SEYFARTH SHAW
INVESTMENT MANAGEMENT ALERT

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Amended Custody Rule for Investment Advisers

On September 25, 2003, the Securities and Exchange Commission ("SEC") issued amendments to modernize the custody rule under the Investment Advisers Act of 1940. The SEC indicated that the amendments are intended to enhance protections for advisory clients' assets, harmonize the custody rule with current custodial practices, and clarify the circumstances under which advisers will be deemed to have custody. The amendments will be effective November 5, 2003, and advisers must comply with the amended custody rule no later than April 1, 2004. After the compliance date, routine SEC examinations will likely involve reviewing an adviser's books and records for compliance with the new custody rule. A copy of the adopting release is available on the SEC's Web site at www.sec.gov/rules/final/ia-2176.htm.

The following are key features of the new custody rule:

- **Definition of "Custody"**

  Unlike the old custody rule, which did not define the term "custody," the amended custody rule defines "custody" as "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them." As additional guidance, the new rule also provides a number of non-exclusive examples of custody. For instance, an adviser would have custody in any arrangement (including a general power of attorney) pursuant to which the adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the adviser's instructions. Such an arrangement would include the adviser's ability to deduct advisory fees from a client's account. As another example, an adviser would have custody if the adviser had "any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position with another type of pooled investment vehicle, or trustee of a trust) that gives the adviser or its supervised persons legal ownership of — or access to — client funds or securities." Such an arrangement would include instances in which an adviser is both investment adviser to and general partner of an investment limited partnership.

- **Maintaining Client Assets with Qualified Custodians**

  The amended rule requires advisers with custody to maintain client funds and securities in accounts with "qualified custodians" (e.g., banks or savings associations, broker-dealers, futures commission merchants, and certain foreign financial institutions). Such accounts must be maintained separately under the clients' names — or in accounts that contain only client funds and securities under the adviser's name as agent or trustee for its clients.

- **Quarterly Client Account Statements**

  Under the amended custody rule, advisory clients — or their designated independent representatives — must receive account statements at least quarterly from the qualified custodian or from the adviser. If the adviser sends the quarterly statements, the adviser

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must have an independent public accountant conduct a surprise examination at least once per calendar year on different dates each year. The independent public accountant must file a certificate on Form ADV-E within 30 days after such an examination and, upon finding any material discrepancies during the course of the examination, notify the SEC within one business day of the finding.

- **Exception for Pooled Investment Vehicles**

  Advisers to investment partnerships, limited liability companies and other pooled investment vehicles (e.g., hedge funds, commingled funds, etc.) are exempted from the account statement and surprise examination requirements if the pooled investment vehicle undergoes an annual audit and distributes the results to investors within 120 days of the end of its fiscal year.

- **Exceptions for Mutual Funds and Private Offerings**

  The new custody rule provides limited exemptions from the qualified custodian requirement for mutual fund shares held with a fund's transfer agent and certain privately offered securities. In addition, advisers are not required to comply with the new custody rule with respect to an account for an investment company registered under the Investment Company Act of 1940.

- **Form ADV**

  Although automatic deduction of advisory fees may require an adviser to comply with the custody rule, the SEC amended Part 1A of Form ADV to allow an adviser to answer "no" to Items 9A.(1) and 9A.(2) if the adviser has custody solely because the adviser deducts its advisory fees directly from its clients' accounts. The SEC also amended Item 14 of Part II of Form ADV so that federally registered advisers are not required to file balance sheets if they maintain custody of client assets.

This *Investment Management Alert* is intended only as a summary of the amended custody rule for investment advisers. If you have any questions regarding the amended custody rule, please contact the Seyfarth Shaw attorney with whom you regularly work or any of the following attorneys in the Investment Management Group of Seyfarth Shaw:

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