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presents

New SEC Custody Rules for Investment Advisers

Implementing Effective Compliance Policies and Procedures to Avoid SEC Penalties and Sanctions

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

Daphne Tippens Chisolm, Partner, **Law Offices of DT Chisolm**, Charlotte, N.C.
Dilia M. Caballero, Associate General Counsel, **E*Trade Financial**, Arlington, Va.
Fiona A. Philip, Partner, **Howrey**, Washington, D.C.

Thursday, March 25, 2010

The conference begins at:

1 pm Eastern
12 pm Central
11 am Mountain
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New SEC Custody Rules for Investment Advisers

A Presentation By

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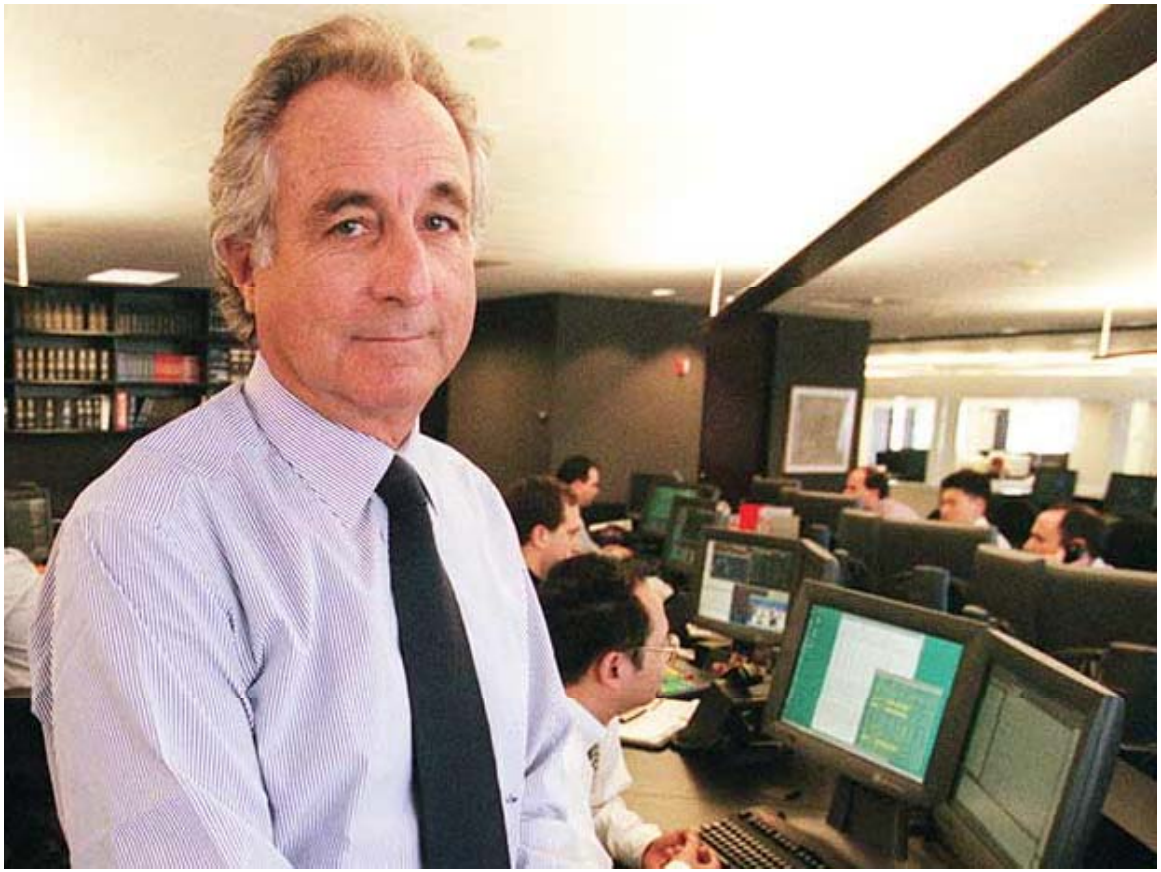


How We Got Here

Understanding the new rules and what you need to know to be compliant

The Basics

Rule 206(4)-2 under the Advisers Act, which was most recently amended on December 30, 2009, imposes requirements on investment advisers with custody of client funds or securities ("client assets")

What Does It Mean To Have Custody?

