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Practical Application of the Adviser Custody Rule and How to Report Custody on Form ADV

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The adviser custody rule—Rule 206(4)-2 under the Investment Advisers Act of 1940 (Advisers Act)—was amended again effective in March 2010.¹ Since then, advisers have been coping with the implications of the amended rule and its myriad new requirements, exceptions and interpretations. Many advisers will face another custody hurdle very soon, when they prepare their next annual updating amendment to Form ADV and have to report custody in amended Item 9 of Part 1 for the first time.

To illustrate some of these custody issues, this article analyzes the practical application

of the amended rule to a hypothetical advisory firm, discussing how the firm's custodial arrangements would be treated under the rule and how they would be reported in Item 9.

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The Hypothetical

Consider a hypothetical investment adviser, ADVISER, registered with the Securities and Exchange Commission (SEC) under the Advisers Act. ADVISER is owned and

controlled by a holding company that also owns and controls an SEC-registered broker-dealer, a bank and a limited liability company (LLC) that acts as the general partner of a private fund. As a result of this “control” relationship, the broker-dealer, bank and LLC are “related persons” of ADVISER under the custody rule. Assume that ADVISER’s related LLC and broker-dealer are *not* “operationally independent” of ADVISER,² although ADVISER’s related bank *is*.

ADVISER provides advisory services to the following types of accounts:

- Five separate accounts holding an aggregate of \$3.0 billion custodied by various qualified custodians that are independent of ADVISER (meaning they are not the ADVISER itself or any of its related persons). ADVISER has “fee deduction authority” over these accounts, that is, the authority to make withdrawals from these accounts to pay its advisory fees.
- A private fund organized as a limited partnership for which ADVISER’s related person, an LLC, acts as general partner. The private fund holds assets of \$2.0 billion custodied by an independent (unrelated to ADVISER) SEC-registered broker-dealer serving as the fund’s prime broker.
- One hundred separately managed wrap accounts holding an aggregate of \$500 million, custodied by ADVISER’s related broker-dealer, the wrap program sponsor.
- Ten trust accounts holding an aggregate of \$1.5 billion, custodied by ADVISER’s related bank. For one of the trust accounts, ADVISER’s chief executive officer (CEO) acts as trustee at the request of the trust grantor, an old childhood acquaintance of the CEO who has been a close family friend for many years. For another trust account, an ADVISER portfolio manager acts as trustee at the request of the trust

grantor, who met the portfolio manager when the trust account was opened and who felt it was best to have someone from the bank’s organization named as trustee.

Note that ADVISER has a total of 116 clients and \$7.0 billion in assets under management. Assume that each of ADVISER’s advised accounts contains both “funds” (cash, cash equivalents and/or bank accounts) and “securities” within the meaning of the custody rule.

The Issues

First this article will discuss two questions for each type of advised account:

1. Does ADVISER have “custody” under the rule of client funds and securities in these accounts?
2. If so, what are the primary consequences under the rule? This will include a discussion of whether the assets in the accounts are subject to an annual surprise exam,³ and whether ADVISER must obtain an annual internal control report⁴ from the qualified custodian maintaining those accounts.

This article will then discuss how ADVISER should report these arrangements in amended Item 9 of Form ADV Part 1. Lastly, this article will discuss a number of anomalies and opportunities for confusion that arise when responding to Item 9.

Analysis of “Custody”

The Separate Accounts

1. Does ADVISER have “custody” under the rule of client funds and securities in these accounts?

Yes. Even though the qualified custodians holding the assets in these accounts are independent of ADVISER, ADVISER has fee deduction authority over these accounts. Typically, an adviser with fee deduction authority can simply calculate the advisory fee it is owed each

quarter and tender an invoice to the qualified custodian for that amount. The qualified custodian will then remit the amount owed to the adviser without verifying the fee calculation and without obtaining verification of the amount from the client.

Under the amended custody rule, this arrangement gives ADVISER sufficient authority to obtain possession of or withdraw client assets to fall within the “custody” definition. Indeed, paragraph (d)(2)(ii) of the rule says custody includes “[a]ny arrangement...under which [an adviser is] authorized or permitted to withdraw client funds or securities maintained with a custodian upon [the adviser’s] instruction to the custodian.”

2. If so, what are the primary consequences under the rule?

First, the assets in those accounts must be maintained by qualified custodians.⁵ (They are, according to our hypothetical.)

Second, the qualified custodians must send account statements directly to the clients at least quarterly, including all the information called for by the rule. The adviser may send its own account statements to clients as well, but the adviser’s account statements may not substitute for those sent by the qualified custodian directly.⁶

Third, although accounts over which ADVISER has custody would normally be subject to an annual surprise exam requirement under the rule, paragraph (b)(3) of the rule says advisers are not required to have a surprise exam for assets maintained by a qualified custodian if the adviser has custody of those assets *solely* as a consequence of its fee deduction authority. Since in our hypothetical, ADVISER has custody over the assets in the separate accounts for one reason only—its fee deduction authority—these assets would not be subject to a surprise exam.⁷

Fourth, because the qualified custodians maintaining the assets in the separate accounts are independent of ADVISER—meaning they are not ADVISER itself or a related person of ADVISER—the rule does not call for an internal control report to be obtained from the custodians.

