

■ 6. Form ADV-E (referenced in § 279.8) is amended by revising the instructions to the Form.

The revisions read as follows:

Note: The text of Form ADV-E does not and this amendment will not appear in the Code of Federal Regulations.

Form ADV-E

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Instructions

This Form must be completed by investment advisers that have custody of client funds or securities and that are subject to an annual surprise examination. This Form may *not* be used to amend any information included in an investment adviser's registration statement (*e.g.*, business address).

Investment Adviser

1. All items must be completed by the investment adviser.

2. Give this Form to the independent public accountant that, in compliance with rule 206(4)-2 under the Investment Advisers Act of 1940 (the "Act") or applicable state law, examines client funds and securities in the custody of the investment adviser within 120 days of the time chosen by the accountant for the surprise examination and upon such accountant's resignation or dismissal from, or other termination of, the engagement, or if the accountant removes itself or is removed from consideration for being reappointed.

Accountant

3. The independent public accountant performing the surprise examination must submit (i) this Form and a certificate of accounting required by rule 206(4)-2 under the Act or applicable state law within 120 days of the time chosen by the accountant for the surprise examination, and (ii) this Form and a statement, within four business days of its resignation or dismissal from, or other termination of, the engagement, or removing itself or being removed from consideration for being reappointed, that includes (A) the date of such resignation, dismissal, removal, or other termination, and the name, address, and contact information of the accountant, and (B) an explanation of any problems relating to examination scope or procedure that contributed to such resignation, dismissal, removal, or other termination:

(a) By mail, until the Investment Adviser Registration Depository ("IARD") accepts electronic filing of the Form, to the Securities and Exchange Commission or appropriate state

securities administrators. File the original and one copy with the Securities and Exchange Commission's principal office in Washington, DC at the address on the top of this Form, and one copy with the regional office for the region in which the investment adviser's principal business operations are conducted, or one copy with the appropriate state administrator(s), if applicable; or

(b) By electronic filing of the certificate of accounting and statement regarding resignation, dismissal, other termination, or removal from consideration for reappointment on the IARD, when the IARD accepts electronic filing of the Form.

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Dated: December 30, 2009.

By the Commission.

Florence E. Harmon,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 276

[Release Nos. IA-2969; FR-81]

Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940

AGENCY: Securities and Exchange Commission.

ACTION: Interpretation.

SUMMARY: The Securities and Exchange Commission (the "Commission") is publishing interpretive guidance for independent public accountants in connection with the adoption of amendments to Rule 206(4)-2 under the Investment Advisers Act of 1940 (the "Custody Rule"). This guidance provides direction with respect to the independent verification and internal control report as required under the amended Custody Rule.

DATES: Effective Date March 12, 2010.

FOR FURTHER INFORMATION CONTACT: General questions about this release should be referred to Bryan J. Morris, Assistant Chief Accountant, Jaime L. Eichen, Assistant Chief Accountant, or Richard F. Sennett, Chief Accountant at (202) 551-6918 or IMOCA@sec.gov, Office of the Chief Accountant, Division of Investment Management, U.S. Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-8626. Questions about Rule

206(4)-2 should be directed to staff of the Office of Investment Adviser Regulation, Division of Investment Management, U.S. Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-8549 at (202) 551-6787 or IArules@sec.gov.

SUPPLEMENTARY INFORMATION:

I. Background

Rule 206(4)-2(a) under the Investment Advisers Act of 1940 (the "Act") provides, among other things, that it is a fraudulent, deceptive or manipulative act, practice, or course of business within the meaning of Section 206(4) of the Act for any investment adviser registered (or required to be registered) under Section 203 of the Act (herein "investment adviser") to have custody of client funds or securities unless:

(1) A qualified custodian maintains those funds and securities in a separate account for each client under that client's name; or in accounts that contain only clients' funds and securities, under the investment adviser's name as agent or trustee for the clients;

(2) Clients are notified promptly in writing of the qualified custodian's name, address, and the manner in which the funds or securities are maintained, when an account is opened by an investment adviser on a client's behalf and following any changes to this information; and

(3) The investment adviser has a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement, at least quarterly, to each of its clients for which it maintains funds or securities, identifying the amount of funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period.

Rule 206(4)-2(a) generally requires that client funds and securities of which an investment adviser has custody under the rule be verified by actual examination at least once during each calendar year by an independent public accountant¹ ("accountant"), pursuant to a written agreement, between the investment adviser and the accountant, at a time that is chosen by the accountant without prior notice or announcement to the investment

¹ If the investment adviser itself or a related person maintains clients' funds and securities as qualified custodian, the independent public accountant must be registered with, and subject to inspection by, the Public Company Accounting Oversight Board ("PCAOB"). See Rule 206(4)-2(a)(6)(i).

adviser and that is irregular from year to year.