Do you hold, directly or indirectly, client funds or securities or have authority to obtain possession of them?

- possession of client funds or securities
- general power of attorney
- any capacity giving you legal ownership of or access to client funds or securities
- fee discretion (any capacity giving you legal ownership or access to client funds or securities)
- new: affiliate/related person holds client funds or securities

Key Concepts

- Qualified Custodian
- Notices and Account Statements
- Independent Verification/Surprise Examination
- Internal Control Reports
- Special Rules Involving Pooled Investment Vehicles

Qualified Custodian

Client Assets Must be Maintained by Qualified Custodian

- Banks
- Savings Associations
- Registered Broker-Dealers
- Registered Futures Commission Merchants
- Foreign Financial Institutions

Adviser Must Provide Notice to Client if Opening Custodial Account on Behalf of Client

- Name and address of the qualified custodian
- The manner in which the funds or securities in the account are maintained
- If the adviser sends account statements, adviser must include a legend which urges the client to compare the account statements from the custodian with those from the adviser (required both for initial notice and any subsequent account statements)

Qualified Custodian Must Send Account Statements

- Amount of funds in the account at the end of the period
- Each security in the account at the end of the period
- All transactions in the account during the period

Reasonable Basis Requirement

Advisers must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends quarterly account statements to adviser's clients

- a senior SEC official has suggested that the use of "certifications" would not be enough
- adviser receiving copies of account statements is sufficient for due inquiry
  - but need more than access to custodial statements on website

Adviser Must Engage Auditor for an Annual Surprise Exam (the Verification)

- Written agreement with an independent public accountant
- Accountant must notify the SEC within one business day of any “material discrepancies” uncovered during the examination
- Form ADV-E Certification
- Noisy withdrawal – Accountant must file Form ADV –E within four business days upon termination or resignation

Additional Requirement for Adviser that Self-Custodies

An adviser that acts as a qualified custodian or uses a related person as a qualified custodian must retain the services of a PCAOB-registered independent public accountant for the surprise examination

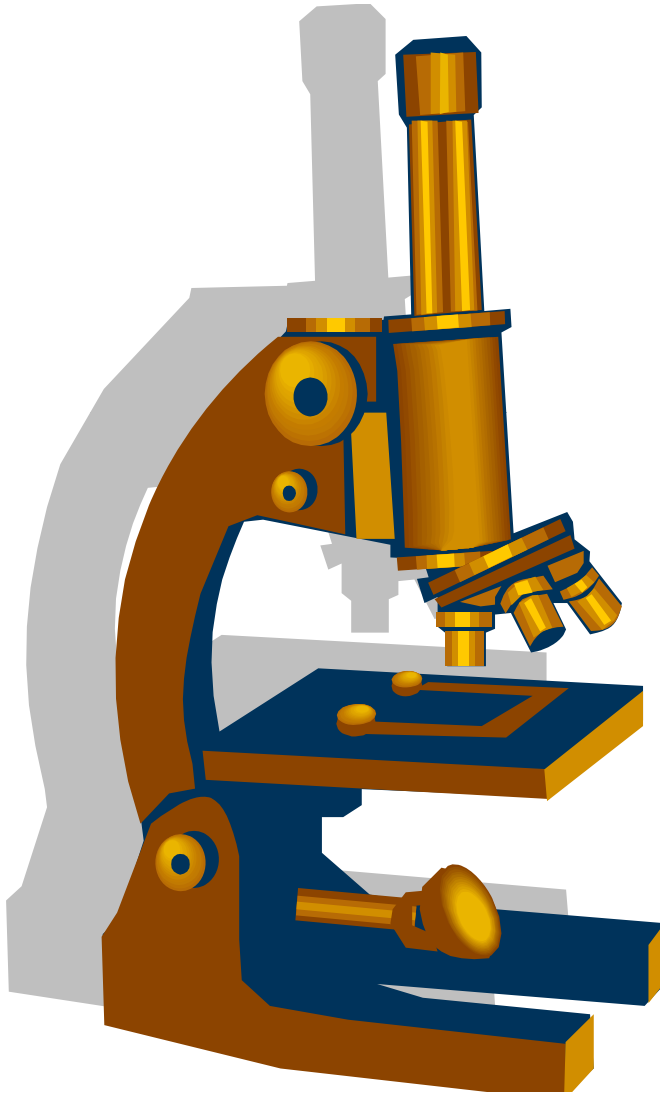
Notable Exceptions to the Surprise Examination