The Private Fund

1. Does ADVISER have “custody” under the rule of client funds and securities in this account?

Yes. This is because ADVISER’s related person, the LLC, is acting as general partner of the private fund, which is organized as a limited partnership. Typically, a general partner would have, by law, the general power and authority to manage the affairs of its limited partnership. Although it could conceivably be different in any given case, a general partner’s authority would normally include being able to buy, sell, transfer and otherwise manage all partnership assets, affording it “access” to the partnership’s assets within the definition of “custody” in the rule. Indeed, paragraph (d)(2)(iii) of the custody rule expressly lists a general partner of a limited partnership as one person with sufficient “ownership” of or “access” to assets to fall within the definition. Accordingly, in our hypothetical, the LLC is itself treated as having “custody” over the assets in the private fund.

As a consequence of the LLC’s custody, ADVISER will also have custody. This is because under paragraph (d)(2) of the rule, a related person’s custody over client assets is attributed to the adviser if the related person’s custody is in connection with any advisory services the adviser provides to those clients. Since ADVISER is providing advisory services to the same assets in the private fund as to which the LLC is acting as general partner, ADVISER will have custody over those assets by virtue of the LLC’s custody.

Note that both ADVISER and its related LLC have “custody” over the private fund’s assets under the rule, even though the broker-dealer acting as the fund’s prime broker and qualified custodian is independent of both.

2. If so, what are the primary consequences under the rule?

First, the assets in the private fund must be maintained by a qualified custodian. (They are, according to our hypothetical. The independent SEC-registered broker-dealer acting as prime broker serves as the qualified custodian.)

Second, the qualified custodian must send account statements directly to the clients (in this case, the limited partners/investors in the fund)⁸ at least quarterly, unless the private fund uses the so-called “audit approach” under the custody rule. To use the “audit approach,” the fund would have to satisfy all the requirements of paragraph (b)(4) of the rule, including having its financial statements audited at least annually by an independent PCAOB-registered and inspected accounting firm⁹ and delivered to all the limited partners in the fund per the rule.¹⁰

Third, the private fund’s assets must be verified by a surprise exam conducted at least annually by an independent accounting firm, again, unless the fund uses the “audit approach,” in which case the fund is deemed to have satisfied the surprise exam requirement by virtue of paragraph (b)(4) of the rule.

Note that if the private fund does not use the “audit approach,” it cannot avoid a surprise exam by relying on paragraph (b)(6) under the rule, which says in substance a surprise exam is not required if related person custody is the sole basis on which an adviser has “custody” under the rule and the related person is “operationally independent” of the adviser.¹¹ However, according to our hypothetical facts, the LLC is *not* operationally independent of ADVISER and paragraph (b)(6) would therefore not apply.

Fourth, because the qualified custodian that maintains the private fund’s assets is independent of ADVISER (meaning it is not ADVISER itself or a related person of ADVISER), the rule does not call for an internal control report to be obtained from the custodian.¹²

The Wrap Accounts

1. Does ADVISER have “custody” under the rule of client funds and securities in these accounts?

Yes. This is because ADVISER’s related broker-dealer is maintaining those assets as the qualified custodian and therefore has “custody” of the assets in that capacity. Since its related person’s “custody” will be attributed to ADVISER, it too will be deemed to have “custody,” under the same rationale and

rule provisions explained above for the private fund.

2. If so, what are the primary consequences under the rule?

First, the assets in the wrap accounts must be maintained by a qualified custodian. (They are, according to our hypothetical. As an SEC-registered broker-dealer, ADVISER’s related broker-dealer is among those financial institutions recognized as a “qualified custodian” under the rule. Note that in order to be “qualified custodian” under the custody rule, the custodian need not be “independent” of the adviser or even “operationally independent.”)

Second, the qualified custodian must send account statements directly to the wrap clients at least quarterly, including all the information called for by the rule. As noted previously, the adviser may send its own account statements to clients as well, but the adviser’s account statements may not substitute for those sent by the qualified custodian directly.

Third, the assets must be independently verified at least annually by a surprise exam. Note that, as was the case for the private fund explained above, ADVISER cannot avoid a surprise exam by relying on paragraph (b)(6) of the custody rule because, according to our hypothetical facts, ADVISER’s related broker-dealer is not “operationally independent.” Moreover, because the broker-dealer acting as qualified custodian for the wrap accounts is a related person of ADVISER, the surprise exam must be conducted by not just any independent accounting firm, but an independent accounting firm that is registered and inspected by the PCAOB.

Fourth, because the qualified custodian maintaining the assets is ADVISER’s related person, an internal control report must also be obtained from the custodian at least annually. The internal control report must also be prepared by an independent PCAOB-registered and inspected accounting firm.

The Trust Accounts

1. Does ADVISER have “custody” under the rule of client funds and securities in these accounts?

Yes. This is because ADVISER's related person, the bank, is maintaining those assets as the qualified custodian and therefore has "custody" of the assets in that capacity. As explained above, because it is a related person, the bank's "custody" will be attributed to ADVISER. Therefore, ADVISER will also have "custody" of assets in the trust accounts.

ADVISER will also have "custody" over one of the trust accounts for a second reason, because its supervised person—a portfolio manager—acts in the role as trustee for the account, which will be imputed to ADVISER.¹³ A trustee has, by law, legal ownership of and access to assets in the trust, typically including the power to buy, sell, transfer and otherwise manage the assets in the trust. As expressly noted in paragraph (d)(2)(iii) of the custody rule, the portfolio manager's role as trustee is sufficient to cause ADVISER to have "custody" over that particular account due to that relationship as well.

