy the rule's requirements, the independent public accountant must verify that the client assets are reconciled to a custodian other than the adviser or its related person.[44] The adviser will be required to maintain the internal control report in its records for five years after the fiscal year in which it was finalized and make it available to the SEC or its staff upon request.[45] The examination and report must comport to PCAOB standards, but the SEC did not mandate the specific type of report required.[46]

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37 Amended rule 206(4)-2(d)(2). The "in connection with" limitation of the amended rule is designed to prevent an adviser from being deemed to have custody of client assets held by a related person broker-dealer (or other qualified custodian) with respect to which the adviser does not provide advice. *See* Adopting Release at 33 n.106.

38 Amended rule 206(4)-2(d)(7). Under amended rule 206(4)-2(d)(1) "control" is be defined as the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract or otherwise.

39 The exemption for shares of mutual funds described above will continue to apply and privately offered securities will continue to be exempt from the qualified custodian requirement. Rule 206(4)-2(b)(1), (2). The exemption for privately offered securities held for the account of a pooled investment vehicle will only apply if the pool is audited annually and the annual financial statements are delivered as described above. Amended rule 206(4)-2(b)(3).

40 *See* Adopting Release at 24-31.

41 Adopting Release at 26.

42 *See* Adopting Release at 27.

43 Amended rule 206(4)-2(a)(6).

44 Amended rule 206(4)-2(a)(6)(ii)(B).

45 Amended rule 204-2(a)(17)(iii).

46 A report describing the controls and tests of operating effectiveness (commonly referred to as a "Type II SAS 70 Report") conducted in accordance with PCAOB standards will be sufficient for purposes of the amended rule. *See* Adopting Release at 28-29.

Investment advisers or their related persons who maintain client assets with qualified custodians, while able to avoid the annual custody control examination procedures, will nonetheless remain subject to the surprise examination procedures.

## Delivery

The SEC amended rule 206(4)-2 to eliminate the alternative delivery option and to require instead that qualified custodians deliver account statements to clients for all registered advisers with custody of client assets.[47] As noted above, currently an adviser may send reports to clients directly, rather than through a qualified custodian, if it undergoes a surprise examination by an independent public accountant at least annually.[48] The amendment requires all registered advisers with custody of client funds or securities to have a reasonable basis for believing after due inquiry that the qualified custodian is sending an account statement at least quarterly to each client for which the qualified custodian maintains funds or securities. The release does not mandate a specific method for forming this belief, providing advisers with the flexibility to determine how best to meet the reasonable belief requirement. However, the SEC is maintaining the exception from the quarterly account statement delivery requirements for pooled investment vehicles that are subject to the annual audit procedures described above and the liquidation audit described below.[49] The delivery alternative was originally permitted because of concerns about maintaining client confidentiality. The SEC now believes that ensuring the integrity of the account statements is more important than accommodating concerns about confidentiality.[50]

Advisers are required to notify each client in writing of the qualified custodian's name and address and the manner in which the funds and securities are maintained upon opening an account with a qualified custodian on such client's behalf promptly when the account is opened and following any changes to this information.[51] The SEC is now requiring advisers that send account statements to their clients to insert a legend urging clients to compare the account statements from the custodian with those from the adviser: (i) when providing required notice to clients upon opening accounts on their behalf and (ii) in subsequent account statements sent to those clients.[52] The SEC modified its originally proposed amendment to require this cautionary legend only if the adviser sends its own account statements to clients (which is not required).[53]

## Liquidation Audit

Under the revised rule, the SEC sought to clarify that an adviser to a pooled investment vehicle that relies on the annual audit exception from the quarterly account statement delivery requirement must

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47 *See* amended rule 206(4)-2(a)(3).

48 *See* rule 206(4)-2(a)(3).

49 Amended rule 206(4)-2(a)(3)(i).

50 The SEC also notes that such concerns about client confidentiality can be addressed through contractual arrangements that would restrict the custodian's use of confidential information. *See* Adopting Release at 8.

51 Amended rule 206(4)-2(a)(2).

52 *Id.*

53 Adopting Release at 9.

obtain a final audit if the pool is liquidated at a time other than the end of a fiscal year. This requirement is intended to assure that the proceeds of the liquidation are appropriately accounted for.[54]

## Delivery to Related Persons

The SEC adopted a new provision to preclude registered advisers from forming layers of pooled investment vehicles to avoid the application of the custody rules. The provision states that sending an account statement or distributing audited financial statements will not meet the requirements of the rule if all the investors in a pooled investment vehicle to which the statements are sent are related persons of the adviser.[55] To comply with the rules the adviser may either (i) treat the special purpose vehicle as a separate client and distribute audited financial statements or account statements of the special purpose vehicle to the beneficial owners of the pooled investment vehicles or (ii) treat the special purpose vehicle's assets as assets of pooled investment vehicles of which the adviser has custody indirectly and include such assets within the scope of the pooled investment vehicle's financial statement audit or surprise examination.[56]

## Compliance Policies and Procedures

Rule 206(4)-7 requires registered advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules, including policies and procedures that impose controls over access to client assets that are reasonably designed to prevent misappropriation or misuse of client assets, to assure prompt detection of any misuse and to take appropriate action if any misuse occurs.[57] The SEC provided examples of such policies and procedures such as conducting background and credit checks on employees with access to client assets; requiring more than one employee to move client assets; limiting the number of employees who interact with the qualified custodian; and segregating advisory personnel from custodial personnel.[58] Advisers with custody of client assets should consider adopting procedures for the adviser's chief compliance officer to periodically test the account statements prepared by the adviser with the account statements reported by qualified custodians. Advisers that deduct advisory fees should have policies and procedures in place to ensure that the proper deduction is made, such as periodic testing of fee calculations and segregating personnel responsible for processing bills from personnel responsible for reviewing the bills for accuracy.[59] The controls need to be tailored for each adviser, and the SEC accordingly does not suggest a single set of policies and procedures for all advisers.[60]

## Amendments to Form ADV

The amendments to Form ADV are designed to provide more complete information about custody practices of registered advisers and to provide the SEC with the ability to assess compliance risk. As amended, Item 7 requires, rather than permits, advisers to report the names of related person

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54 Amended rule 206(4)-2(b)(4)(iii); *see* Adopting Release at 38-39.