- **Fee Deduction Exception**. Surprise exam does not apply to advisers that have custody solely because they have the authority to automatically deduct advisory fees from client accounts
- **Operationally Independent Exception.** An adviser that is "operationally independent" from its related person that acts as a qualified custodian for the adviser's client assets also is not subject to the surprise exam requirement
  - **From practical perspective , this standard is virtually impossible to meet**
    - **there can be no other circumstances "reasonably expected" to compromise operational independence of related person**
    - **memo substantiating operational independence**
- **Pooled Investment Vehicle Exception.** Advisers to private funds that distribute annual audited financial statements generally are exempt from the surprise examination requirement

More Detail on Pooled Investment Vehicle Exemption

Advisers to pooled investment vehicles may obtain an audit instead of a surprise exam if the pooled vehicle is audited annually by an independent public accountant that is registered with the PCAOB, the audited financial statements prepared in accordance with GAAP are distributed to all limited partners within 120 days of the end of the pooled vehicle's fiscal year, and the pooled vehicle is audited upon liquidation

Internal Reports



Internal Report Required by an Adviser that Self-Custodies

Advisers or their related persons that act as qualified custodians must obtain an annual written internal control report (*e.g.*, SAS 70)

- Applies even if the adviser is "operationally independent" from the related person
- Must be issued by a PCAOB-registered independent public accountant
- Same report can be used by custodian for several related advisers
- Auditor must verify that funds and securities reconciled with a custodian other than adviser or related person

Form ADV Amendments – Item 7 and Section 7.A of Schedule D

Advisers must disclose *all* related persons who are broker-dealers and which, if any, serve as qualified custodians with respect to client assets

- If relying on "operationally independent" exception must note here

Form ADV Amendments – Item 9

Requires disclosing:

- the total U.S. dollar amount, and the number of clients, over which the adviser or its related persons have custody
- whether an independent public accountant conducts an annual surprise examination of client assets
- whether an independent public accountant prepares an internal control report with respect to the adviser or its related person
- whether the adviser or a related person serves as qualified custodian for the adviser's clients
- whether, for the adviser or its related person that acts as adviser to a pooled investment vehicle, the pooled investment vehicle is audited and whether the qualified custodian sends account statements to pool investors

Form ADV Amendments – Schedule D

An adviser must:

- identify and provide certain information about the accountants that perform audits or surprise examinations and that prepare internal control reports
- identify related persons, such as banks, that serve as qualified custodians with respect to their client assets, but are not otherwise reported in Item 7
- report whether it has determined that it has overcome the presumption that it is not operationally independent from a related person qualified custodian, and thus is not required to obtain a surprise examination for client assets maintained at that custodian

Books and Records Requirements

Advisers should maintain a copy of:

- internal control report
- memorandum describing the basis upon which the adviser determined that the presumption that any related person is not operationally independent has been overcome
- written agreement with independent public accountant
- surprise exam results

SEC Suggested Compliance Policies and Procedures

- Background and credit checks
- Dual authorization for the movement of client assets
- Rotation of advisory personnel
- Segregation of duties
- Testing

HELPFUL DETAILS

- Adopting release is available at:

http://www.sec.gov/rules/final/2009/ia-2968.pdf

- Proposing release is available at:

http://www.sec.gov/rules/proposed/2009/ia-2876.pdf

- Interpretive release is available at:

http://www.sec.gov/rules/interp/2009/ia-2969.pdf

- FAQ is available at:

http://www.sec.gov/divisions/investment/custody_faq_030510.htm

Relevant Compliance Dates

- Statement legends – March 12
- Due inquiry requirement – March 12
- Surprise exams – December 31 deadline for exam if do not directly custody. If direct custody, 6 months after internal control report
- Form ADV – First annual amendment after 1/1/11
- Internal control reports – Within 6 months of effective dated
- Policies and procedures – March 12

Practical Aspects

- Highlights from the FAQs
- Internal Control Report completed by 9/12/10, but covers controls after 3/12/10

QUESTIONS?