In contrast, the role of ADVISER's CEO as trustee of one of the other trust accounts would not be imputed to ADVISER. This is due to a long-standing SEC interpretation¹⁴ which says that if the supervised person has been appointed as trustee as a result of a family or personal relationship with the grantor or beneficiary, and not as a result of employment with the adviser, the supervised person's appointment as trustee will not be imputed to the adviser. Under this interpretation, ADVISER would not have "custody" over this trust account for a second reason as a result of the CEO's role as trustee, since our hypothetical facts say the CEO was appointed as a result of a pre-existing personal relationship with the grantor and not as a result of employment with ADVISER.

2. If so, what are the primary consequences under the rule?

First, the assets in the accounts must be maintained by a qualified custodian. (They are, according to our hypothetical. Banks are among those financial institutions recognized as "qualified custodians" under the rule. Again, "qualified custodians" are not required to be independent.)

Second, the qualified custodian must send account statements directly to the clients at least quarterly, including all the information called for by the rule. As noted previously, the adviser may send its own account statements to clients as well, but the adviser's account statements may not substitute for those sent by the qualified custodian directly.

Third, a surprise exam will not be required for any of the trust accounts except the trust account where ADVISER's portfolio manager acts as trustee. This is because under paragraph (b)(6) of the custody rule, a surprise exam is not required if related person custody is the sole basis on which an adviser has "custody" of the assets under the rule and the related person is "operationally independent" of the adviser. In our hypothetical, the bank is "operationally independent" of the adviser and the bank's "custody" is the sole basis on which ADVISER has custody of all the trust accounts but one, the trust account where the portfolio manager acts as trustee. There, the portfolio manager's "access" to assets in that account as trustee gives ADVISER a second basis for "custody" under the rule and paragraph (b)(6) therefore would not apply to avoid a surprise exam for that account. Note that a surprise exam could be avoided for the trust account where ADVISER's CEO acts as trustee because, according to the SEC's interpretation discussed above, the CEO's role as trustee in that case would not be imputed to ADVISER and paragraph (b)(6) would therefore still apply.

For the one trust account where a surprise exam is required, the surprise exam must be conducted by not just any independent accounting firm, but an independent accounting firm that is registered with and inspected by the PCAOB. This is because the bank acting as qualified custodian is a related person of ADVISER. For this purpose, it does not matter that the bank is operationally independent of ADVISER.

Fourth, because the qualified custodian is a related person, an internal control report must also be obtained from the custodian at least annually, prepared by an independent PCAOB-registered and inspected accounting firm. This is true even though the bank is "operationally independent" of ADVISER.

Even when applicable, paragraph (b)(6) of the rule provides an exception only from the surprise exam requirement and not from the requirement to obtain an internal control report.

Reporting Custody in Item 9 of Form ADV Part 1

The latest amendments to the adviser custody rule were accompanied by amendments to Item 9 of Form ADV Part 1 requiring advisers to report “custody.” Amended Item 9 calls for details about custody never called for before. Advisers must report their custody separately from their related persons’ custody even though, under the rule itself, a related person’s custody is attributed to the adviser. This and other ambiguities on the form will likely lead to confusion in reporting.

The following discussion focuses on how “custody” of ADVISER and its related persons would be reported under amended Item 9.

Item 9.A.(1)

Item 9.A.(1) asks about ADVISER’s custody, which would be reported as follows based on our hypothetical facts:

Item 9. A. (1) Do you have custody of any advisory clients’:	Yes	No
(a) cash or bank accounts?	X	
(b) securities?	X	

The instruction appearing beneath Item 9.A. on Form ADV Part 1 says in substance that SEC-registered advisers should answer “No” to these items if they have custody *solely* because they have fee deduction authority or because the custody of an *operationally independent* related person acting as *qualified custodian* is attributed to the adviser. With this in mind, ADVISER’s responses to this item would be analyzed as follows:

- **Separate accounts:** Per the instruction, ADVISER’s custody over the separate accounts alone would not cause it to respond “Yes” here because it has custody

over those accounts solely as a result of fee deduction authority.

- **Private fund account:** However, ADVISER would be required to respond “Yes” to this item because its related LLC’s “custody” would be attributed to ADVISER. ADVISER would not be able to rely on the instruction to respond “No” to this item since the LLC in our hypothetical is neither operationally independent nor acting as the qualified custodian.
- **Wrap accounts:** Similarly, ADVISER would be required to respond “Yes” to this item because its related broker-dealer’s custody of the wrap accounts would be attributed to ADVISER. Again, ADVISER would not be able to rely on the instruction to respond “No” because, even though its related broker-dealer is acting as the qualified custodian, it is not operationally independent on our hypothetical facts.
- **Trust accounts:** ADVISER’s custody over the trust accounts alone would not cause it to respond “Yes” here because, per the instruction, it has custody over those accounts only as a result of the bank’s custody being attributed to ADVISER and the bank is both acting as the qualified custodian and operationally independent. The only exception to this is the one trust account where ADVISER’s portfolio manager acts as trustee. Since that trustee arrangement gives ADVISER a basis for custody other than solely fee deduction authority or the bank’s attributed custody, ADVISER would also have to respond “Yes” here as a result of that account.

