AMENDED CUSTODY AND RECORDKEEPING RULES TO BECOME EFFECTIVE ON MARCH 12, 2010

Beginning on March 12, 2010 (the "Effective Date"), all advisers registered with the Securities and Exchange Commission (the "SEC") must comply with the amendments to rule 206(4)-2 and rule 204-2 promulgated under the Investment Advisers Act of 1940, as amended (the "Act"). The SEC issued Release no. IA-2968 on December 30, 2009, which amended the custody requirements of rule 206(4)-2 (the "Custody Rule") and the recordkeeping requirements of rule 204-2 (the "Recordkeeping Rule" and, together with the Custody Rule, the "Rules").[1] These amendments provide for a more robust set of controls over client funds and securities ("client assets") in custody by a registered investment adviser ("RIA") or its related person. The SEC also amended Form ADV and Form ADV-E to supplement the amendments to the Rules and to require RIAs to report to the SEC more detailed information about their custody practices in their registration form and to update such information. RIAs must provide responses to the revised Form ADV in their first annual amendments after January 1, 2011.

The notable new requirements of the amended Custody Rule are the annual surprise examination requirement for an RIA that has custody of client assets, the notice delivery requirement for an RIA to its clients, the account statement delivery requirement for an RIA to its clients and the internal control report requirement for an RIA or its related person that serves as a qualified custodian for client assets. The amended Custody Rule also contains exceptions to one or more of these new requirements, including exceptions that are applicable to pooled investment vehicles ("PIVs") that distribute their audited financial statements, operationally independent related persons and RIAs that have custody of client assets only for fee deduction purposes.

APPLICATION OF THE RULES

All RIAs, including investment advisers required to be registered under section 203 of the Act, are subject to the Rules and the amendments thereto. Currently, the Rules, as amended, do not apply to unregistered investment advisers. However, in light of recent proposals by the SEC and other regulatory authorities for greater regulation of investment advisers, it is possible that unregistered investment advisers may become required to register as investment advisers and therefore comply with the requirements of the Rules. Furthermore, complying with the new requirements of the amended Rules may become the market standard for all investment advisers, including unregistered investment advisers.

CUSTODY AND QUALIFIED CUSTODIANS

A RIA has custody of any client assets if it, or its "related person," directly or indirectly holds or has any authority to obtain possession of such client assets. A "related person" is defined as a person directly or indirectly controlling or controlled by the RIA and any person under common control with the RIA. Custody can arise in a number of ways, including by possession of client assets, by an arrangement under which client assets maintained with a custodian are authorized or permitted to be withdrawn upon instruction to the custodian and by serving in a capacity that gives legal ownership of or access to client assets.

If a RIA has custody of client assets, then a qualified custodian must maintain such assets. The RIA, its related person or an independent entity may serve as a qualified custodian. However, if the RIA or its related person

[1] Available at: http://www.sec.gov/rules/final/2009/ia-2968.pdf.

serves as a qualified custodian, then the RIA or its related person will be subject to additional controls. Regardless of who serves as the qualified custodian, the qualified custodian must maintain client assets in either:

(a) a separate account for each client under each such client's name; or
(b) accounts that contain only the RIA's client assets, under the RIA's name as agent or trustee for the clients.

ANNUAL SURPRISE EXAMINATION

Under the amended Custody Rule, a RIA with custody of client assets is required to obtain a surprise examination (or an audit, if applicable in the case of a PIV) of such client assets by an independent public accountant. The RIA must enter into a written agreement with an independent public accountant pursuant to which the accountant agrees to conduct the surprise examination. The written agreement must contain the following provisions concerning the timing of the surprise examination and the protocol for the accountant during and after such surprise examination.

Timing

(a) The surprise examination must occur at least once during each calendar year at a time chosen by the accountant. The surprise examination must occur at irregular times from year-to-year and without prior notice or announcement to the RIA.
(b) For a RIA currently with custody of client assets, the first surprise examination must occur by December 31, 2010. For a RIA that becomes subject to the Custody Rule after the Effective Date, the first surprise examination must occur within six (6) months of becoming subject to the requirement. If the RIA or its related person itself maintains client assets as the qualified custodian, the first surprise examination must occur within six (6) months after obtaining the internal control report.

Protocol for Accountants During and After the Surprise Examinations

(a) The accountant must file a certificate on Form ADV-E with the SEC within one hundred twenty (120) days of the date of surprise examination chosen by the accountant. The certificate must state that the accountant has examined the client assets and describe the nature and extent of the examination.
(b) The accountant must notify the SEC within one (1) business day of finding any material discrepancies during the course of the examination.
(c) The accountant must file Form ADV-E with the SEC within four (4) business days after its resignation, dismissal or removal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed.