55 Adopting Release at 40; *see* amended rule 206(4)-2(c).

56 Adopting Release at 41-42.

57 Adopting Release at 42.

58 Adopting Release at 43-44.

59 Adopting Release at 44-45.

60 Adopting Release at 46-47.

broker-dealers (which previously was required for related persons that are investment advisers) and to identify which serve as qualified custodians to the adviser's clients.[61] Item 7.A of Schedule D 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 broker-dealer qualified custodian and thus is not required to obtain a surprise examination for the client assets maintained with this custodian.[62]

Item 9 was amended to require additional information about custodial practices for advisers with custody (directly or through related persons), including separately reporting the amount of assets of which it has custody, excluding those assets maintained by a related person qualified custodian, the amount of assets a related person has in custody and the number of clients with assets in custody, whether the adviser or a related person serves as qualified custodian, whether a qualified custodian sends quarterly account statements to investors in pooled investment vehicles the adviser manages, whether the financial statements of the pooled investment vehicle are audited, whether the client's funds or securities are subject to a surprise examination and the month in which the last examination commenced, and whether an independent public accountant registered with, and subject to regular inspection by, the PCAOB prepares an internal control report relating to the adviser or its related persons' custodial services.[63] The amendments also will require additional information about the independent accountants and the qualified custodian.[64]

## Adopting Release Guidance for Public Accountants

The SEC has provided revised guidance to independent accountants tasked with performing audits pursuant to the revised custody rules. The guidance discusses the relevant auditing and attestation standards that apply to the required engagements. It is the SEC's belief that revised standards will modernize the procedure for surprise examinations and lower the costs to smaller advisers.[65] Pursuant to the surprise examination, accountants should obtain from the adviser records that detail client assets of which the investment adviser has custody and the identity of the qualified custodian of those assets.[66] In an attempt to reduce the risk of fraud in respect to any privately offered securities, the Accounting Release recommends that verification procedures for selected securities should include confirmation with the issuer of or counterparty to the security.[67] The Accounting Release also provides guidance regarding the internal control requirement and emphasizes a number of control objectives and associated controls related to the areas of client account setup and maintenance and authorization and processing of client transactions.[68]

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61 Adopting Release at 47-48.

62 Adopting Release at 48.

63 Adopting Release at 48-49.

64 Adopting Release at 49.

65 Adopting Release at 23.

66 Accounting Release at 2.

67 Accounting Release at 5.

68 Accounting Release at 6-8.

## The Estimated Burden of the Amendments to Advisers

The Adopting Release includes the SEC's estimates of the additional costs required under the amendments to the custody rules. Advisers that act as qualified custodian for their clients or that have a related person that acts as qualified custodian are projected to spend an average of $125,000 annually for surprise examinations.[69] The SEC estimated internal control reports should cost, on average, $250,000 per year.[70]

## Effective Date of Amendments and Compliance Deadlines

The effective date of the amendments to rules 206(4)-2, 204-2, and Forms ADV and ADV-E is March 12, 2010, except as described below.

Upon the effective date, advisers with custody of client assets must promptly upon opening a custodial account on a client's behalf, and following any changes to such custodial account information, provide notification to their clients, 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. This legend also should be included in any account statements that the advisers send to these clients after they are required to send the notification described above.[71]

Also upon the effective date, each adviser that has custody of client assets must have a reasonable belief that a qualified custodian sends account statements directly to clients at least quarterly (except with respect to pooled investment vehicles that are annually audited and whose annual audited statements are delivered to investors).[72]

Advisers 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, and advisers that become subject to surprise examination after the effective date, must enter into such an agreement within six months of becoming subject to such a requirement. Advisers that also maintain client assets as qualified custodians must provide for the first surprise examination to occur no later than six months after obtaining the internal control report.[73]

An 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.[74]

An adviser to a pooled investment vehicle relying on the annual audit provision must become contractually obligated to obtain an audit for fiscal years on and after January 1, 2010, by an independent public accountant registered with, and subject to regular inspection by, the PCAOB.[75]

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69 Adopting Release at 89. *Id*. at 89-90.

70 Adopting Release at 91.

71 Adopting Release at 51-52.

72 Adopting Release at 52.

73 Adopting Release at 52-53.

74 Adopting Release at 53.

75 Adopting Release at 53-54.

Under the amended rules, advisers must provide responses to the revised Form ADV in their first annual amendment after January 1, 2011. The SEC anticipates that the IARD system will be able to accept Form ADV-E in the fourth quarter of 2010 and will notify advisers when the IARD system is ready.[76]

## Further Information

If you have any questions, please contact any of the attorneys listed on page one or your regular Skadden contact. For more details, please visit http://www.sec.gov/rules/final/2009/ia-2968.pdf.

76 Adopting Release at 54 & n.161.