Consequently, for at least three reasons in our hypothetical scenario—its custody over the private fund account, the wrap accounts and the trust account for which its portfolio manager acts as trustee—ADVISER must respond “Yes” to Items 9.A.(1)(a) and (b) and may not rely on the instruction underneath those items to answer “No.”

Item 9.A.(2)

Item 9.A.(2) then asks for details about ADVISER'S custody:

(2) If you checked “yes” to Item 9.A.(1)(a) or (b), what is the amount of client funds and securities and total number of clients for which you have custody:	
US Dollar Amount	Total Number of Clients
(a) \$5.0 billion	(b) 6

The instruction beneath Item 9.A.(2) on Form ADV Part 1 says: “If your related person serves as qualified custodian of client assets, do not include the amount of those assets and the number of those clients in your response to Item 9.A.(2). Instead, include that information in your response to Item 9.B.(2).” Note that this would exclude in this item assets over which a related person has custody (attributed to the adviser) if the related person acts as the qualified custodian, but not assets over which a related person has custody (attributed to the adviser) if the related person does *not* act as the qualified custodian.

With this in mind, ADVISER's responses to this item would be analyzed as follows:

- Separate accounts: There are two possible ways to report ADVISER's separate accounts under this item. Which way was intended by the SEC is unclear. The first way would be to exclude the separate accounts here because ADVISER has custody of them only as a result of fee deduction authority and that alone is not a basis for reporting “Yes” to the question “Do you have custody?” in Item 9.A.(1) (per the instructions underneath that item).¹⁵

The second way would suggest that once ADVISER has custody over any client assets that require a “Yes” on Item 9.A.(1), then *all* assets over which ADVISER has custody should be reflected in Item 9.A.(2) (except those where a related person acts as qualified custodian, which get reported in Item 9.B.(2) instead).¹⁶ Under this second way,

ADVISER should include the separate account assets in this item even though it has custody over them solely because of fee deduction authority, because it has custody over other assets for other reasons that require it to check “Yes” to Item 9.A.(1).

The Item 9.A.(2) responses shown above for ADVISER follow the second way for two reasons:

- First, because a strict reading of the form points to this result. Technically, the instruction underneath Item 9.A.(1) applies only to that item. Moreover, Item 9.A.(2) has an ‘all-or-nothing’ trigger, meaning that if an adviser responds “Yes” to Item 9.A.(1)—ostensibly for any reason at all—then it must provide the details called for by Item 9.A.(2). Although certain assets are carved out of Item 9.A.(2) by the instruction underneath, the only assets carved out are those for which a related person acts as qualified custodian (which are reported elsewhere).
- Second, because it is the more conservative approach to report the greater number of assets and client accounts over which the adviser has custody, which would be the wiser approach in the absence of clear instructions to the contrary, at least until further guidance is provided by the SEC Staff.¹⁷

As a result, the figures shown above for ADVISER in Item 9.A.(2) include the five separate accounts/clients holding \$3.0 billion in assets.

- Private fund account: ADVISER's response to Item 9.A.(2) also includes the private fund—counted as a single client—holding \$2.0 billion in assets. This is because ADVISER has custody of those assets as a result of the LLC's “custody” (as explained under prior headings) and because the qualified custodian holding those assets is not a

related person. If it were a related person, the amounts would be reported under Item 9.B.(2) instead.

- **Wrap accounts:** ADVISER’s response to Item 9.A.(2) excludes the 100 wrap accounts/clients holding \$500 million in assets. Even though ADVISER has “custody” of those assets as a result of its related broker-dealer’s “custody” (as explained under prior headings), the related broker-dealer is acting as the qualified custodian of those assets. Therefore, according to the instruction underneath Item 9.A.(2), those assets and clients must be reported under Item 9.B.(2) instead.
- **Trust accounts:** Similarly, ADVISER’s response to Item 9.A.(2) excludes the 10 trust accounts/clients holding \$1.5 billion in assets. Even though ADVISER has “custody” of those assets as a result of its related bank’s “custody” (as explained under prior headings), the related bank is acting as the qualified custodian of those assets. Therefore, according to the instruction underneath Item 9.A.(2), those assets and clients must be reported under Item 9.B.(2) instead.

Note that, according to the instruction, even the one trust account where ADVISER’s portfolio manager acts as trustee should be reported under Item 9.B.(2) *instead of* Item 9.A.(2). Even though ADVISER has “custody” of that one trust account for a reason other than the fact that its related bank acts as qualified custodian, the instruction underneath Item 9.A.(2) does not make that distinction. Instead, a straightforward reading of the instruction requires *all* accounts for which a related person acts as qualified custodian to be reported in Item 9.B.(2) instead.

Consequently, ADVISER has reported six clients (five separate account clients + one private fund client) and \$5.0 billion in assets (\$3.0 billion in the separate accounts + \$2.0

billion in the private fund) in Items 9.A.(2)(a) and (b).

Item 9.B.(1)

Next, Item 9.B. asks questions about an adviser’s related persons that are similar to those asked in Item 9.A. about the adviser.