Certain client assets in custody by the RIA, such as privately offered securities and mutual fund shares, typically are not required to be maintained by a qualified custodian. However, if such private securities and mutual fund shares are maintained by a qualified custodian, then such assets will be subject to the surprise examination requirement. Furthermore, the exception for privately offered securities is only available with respect to securities held for the account of a limited partnership (or a limited liability company or other type of PIV) only if the limited partnership is audited, and the audited financial statements are distributed in accordance with the amended Custody Rule.

DELIVERY OF ACCOUNT STATEMENTS TO CLIENTS

Generally, a RIA that has custody of client assets must maintain such client assets with a qualified custodian and must have a reasonable basis for believing that the qualified custodian sends an account statement to each client for which the qualified custodian maintains such client assets that:

(a) is sent at least once per calendar quarter;
(b) identifies the amount of funds and each security in the account at the end of that period; and
(c) sets forth all transactions in the account during that period.

The RIA must form its reasonable basis after "due inquiry." There is no single, definitive standard for what constitutes due inquiry. For example, according to the SEC, it may be sufficient for a qualified custodian to send to the RIA a copy of the account statement that was delivered to the RIA's client.

Special Account Statement Requirements for PIVs

If the RIA or its related person is a general partner or a manager of a PIV, such as an investment fund in the form of a limited partnership or a limited liability company, the RIA must have a reasonable basis to believe that its qualified custodian sends an account statement to each investor in such PIV (such as a limited partner, member or other beneficial owner of the PIV).

However, if all of the PIV's investors are themselves (i) PIVs *and* (ii) related persons of the RIA, then the RIA's reasonable basis for believing that its qualified custodian sends an account statement (or distributes audited financial statements, if applicable) to each investor of such PIV will not satisfy this requirement of the amended Custody Rule. This situation often arises when a RIA to several PIVs, which are each managed by the RIA or its related person, creates a special purpose vehicle ("SPV") to facilitate investments in certain securities for such PIVs. Such SPV typically is established or controlled by the RIA or its related person. In order to satisfy the account statement delivery requirement, the amended Custody Rule requires that the RIA either treat the SPV as a separate client or treat the SPV's assets as the assets of the PIVs.

(a) Separate Client Treatment. In this case, the RIA will be deemed to have custody of the SPV's assets. The RIA either must comply with the surprise examination, notice delivery and account statement delivery requirements or comply with the exception from these requirements by distributing the audited financial statements of the SPV. Accordingly, the RIA should distribute the audited financial statements or account statements to the beneficial owners of the PIVs that are managed by the RIA or its related person and invest in the SPV, and not just to the PIVs themselves.
(b) PIV Asset Treatment. In this case, the RIA will be deemed to have indirect custody of the SPV's assets. As a result, the SPV's assets are considered within the scope of the PIV's assets for the purpose of such PIV's financial statement audit or surprise examination.

In both cases, if the RIA has to comply with the account statement delivery requirement for either the SPV or PIVs, the RIA must have a reasonable basis to believe that the qualified custodian delivers the account statements of the SPV to the beneficial owners of the PIVs that are managed by the RIA or its related person and invest in the SPV.

DELIVERY OF NOTICES TO CLIENTS

Generally, a RIA with custody of client assets must satisfy new notification requirements to its clients. If the RIA opens an account with a qualified custodian on the client's behalf, the RIA must promptly notify the client in writing when the account is opened of the following:

(a) the qualified custodian's name;
(b) the qualified custodian's address; and
(c) the manner in which the client assets are maintained.

The RIA also must promptly notify the client in writing if there are any changes to any of the above information.

If the RIA sends account statements to a client to which it is required to provide this notice in addition to the account statements sent by the qualified custodian maintaining the client assets, then the RIA must include in the notification provided to the client and in any subsequent account statement it sends to such client a legend that urges such client to compare the account statements from the qualified custodian with those from the RIA.