II. Independent Verification of Funds and Securities

The objective of the accountant's examination² is to verify that client funds and securities of which an investment adviser has custody are held by a qualified custodian in a separate account for each client under that client's name, or in accounts that contain only clients' funds and securities, under the investment adviser's name as agent or trustee for the clients. The accountant should obtain from the investment adviser records that detail client funds and securities of which the investment adviser has custody and the identification of the qualified custodian(s) of those funds and securities.³ The accountant should also obtain records of accounts that were closed during the period or that have a zero balance as of the date of the examination.

For a sample of client accounts, the accountant should obtain records of the purchases, sales, contributions, withdrawals and any other debits or credits to each selected client's account occurring since the date of the last examination. The accountant's procedures to meet the objective of the examination should normally include, but are not limited to, the following with respect to each selected client account:

- Confirmation with the qualified custodian(s) of client funds and securities as of the date of the examination and that the client's funds and securities are held in either a separate account under the client's name or in accounts under the name of the investment adviser as agent or trustee for clients;
- Confirmation with the client of funds and securities held in the account as of the date of the examination and contributions and withdrawals of funds

² The examination is a compliance examination to be conducted in accordance with American Institute of Certified Public Accountants' ("AICPA") attestation standards. See AT Section 601, *Compliance Attestation* ("AT 601").

³ Rule 204-2(b) under the Act requires that an investment adviser who has custody or possession of funds and securities of any client must record all transactions for such client in a journal and in separate ledger accounts for each client and must maintain copies of confirmations of all transactions in such accounts and a position record for each security in which a client has an interest. Rule 204-2(h) of the Act indicates that records maintained and preserved in compliance with Rules 17a-3 and 17a-4 under the Securities Exchange Act of 1934 (i.e., records maintained by a broker-dealer) can be deemed to satisfy the requirements of Rule 204-2(b), provided that they are substantially the same types of records. See Rule 204-2(b) and Rule 204-2(h) under the Act.

and securities to and from the account since the date of the last examination; where confirmation replies are not received, the accountant should perform alternative procedures; and

- Reconciliation of confirmations received and other evidence obtained to the investment adviser's records.

Privately Offered Securities

Rule 206(4)-(2)(b)(2) generally exempts privately offered securities from the qualified custodian requirements established under Rule 206(4)-(2)(a)(1).⁴ Under the rule, a privately offered security is a security that is:

- (1) Acquired from the issuer in a transaction or chain of transactions not involving any public offering;
- (2) Uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client; and
- (3) Transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.

The accountant's verification procedures with respect to any privately offered security selected for testing should include confirmation with the issuer of or counterparty to the security, or, where replies are not received, alternative procedures.

Reporting—Independent Verification

The accountant's examination report should include an opinion as to whether, with respect to the rules under the Act, the investment adviser was in compliance, in all material respects, with paragraph (a)(1) of Rule 206(4)-2 as of the examination date and had been complying with Rule 204-2(b) during the period since the prior examination date. The accountant should identify the date as of which the examination was made within the report.

Pursuant to the written agreement required under Rule 206(4)-2(a)(4), upon finding any material discrepancy during the course of the examination, the accountant should notify the Commission within one business day of the finding, by means of a facsimile transmission or electronic mail, followed by first class mail, directed to the attention of the Director of the Office of Compliance Inspections and Examinations. For purposes of this examination, a material discrepancy is material non-compliance with the

⁴ The exemption provided by the rule is available with respect to securities held for the account of a limited partnership (or a limited liability company, or other type of pooled investment vehicle) only if the limited partnership is audited, and the audited financial statements are distributed, as described in paragraph (b)(4) of the rule.

provisions of either Rule 206(4)-2 or Rule 204-2(b) under the Act.⁵

Pursuant to the written agreement required under Rule 206(4)-2(a)(4), the examination should be completed and the resulting examination report should be filed on Form ADV-E by the accountant within 120 days of the time chosen by the accountant. The accountant should also file Form ADV-E with the Commission upon resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed within four business days. Such filing should be accompanied by a statement that includes:

- (1) The date of such resignation, dismissal, removal, or other termination, and the name, address, and contact information of the accountant; and
- (2) An explanation of any problems relating to examination scope or procedure that contributed to such resignation, dismissal, removal, or other termination.