Item 9. B. (1) Do any of your related persons have custody of any of your advisory clients?:	Yes	No
(a) cash or bank accounts?	X	
(b) securities?	X	

The instruction underneath this item on Form ADV states that an adviser is required to answer this item regardless of how it answered Item 9.A.(1)(a) or (b). Also, note carefully that this item is asking about related persons with “custody” over the adviser’s clients’ assets *for any reason*, which could be because the related person acts as the qualified custodian or because the related person otherwise has “access” to or the authority to withdraw assets from the account which causes it to fall within the “custody” definition for other reasons. As a consequence, an adviser might have to answer “Yes” to Item 9.A.(1) because its related person has custody (which is attributed to the adviser), and then have to answer “Yes” again to Item 9.B.(1) because of that same related person’s custody.

With this in mind, ADVISER’s responses to this item would be analyzed as follows:

- **Separate accounts:** The qualified custodians maintaining the separate accounts are independent of ADVISER (meaning they are not ADVISER or a related person) and none of ADVISER’s related persons have “custody” over the separate accounts for other reasons. As a result, ADVISER would not have to respond “Yes” here solely because of the separate accounts.
- **Private fund account:** However, ADVISER would be required to respond “Yes” to this item because its related LLC has “custody” over the assets in the private fund as the fund’s general partner

(as explained under prior headings). This is the case even though the qualified custodian maintaining the assets in the account is independent of ADVISER (meaning it is not ADVISER or a related person).

- Wrap accounts: Similar to the result with the private fund, ADVISER would be required to respond “Yes” to this item because its related broker-dealer has “custody” over the wrap accounts as the qualified custodian for the accounts.
- Trust accounts: Likewise, ADVISER would be required to respond “Yes” to this item because its related bank has “custody” over the trust accounts as the qualified custodian for the accounts. This is the case even though the bank is “operationally independent” of ADVISER. Note that merely being “operationally independent” does not make the bank “independent” (meaning not the ADVISER itself or a related person).

Consequently, related persons of ADVISER have “custody” of three different types of client accounts in our hypothetical scenario—the private fund account, the wrap accounts and the trust accounts. Therefore, ADVISER must respond “Yes” to Items 9.B.(1)(a) and (b).

Item 9.B.(2)

Item 9.B.(2) then asks for details:

(2) If you checked “yes” to Item 9.B.(1)(a) or (b), what is the amount of client funds and securities and total number of clients for which your related persons have custody:	
US Dollar Amount	Total Number of Clients
(a) \$4.0 billion	(b) 111

There are no exclusions that apply to this item. Since the item does not distinguish related person “custody” as a result of acting as qualified custodian from “custody” as a result

of any other arrangement, some “double counting” could occur between this item and Item 9.A.(2) above. For example, ADVISER’s responses to this item should include all the clients and assets in:

- The private fund account, because of the related LLC’s custody as general partner of the private fund;
- The wrap accounts, because ADVISER’s related broker-dealer has custody as the qualified custodian of those accounts; and
- The trust accounts, because ADVISER’s related bank has custody as the qualified custodian of those accounts, regardless of the fact that the bank is “operationally independent” of ADVISER.

This is the case even though the private fund’s assets were also counted under Item 9.A.(2) above.

Consequently, ADVISER has reported in Items 9.B.(2)(a) and (b) 111 clients (one private fund client + 100 wrap accounts clients¹⁸ + 10 trust account clients) and \$4.0 billion in assets (\$2.0 billion in the private fund + \$500 million in the wrap accounts + \$1.5 billion in the trust accounts).

Item 9.C.

Item 9.C. asks advisers to check all the custodial and related circumstances that apply. Responses in any adviser’s case will vary depending on the facts. For example, ADVISER might check C.(1) indicating a qualified custodian sends clients statements directly to pooled vehicle investors, unless it uses the “audit approach” for its private fund, in which case it would likely leave C.(1) unchecked, but check C.(2) indicating the fund is audited annually.

ADVISER would also check C.(3) indicating a surprise exam is conducted annually, because of the surprise exam requirements for the wrap accounts and the one trust account where a portfolio manager serves as trustee. As noted under previous headings, a surprise

exam would also be required for the private fund unless it uses the “audit approach.”

ADVISER would also check C.(4) indicating an internal control report is obtained, because of the internal control report requirements triggered for the wrap accounts and trust accounts as a result of related persons acting as the qualified custodians for those accounts.

Item 9.D.

Items 9.A. and 9.B. simply ask whether an adviser or its related persons have “custody” of an adviser’s clients’ assets without specifying the reason why, which could be because the adviser or a related person acts as qualified custodian or because the adviser or a related person falls within the “custody” definition for other reasons. In contrast, Item 9.D. asks specifically whether an adviser or its related persons act as the qualified custodian for any of the adviser’s clients’ assets in connection with the adviser’s advisory services. As such, ADVISER would report as follows:

Item 9. D. Do you or your related persons act as qualified custodians for your clients in connection with advisory services you provide to clients?	Yes	No
(1) you act as a qualified custodian		X
(2) your related persons act as qualified custodians	X	

Although ADVISER itself does not act as a qualified custodian for any of its clients’ assets, it must answer “Yes” to Item 9.D.(2) because its related broker-dealer acts as qualified custodian for the wrap accounts and its related bank acts as qualified custodian for the trust accounts. As directed by the instruction underneath Item 9.D. on the Form, ADVISER’s related broker-dealer and bank would also have to be disclosed in the appropriate sections of Schedule D.