SEC ENFORCEMENT RULES FOR INVESTMENT ADVISERS 2010

POST-MADOFF REFORMS

HOWREY LLP

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March 2010

Failure of the SEC to Uncover the Ponzi Scheme of Bernie Madoff

- The SEC received six complaints between June 1992 and December 2008.

- Three examinations and two investigations were conducted.

- The Madoff Ponzi Scheme went undetected until Madoff's sons reported it to authorities in December 2008.

Ponzi Schemes

- A fraudulent investment operation that pays returns from money obtained from subsequent investors rather than from any profit actually earned.
- The system fails because the earnings, if any, are less than funds received.
- Named after Charles Ponzi
  - 50% profit within 50 days
  - 100% profit within 90 days
  - Arbitrage of International Postage Reply coupons
  - Scheme promoted through his company, “Securities Exchange Company”

Ponzi Schemes
Bernard Madoff Investigation

- Former Chairman of NASDAQ stock exchange
- Madoff, through his asset management firm (Bernard L. Madoff Securities LLC), engaged in a multi-billion dollar Ponzi scheme.
- Paid profits and redemptions to clients from funds received from other clients.
  - In December 2008, due to credit crunch and falling stock prices, clients requested approximately $7 billion in redemptions.
- “Managing” funds of approximately 4800 clients as of November 30, 2008
- Firm had $17 billion in assets under management in 2007.

Madoff

- **March 12, 2009- Pled guilty**
- **Sentenced on June 16, 2009 to 150 years**
- **Civil and Criminal Violations**
  - Investment advisor fraud
  - Antifraud provisions of the Securities and Exchange Act
  - Mail fraud
  - Wire fraud
  - Money Laundering
  - False statements and perjury

Madoff

- **How did he do it for so many years?**
  - Deposited funds in Chase Manhattan Bank;
  - False trading confirmations;
  - False monthly statements;
  - Returns that consistently beat the market; and
  - Transferred funds between US and UK operations to give appearance that purchasing securities on European markets.

Madoff Victims

- Individuals
- Charitable Organizations
- Trusts
- Pension Funds
- Hedge Funds

OTHER SEC CASES INVOLVING INVESTMENT ADVISERS

- *SEC v. Crossroads Financial Planning, Inc., et al.*, Litigation Release No. 20996 (Apr. 10, 2009)- SEC complaint alleges registered investment adviser, through its president, chief operating officer and principal owner, misappropriated at least $2.3 million of client assets.
- *SEC v. Frederick J. Barton, Barton Asset Management, LLC, and TwinSpan Capital Management,* LLC, Litigation Release No. 21016 (Apr. 29, 2009)- SEC obtained a default judgment against registered investment adviser and its majority owner for diverting approximately $500,000 of offering proceeds for personal use and for misappropriating approx. $1.5 million from advisory clients.
- *SEC v. Weitzman*, Litigation Release No. 21078 (June 10, 2009)- a settled SEC action alleges registered investment adviser's co-founder and principal stole more than $6 million in investor funds for his own personal use and falsified client account statements.

OTHER SEC CASES INVOLVING INVESTMENT ADVISERS

- *In the Matter of Paul W. Oliver, Jr.*, Advisers Act Release No. 2903 (Jul. 17, 2009)- a settled SEC action alleges registered investment adviser's chairman aided and abetted misappropriations of more than $23 million in client funds by the investment adviser's co-founder and president.
- *SEC v. Titan Wealth Management, LLC, et al.*, Litigation Release No. 21184 (Aug. 26, 2009)- SEC complaint alleges a registered investment adviser misappropriated 80% of investor funds for personal use, to make Ponzi payments to certain investors or transfers to others.
- *SEC v. Brantley Capital Corporation,* Litigation Release No. 21178 *(August 13, 2009)- SEC* complaint alleges securities fraud against the investment adviser and his firm for overvaluing assets in an investment portfolio they managed in order to generate higher investment advisory fees.