III. Internal Control Report

Rule 206(4)-2(a)(6) establishes additional requirements for an investment adviser that itself, or its related person, maintains client funds or securities as a qualified custodian in connection with advisory services provided to clients. Such an investment adviser must at least once each calendar year obtain or receive from its related person an internal control report related to its or its affiliates' custody services, including the safeguarding of funds and securities, prepared by an independent public accountant that is registered with, and subject to inspection by, the PCAOB.⁶

The objective of the examination supporting the internal control report is to obtain reasonable assurance that the qualified custodian's controls have been placed in operation as of a specific date, and are suitably designed and are operating effectively to meet control objectives related to custody of funds and securities during the period specified. The internal control report should address control objectives and associated controls related to the areas of client account setup and

⁵ Reporting on material non-compliance is discussed within AT 601 of the AICPA attestation standards. See AT 601.

⁶ A Type II SAS 70 Report conducted in accordance with AU Section 324, *Service Organizations* ("AU 324") of the AICPA auditing standards would be sufficient to satisfy the requirements of the internal control report. In addition to the Type II SAS 70 Report, an examination on internal control conducted in accordance with AT 601 would also be sufficient.

maintenance, authorization and processing of client transactions, security maintenance and setup, processing of income and corporate action transactions, reconciliation of funds and securities to depositories and other unaffiliated custodians, and client reporting. Control objectives addressing these areas should include—

- Documentation for the opening and modification of client accounts is received, authenticated, and established completely, accurately, and timely on the applicable system.
- Client transactions, including contributions and withdrawals, are authorized and processed in a complete, accurate, and timely manner.
- Trades are properly authorized, settled, and recorded completely, accurately, and timely in the client account.
- New securities and changes to securities are authorized and established in a complete, accurate and timely manner.
- Securities income and corporate action transactions are processed to client accounts in a complete, accurate, and timely manner.
- Physical securities are safeguarded from loss or misappropriation.
- Cash and security positions are reconciled completely, accurately and on a timely basis between the custodian and depositories.
- Account statements reflecting cash and security positions are provided to clients in a complete, accurate and timely manner.

Rule 206(4)–2(a)(6)(ii)(B) states that, as part of the internal control report, the independent public accountant must verify that funds and securities are reconciled to a custodian other than the adviser or its related person (for example, the Depository Trust Corporation). The accountant's tests of the custodian's reconciliation(s) should include either direct confirmation, on a test basis, with unaffiliated custodians or other procedures designed to verify that the data used in reconciliations performed by the qualified custodian is

obtained from unaffiliated custodians and is unaltered.

Reporting—Internal Control Report

The accountant's internal control report should identify the control objectives included within the scope of the examination and include the accountant's opinion as to whether controls have been placed in operation as of the specific date, and are suitably designed and are operating effectively to meet the identified control objectives during the specified period. The report should also describe the nature, timing, extent and results of the accountant's procedures performed to verify that funds and securities are reconciled to depositories and other unaffiliated custodians.⁷

IV. Relationship Between Independent Verification and Internal Control Report

When performing an independent verification of client funds and securities for an investment adviser that itself, or its related person, maintains custody as a qualified custodian, the accountant should obtain a copy of the most recently issued internal control report and determine whether there are any findings in the internal control report that would affect the nature and extent of his or her procedures. If findings within the internal control report indicate information provided by the qualified custodian may not be reliable, the accountant should consider whether the circumstances warrant the issuance of a qualified or adverse opinion, or a disclaimer of opinion.

If a significant period of time has elapsed since the issuance of the internal control report, the accountant should perform appropriate procedures to determine whether there have been significant changes to the procedures and controls related to custody at the qualified custodian since the date of the report. If significant changes have

⁷ Paragraph .62 of AU 324 discusses reporting on substantive procedures as part of a Type II SAS 70 report. See AU 324.

occurred, the accountant should perform procedures to update his or her understanding of whether the controls at the qualified custodian have been placed in operation, are suitably designed, and are operating effectively to meet the identified control objectives, as appropriate in the circumstances. The accountant can perform these procedures directly or can request that the accountant that prepared the internal control report perform such procedures.

V. Codification Update

The "Codification of Financial Reporting Policies" announced in Financial Reporting Release No. 1 (April 15, 1982) [47 FR 21028] is updated by replacing Section 404.01.b. *Investment Advisers* with the text in Sections I, II, III, and IV of this release. The Codification is a separate publication of the Commission. It will not be published in the **Federal Register**/Code of Federal Regulations.

List of Subjects in 17 CFR Part 276

Reporting and recordkeeping requirements, Securities.

Amendments to the Code of Federal Regulations

- For the reasons set out in the preamble, the Commission is amending title 17, chapter II of the Code of Federal Regulations as set forth below:

PART 276—INTERPRETATIVE RELEASES RELATING TO THE INVESTMENT ADVISERS ACT OF 1940 AND GENERAL RULES AND REGULATIONS THEREUNDER

- Part 276 is amended by adding Release No. IA–2969 and the release date of December 30, 2009 to the list of interpretive releases.

Dated: December 30, 2009.

By the Commission.

Florence E. Harmon,
Deputy Secretary.

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