Item 9.E.

For every annual ADV update ADVISER files following the first year in which any of

its accounts are subject to an annual surprise exam, it would also have to report in Item 9.E. the date on which the surprise exam commenced. This would allow the SEC to check that the appropriate certificate (on Form ADV-E) has been filed by the accounting firm performing the surprise exam within the time frame contemplated by the custody rule (120 days of commencement).

Anomalies and Opportunities for Confusion

Whenever the SEC adopts new rules, forms or instructions, anomalies and opportunities for confusion invariably arise when advisers try to apply them to the complex situations they face in real life. Here are a few that have already come to light under amended Item 9:

- **Double counting.** As noted previously, double counting could occur between Items 9.A. and 9.B. in certain circumstances. Indeed, double counting will occur in ADVISER’s case because the private fund must be reported in response to both items. As a result, the sum of assets and clients it reports in Items 9.A.(2) and 9.B.(2) (\$5.0 billion + \$4.0 billion = \$9.0 billion in assets; 6 + 111 = 117 in clients) exceeds the total number of assets and clients ADVISER actually has (\$7.0 billion in assets; 116 clients). For the same reason, the figures ADVISER reports in Item 9 will not tie to the figures it reports under Item 5 of ADV Part 1.
- **Related person custody.** Item 9.A.(2) instructs advisers to report assets for which a related person acts as *qualified custodian* under Item 9.B.(2) instead of Item 9.A.(2). This could lead advisers to mistakenly assume that Item 9.B.(2) is asking for information only about related persons that have custody because they act as *qualified custodian*. However, as noted under prior headings, Item 9.B. asks for information about related persons who have “custody” without specifying why, which could presumably include because they act as qualified custodian or because they have “access”

to or authority to withdraw assets from advisory client accounts and therefore fall within the “custody” definition for other reasons. This presents another opportunity for confusion.

- **Counting clients versus accounts.** For simplicity, the number of “clients” ADVISER has is assumed in this article to be equal to the number of “accounts” it has, meaning there has been assumed to be one account for each client. Note carefully, however, that Item 9 (as well as other items on Form ADV) requests information about the adviser’s “clients,” not its “accounts.” For many advisers there will be a difference between the number of clients it has and the number of accounts it has, for example, whenever a single client has more than one account under the adviser’s management. This could create confusion when reporting in Item 9.

Adding to the “client” count confusion is the fact that under certain Advisers Act rules—perhaps most notably Rule 203(b)(3)-1¹⁹—more than one “client” may be counted as “one” in certain cases. For example, an individual and the individual’s spouse, relatives and minor children who have the same principal residence may all be counted as “one” client. Under that rule, other clients do not have to be counted at all, such as clients for whom the adviser provides services without compensation.²⁰

Even though the SEC Staff has specifically disclaimed that Rule 203(b)(3)-1 applies to the definition of “client” for purposes of the custody rule,²¹ they nonetheless allow advisers to use Rule 203(b)(3)-1 for counting clients under Item 5 of Form ADV Part 1, saying:

“Q: Can I follow rule 203(b)(3)-1 under the Investment Advisers Act of 1940 when counting clients for purposes of Item 5.C of Form ADV?

A: Yes. Rule 203(b)(3)-1 provides a safe harbor to investment advisers who are

relying on the fewer-than-15-clients exception to the registration requirements of the Investment Advisers Act of 1940. While you may rely on rule 203(b)(3)-1, you are not required to follow it.”²²

“When answering Item 5.C, count clients the way you normally count them for your firm. Some advisers, for example, treat multiple members of the same family (and a family trust) as a single client, and other advisers treat multiple members of the same family (and a family trust) as separate clients. Similarly, an adviser could reasonably treat an individual and the individual’s IRA account as one—or two—clients, depending on the circumstances.”²³

The SEC Staff has not addressed whether similar flexibility is permitted under *Item 9*, although there is no apparent reason why it should not be.

- **Calculating assets.** Discrepancies between the figures an adviser reports on Item 5 and on Item 9 could also arise because Item 5 contains very explicit instructions on how to count assets under management (AUM) which might not apply under Item 9. In short, the count for Item 5 should include “securities portfolios” for which the adviser provides “continuous and regular supervisory or management services.”²⁴ An account is considered a “securities portfolio” for purposes of Item 5 if at least 50 percent of the total value of the account consists of securities, cash and cash equivalents. However, what happens if an adviser has “custody” over assets in an advisory client’s account for which the adviser does not provide “continuous and regular supervisory or management services”? Or in an account where less than 50 percent of the total value is securities, cash and cash equivalents? In that case, the assets would not be included in the adviser’s AUM calculation for purposes of Item 5. However, the adviser would presumably not be able to ignore the custody

rule requirements for those assets just because they are in an account that falls outside of AUM under Item 5. Under a similar rationale, the adviser presumably should not be able to omit those assets in response to Item 9. Unfortunately, the instructions provide no guidance either way.