ADDITIONAL REQUIREMENTS FOR A RIA OR ITS RELATED PERSON SERVING AS A QUALIFIED CUSTODIAN

If a RIA or its related person maintains client assets as a qualified custodian in connection with advisory services the RIA provides to its clients, the RIA must comply with two additional requirements:

(a) the independent public accountant retained to perform the surprise examination must be registered with the Public Company Account Oversight Board (the "PCAOB"); and
(b) the RIA must obtain, or receive from its related person, an internal control report, such as a Type II SAS 70 report, from an independent public accountant registered with the PCAOB. The RIA must have an internal control report within six (6) months of becoming subject to the requirements of the amended Custody Rule and at least once each calendar year thereafter. The internal control report must contain, among other things:

    (1) an opinion from the accountant regarding whether the internal controls of the RIA are in operation as of a specific date and whether such internal controls are sufficient to meet the control objectives relating to custodial services; and
    (2) the accountant's verification that the client assets held by the RIA or its related person as a qualified custodian are reconciled to an unaffiliated custodian.

EXCEPTIONS TO THE AMENDED CUSTODY RULE

The amended Custody Rule carves out several exceptions to one or more of its new requirements. The most notable exceptions apply to PIVs that distribute their audited financial statements, operationally independent related persons and RIAs that have custody of their client assets only for fee deduction purposes.

PIVs

A RIA is exempt from the account statement and notice delivery requirements and is deemed to have complied with the surprise examination requirement with respect to the account of a PIV that is subject to audit:

(a) at least annually and distributes its audited financial statements prepared in accordance with generally accepted accounting principles ("GAAP") to all investors within one hundred twenty (120) days (one hundred eighty (180) days for fund of funds) of the end of its fiscal year, starting with the audits relating to the fiscal year beginning on January 1, 2010;
(b) by an independent public accountant that is registered with the PCAOB; and
(c) upon liquidation and distributes its audited financial statements prepared in accordance with GAAP to all investors promptly upon the completion of such audit.

However, a RIA of a PIV in certain situations must still comply with some of the amended Custody Rule's other requirements, including:

(a) if the RIA or its related person serves as a qualified custodian to the RIA's client assets, the entity serving as a qualified custodian must obtain an internal control report;
(b) if all of the PIV's investors are PIVs and related persons of the RIA, the RIA must treat the PIV as a separate client or treat the investor's assets as if they were assets of the PIV investors; and
(c) if the RIA relies on the annual audit provision of the amended Custody Rule, it must nonetheless undergo an annual surprise examination of non-PIV assets of which it has custody.

Operationally Independent Related Persons

A RIA is exempt from the surprise examination requirement if:

(a) such RIA has custody under the amended Custody Rule solely because a related person holds, directly or indirectly, client assets, or has any authority to obtain possession of such assets, in connection with advisory services the RIA provides to clients; and
(b) such RIA's related person is "operationally independent" of such RIA.

The amended Custody Rule creates a presumption that a related person that holds, or has authority to obtain possession of, advisory client assets is not operationally independent of the RIA. However, this presumption is overcome by satisfying all of the following conditions:

(a) client assets in the custody of the related person are not subject to claims made by the RIA's creditors;
(b) advisory personnel do not have custody or possession of, or direct or indirect access to, client assets of which the related person has custody, or the power to control the disposition of such client assets to third parties for the benefit of the RIA or its related persons, or otherwise have the opportunity to misappropriate such client assets;
(c) advisory personnel and the related person's personnel who have access to advisory client assets are not under common supervision;
(d) advisory personnel do not hold any position with the related person or share premises with the related person; and
(e) there are no other circumstances that can reasonably be expected to compromise the operational independence of the related person.

A RIA that is able to satisfy these conditions and overcome the presumption would not have to obtain a surprise examination of client assets held by a related person, including a related person that is a qualified custodian. However, the RIA would have to comply with the other provisions of the amended Custody Rule unless an exception is otherwise available.

Furthermore, under the amended Recordkeeping Rule, the RIA must make and keep a memorandum describing:

(a) the relationship with the related person in connection with the RIA's advisory services to its clients; and
(b) the RIA's basis for determining that it has overcome the presumption against operational independence of its related person, which basis also must be stated on the RIA's Form ADV-E.

Custody for Fee Deductions

A RIA is not required to be subject to a surprise examination of client assets maintained by a qualified custodian:

(a) if such RIA has custody of such client assets solely as a consequence of its authority to make withdrawals from client accounts to pay its advisory fee; and
(b) if the qualified custodian is a related person, the RIA can rely on the exemption for operationally independent related persons.

IMPLICATIONS FOR ADVISERS TO INVESTMENT FUNDS

The new requirements of the amended Rules may prove to be burdensome to RIAs of investment funds from both a time and monetary cost perspective. From a monetary cost perspective, the SEC estimates that a surprise examination will cost approximately $10,000 annually for small-sized advisers, $20,000 annually for medium-sized advisers and $125,000 for large advisers.[2] The SEC also estimates that preparing an internal control report will cost approximately $250,000. Furthermore, the unpredictability of the surprise examinations could be disruptive to the RIA's business.