- **Accounts holding assets that are not “funds and securities.”** A related uncertainty arises because Item 9 requests the adviser to report the amount of client “funds and securities” for which the adviser or its related person has “custody.” What should the adviser report in Item 9 if the adviser has “custody” with respect to all the assets in an account, but only a portion of the assets are “funds and securities”? For example, what if the account also includes commodities, insurance products, futures, real estate or other investments not generally considered “funds”²⁵ or “securities”? If more than 50 percent of the value of the account consists of securities, cash and cash equivalents, the adviser is instructed to include the entire value of the account in its calculation of AUM for purposes of Item 5.²⁶ However, it is unclear whether the entire value of that account should be included in response to Item 9. Although the SEC Staff has stated that assets that are not “funds and securities” are not required to be maintained with a qualified custodian under the custody rule,²⁷ it has not clarified how those types of assets should be reflected in Item 9.
- **Valuation date.** There is also no guidance on what date should be used to value assets reported in Item 9. Item 5 permits advisers to value AUM as of any date within 90 days prior to filing the Form ADV.²⁸ While it would be logical for similar flexibility to be permitted for reporting assets on Item 9, the instructions are silent on this point. Moreover, it is unclear whether an adviser must pick the same date to value assets under both Item 5 and Item 9.

Facing Ambiguity

The discussion above highlights a few of the anomalies and opportunities for confusion that have already been identified surrounding Item 9. Undoubtedly, the complexities of real life will reveal many more as advisers respond to the amended item for the first time in the coming months. Advisers facing these or other ambiguities on Form ADV might seek informal SEC Staff guidance or, short of that, would be wise to choose a reasonable, consistent approach and keep clear written documentation supporting their approach. Clear documentation could prove critical to surviving a regulatory inspection by demonstrating that the adviser considered the issue with due care and applied its approach consistently. Disclosure explaining the approach might also be added to the Miscellaneous section on Schedule D of Form ADV Part 1.

Conclusion

By applying the amended custody rule to a hypothetical advisory firm, this article offers practical insight on how various common custodial arrangements would be treated under the rule and reported in amended Item 9 of Form ADV Part 1. It also identifies a number of areas where anomalies and confusion could occur as a result of ambiguities and the absence of clear SEC guidance addressing them.

Notes

1. *Custody of Funds or Securities of Clients by Investment Advisers*, Release No. IA-2968 (Dec. 30, 2009) (effective date March 12, 2010) (the Adopting Release), amending Rule 206(4)-2 under the Advisers Act. For a more complete discussion of the specific amendments to the rule, see Ephraim Lemberger and Steven Vecchio, “Custody Rule Amendments Adopted by the SEC—Expansive New Requirements for Advisers,” *The Investment Lawyer*, Vol.17, No.3 (March 2010).

2. See paragraph (d)(5) of the custody rule for the factors relevant to determining whether a related person is “operationally independent” of an adviser, such as having separate personnel, separate premises and other attributes of “separateness.” According to the Adopting Release, related person custodians that are operationally independent pose significantly less risk than those that are not because misuse of client assets would tend to require collusion among employees, not significantly different than would be necessary to engage in similar misconduct between unaffiliated organizations. Adopting Release at p.34.

3. A surprise exam is aimed at verifying the existence of assets in an account. *See* paragraph (a)(4) of the custody rule for more on surprise exams.

4. An internal control report is aimed at assessing and testing the strength of the controls surrounding an organization's custody function. *See* paragraph (a)(6)(ii) of the custody rule for more on internal control reports.

5. In short, a "qualified custodian" is a bank, SEC-registered broker-dealer, a registered futures commission merchant or foreign financial institution meeting certain parameters. *See* paragraph (d)(6) of the custody rule for a full definition of "qualified custodian."

6. Note also under paragraph (a)(2) of the rule, if an adviser voluntarily sends account statements to a client to which it is required to provide a notice of account opening, it must include on the account statements wording that urges the client to compare the account statements received from the custodian with those received from the adviser.

7. Note that a surprise exam is required to cover only the assets over which the adviser has custody. In substance, Rule 206(4)-2(a)(4) tells advisers it is fraudulent for them to have custody unless, among other things, "[the] client funds and securities *of which you have custody* are verified by actual examination at least once during each calendar year. . . ." (emphasis added). Similarly, the Adopting Release says the SEC is adopting the surprise examination requirement as proposed, requiring advisers with custody of client assets to undergo a surprise examination *of those assets*. Adopting Release at p.10 (emphasis added). As a result, even though an adviser may need a surprise examination for certain assets it advises, it is not required to include in that surprise exam any client assets over which it does not have custody at all or any assets in accounts for which the custody rule provides an exception to the surprise exam requirement.

8. *See* Rule 206(4)-2(a)(5).

9. The PCAOB is the Public Company Accounting Oversight Board, which oversees auditors of public companies. For more information, *see* <http://pcaob.org>. The SEC has granted limited relief from the requirement that the auditors be PCAOB-inspected in a recent no-action letter applicable to certain private funds relying on the "audit provision" to satisfy the custody rule. *See* Robert Van Grover, Esq., Seward & Kissel LLP, SEC No-Action Letter dated October 12, 2010.

10. *See* Rule 206(4)-2(b)(4).

11. *See supra* n.2 for a discussion of the term "operationally independent."

12. *See* Question XIII.1. at http://www.sec.gov/divisions/investment/custody_fa_q_030510.htm.

13. *See* Question II.2. at http://www.sec.gov/divisions/investment/custody_fa_q_030510.htm.

14. *Id.*

15. This way would be consistent, for example, with the reporting of an adviser that has custody of *any* of its

clients' assets *only* as a result of fee deduction authority. In that situation, an adviser would presumably check "No" on Items 9.A.(1)(a) and (b) and then skip Items 9.A.(2)(a) and (b) altogether because Item 9.A.(2) only calls for information if the adviser has checked "Yes" to Item 9.A.(1).

16. This second approach makes sense when viewed in light of the history behind the special instruction permitting advisers to report "No" on Item 9.A.(1) if the sole reason they have has custody is because of fee deduction authority. That instruction was *not* added to Form ADV because the arrangement does not constitute "custody" (because it does). It was also *not* added because the SEC decided it did not need or want the detailed information on those arrangements called for in Item 9.A.(2). Rather, the instruction was added to Item 9 back in 2003 (*see* Release No. IA-2176 (Sep. 25, 2003)), the last time the custody rule was amended, as an accommodation to advisers with fee deduction authority only, who had been reporting historically that they do not have custody in reliance on SEC no-action letters that were then being withdrawn. In order to avoid those advisers having to amend their Form ADVs and suddenly start reporting that they do have custody—inconsistent with their historical reporting and to the potential concern of their clients—the special instruction was added. That special instruction was then carried forward into the 2010 amendments to Item 9, which for the first time required advisers who report having "custody" to also report details (assets and clients). However, once advisers are permitted to report "No" on Item 9.A.(1), it would be logically inconsistent to ask them to then report details in Item 9.A.(2). Thus, it makes sense for *them* to be permitted to not answer Item 9.A.(2).

There is a similar historical explanation for advisers who have custody *solely* because an operationally independent related person acts as the qualified custodian. Often in the past, they also did not report that they had custody, in reliance on certain SEC no-action authority. However, when the no-action authority supporting their position was withdrawn, the special instruction under Item 9 was expanded to cover their situation as well, so they too could continue to report "No" to the question "Do you have custody?" And, as already noted, once advisers are permitted to report "No" on Item 9.A.(1), it only makes sense that they not be required to respond to Item 9.A.(2).

However, in contrast to these situations, advisers (like ADVISER) who have custody as a result of arrangements *other than* or *in addition to* the two covered by the special instruction, must check "Yes" on Item 9.A.(1) regardless. For them, the historical rationale for allowing them to say "No" on Item 9.A.(1) and therefore skip Item 9.A.(2) does not apply. For them, it would not be inconsistent with their historical reporting or their Item 9.A.(1) reporting to have to provide the details of their custody in Item 9.A.(2) (or Item 9.B.(2), if applicable), whether their "custody" results from fee deduction authority, an operationally independent related person acting as the qualified custodian or any other arrangement recognized as "custody." This reasoning is no less applicable just because *other* advisers in *other* circumstances would not be required to report those arrangements as "custody" at all.

17. Additional changes to Form ADV Part 1 were recently proposed to implement various adviser-related provisions of the Dodd-Frank Act. *See* Release Nos. IA-3110 and IA 3111 (Nov. 19, 2010). Even though the proposed amendments include certain changes to Item 9, it does not appear that they would resolve any of the issues discussed in this article.

18. SEC Staff guidance instructs advisers to count each wrap program participant to which it provides advisory services as a “client” rather than counting the wrap program as “one” client. *See* the first question under the “Form ADV: Item 5.C” heading at <http://www.sec.gov/divisions/investment/iard/iardfaq.shtml#item5c>.

19. Rule 203(b)(3)-1 permits advisers to count “clients” in certain ways for purposes of Section 203(b)(3) of the Advisers Act, the so-called ‘private adviser’ exemption, (advisers with fewer than 15 clients) which was eliminated by the Dodd-Frank Act enacted in July 2010. No matter what the Commission decides to do with Rule 203(b)(3)-1 and counting clients for purposes of Item 5, the question will still remain as to how clients should be counted for purposes of Item 9.

20. Rule 203(b)(3)-1(b)(4).

21. *See* Question II.9. at http://www.sec.gov/divisions/investment/custody_faq_030510.htm.

22. *See* the third question under the “Form ADV: Item 5.C” heading at <http://www.sec.gov/divisions/investment/iard/iardfaq.shtml#item5c>.

23. *See* the second question under the “Form ADV: Item 5.C” heading at <http://www.sec.gov/divisions/investment/iard/iardfaq.shtml#item5c>.

24. *See* Instruction 5.b.(1) in the Instructions to Part 1.A. of Form ADV for definitions and details.

25. Although the custody rule refers to “funds,” Form ADV sometimes uses the phrase “cash and cash equivalents” or “cash or bank accounts” instead of the word “funds.” *See*, for example, Instruction 5.b.(1) in the Instructions to Part 1.A., and Item 9.A.(1)(a) in Part 1.A. This could lead one to interpret the word “funds” to mean (or at least include) “cash, cash equivalents and bank accounts.”

26. *See* Instruction 5.b.(2) in the Instructions to Part 1.A. of Form ADV. The only assets this instruction directs advisers to *exclude* are assets under the management of another person or which consist of real estate or businesses under the adviser’s “management” but not as an investment.

27. *See* Question II.3. at http://www.sec.gov/divisions/investment/custody_faq_030510.htm.

28. *See* Instruction 5.b.(4) in the Instructions to Part 1.A. of Form ADV.

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