A RIA to an investment fund or other PIV can avoid the surprise examination, the notice delivery and the account statement delivery requirements, however, if the RIA distributes the audited financial statements of such investment fund to all of such investment fund's investors within one hundred twenty (120) days (one hundred eighty (180) days for fund of funds) of the end of each fiscal year.

With respect to the internal control report requirement, a RIA to an investment fund must obtain an internal control report only if such RIA or its related person serves as a qualified custodian for client assets with respect to the fund. The only way the RIA will not be subject to the internal control report requirement is if it or its related person no longer serves as a qualified custodian for client assets. The RIA may do this, for example, by engaging an independent entity to serve as a qualified custodian for all of client assets with respect to the fund.

[2] The SEC considers a small RIA to have fewer than 806 clients and a medium-sized RIA to have more than 806 clients, and that both use an independent qualified custodian for client assets. The estimated cost is based on the RIA complying with the annual surprise examination requirement for the assets of five percent (5%) of its clients. The SEC considers a large RIA to have an average of 2,315 clients and for whose assets it or its related person serves as a qualified custodian. The estimated cost is based on the RIA complying with the annual surprise examination requirement for assets of all of its clients.

Special requirements arise when the RIA to an investment fund or the RIA's related person creates a SPV to facilitate the investment of the funds managed by the RIA or its related person. The RIA is not exempt from the account statement delivery requirement for the SPV by distributing the SPV's audited financial statements each year to the investment funds that it or its related person manages. Instead, the RIA either must treat the SPV as a separate client or treat the SPV's assets as the investment funds' assets. If the RIA treats the SPV as a separate client, the RIA will be deemed to have custody of the SPV's assets. The RIA has the option of either complying with the surprise examination, account statement delivery and notice delivery requirements or qualifying for the exception to these requirements by distributing the audited financial statements of the SPV. Accordingly, the RIA should distribute the audited financial statements or account statements to the beneficial owners of the investment funds that are managed by the RIA or its related person and invest in the SPV, and not just to the investment funds themselves. Alternatively, if the RIA instead treats the SPV's assets as assets of the investment funds, the SPV structure is effectively ignored and the RIA will be deemed to have indirect custody of the SPV's assets. As a result, the SPV's assets are considered to be part of the investment funds' assets for the purpose of such investment funds' financial statement audits or surprise examinations. In both cases, if the RIA has to comply with the account statement delivery requirement for either the SPV or the investment funds, the RIA must have a reasonable basis to believe that the qualified custodian delivers the account statements of the SPV to the beneficial owners of the investment funds that are managed by the RIA or its related person and invest in the SPV.

Certain RIAs also may take advantage of other exceptions from the surprise examinations. First, a RIA deemed to have custody of client assets solely as a result of an operationally independent related person having custody may be exempt from the surprise examinations. In order to qualify for this exception, the RIA must keep a memorandum describing the relationship with its related person in connection with the RIA's advisory services to its clients and the RIA's basis for determining that it has overcome the presumption against operational independence with respect to the related person. The RIA also must state such basis in Form ADV-E. Second, a RIA is exempt from the surprise examination requirement for client assets maintained by a qualified custodian if such RIA has custody solely for the purpose of deducting its advisory fees. If the qualified custodian is a related person, however, the RIA will need to rely on the exemption for operationally independent related persons. The foregoing two exceptions exempt the RIA from only the surprise examination requirement. A RIA that takes advantage of one of these two exceptions must still comply with the internal control report requirement if such RIA or its related person maintains client assets as a qualified custodian. Also, RIAs that take advantage of one of these two exceptions must still comply with the notice and account delivery requirements, unless the RIA distributes its audited financial statements to all of the investors of the investment fund for which it provides advisory services.

Finally, although the amended Rules only currently apply to RIAs, and not to unregistered investment advisers, unregistered investment advisers may want to consider modifying their procedures to comply with the amended Rules. The recently adopted amendments may be just the beginning of more extensive regulation of investment advisers. Therefore, it is possible that unregistered investment advisers may become forced to register with the SEC and comply with the requirements of the amended Rules. Furthermore, even if unregistered investment advisers are not forced to register with the SEC, compliance with the amended Custody Rule may become the market standard for all investment advisers.

About Curtis

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