OTHER SEC CASES INVOLVING INVESTMENT ADVISERS

- *In re Stratum Wealth Management, LLC and Charles B. Ganz*, Advisers Act Release No. 2930 (Sept. 29, 2009)- a settled SEC action alleges registered investment adviser, through its sole owner and chairman, misappropriated client funds to pay for personal expenses, falsified client account statements, improperly transferred bad investments to client accounts, and failed to properly value restricted securities in client accounts.
- *SEC v. McAdams,* Litigation Release No. 21455 (March 18, 2010) – SEC complaint alleges that Mark McAdams solicited investors to buy bonds through Global Holdings LLC with promises of reselling the notes for a profit with a return on investment as high as 4,900% in two months. McAdams raised approximately $3.5 million from 35 investors and never invested the funds.
- *SEC v. Durmaz* (C.D. Cal. March 8, 2010) – TRO to shut down a Ponzi scheme targeting retirees in California and Illinois. USA Retirement Management Services and other defendants raised at least $20 million from more than 120 investors. Investors were invited to estate planning seminars and were "enticed to purchase" promissory notes with promised returns between 8 and 11 percent.

OTHER SEC CASES INVOLVING INVESTMENT ADVISERS

- *SEC v. Millennium Bank, et al* (N.D. TX March 26, 2009) – TRO to halt a $68 million Ponzi scheme involving the sale of fictitious high-yield CDs. SEC Complaint alleges that defendants disguised their scheme as a legitimate offshore investment and promised investors that their investments would yield high returns.

Statutory Violations

- **Antifraud Provisions:**
  - Sections 206(1) and (2) of the Advisers Act of 1940,
  - Section 17(a)(1), (2), & (3) of the Securities Act of 1933,
  - Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5.
- **Custody Rules-** Section 206(4)-2
- **False and Misleading Filings-** Section 13a-1 and 13a-13
- **False Books and Records and Lack of Internal Controls-** Sections 13(b)(2)A and (B) and 13 (b)(5)

- **Penalties**
  - A permanent injunction against defendants from committing future violations of the Securities Act
  - Disgorgement of ill-gotten gains, along with prejudgment interest
  - Industry bar

SEC Steps for Improving Transparency & Investor Protection

Goals of the New Rules:

- To Better Monitor Compliance
- To Assess Adviser Compliance Risks
- Identify Red Flags

SEC Steps for Improving Transparency & Investor Protection

- **Improving Fraud Detection Procedures for Examiners –** Examiners will now reach out to custodians and counter-parties to verify the existence and integrity of client assets.
- **Recruiting Staff with Specialized Experience** – SEC is seeking

  (a) Senior Specialized Examiners – specialized in training, operations, portfolio management, options, compliance, valuation, new instruments and portfolio strategies, and forensic accounting.
  (b) Staff with Capital Market Expertise – expertise in modern financial products and techniques, such as derivatives and hedge fund activities.
- **Expanding and Targeting Training** – the SEC will continue to provide Staff with training related to hedge funds and specialized products; derivatives and options; *the verification of trades and custody arrangements;* and the use of databases maintained by exchanges and clearinghouses.

SEC Steps for Improving Transparency & Investor Protection

- **Integrating Broker-Dealer and Investment Adviser Examinations** – The SEC is beginning to expand efforts to integrate broker-dealer and investment adviser examinations that include cross-training and increased coordination within the Agency.
- **Enhancing the Licensing, Education and Oversight Regime for "Back-Office" Personnel** – Back-office personnel are usually involved with custody, accounting, transfer agency and account maintenance at broker-dealer firms. Efforts are being made to develop a program where back-office personnel would be subject to licensing and education requirements.

LOOKING FORWARD

- **Vigilance and Openness**
  - Review marketing materials and disclosures
  - Compliance Professionals should periodically test information (randomly select account statements)
- **Accurate books and records are key**
  - Must keep a paper trail and have it readily available
- **System of internal controls to monitor inflow and outflow of funds**
- **Greater Cooperation between SEC's OCIE and Enforcement**
  - More Industry Professionals in the ranks of OCIE
- **Whistleblowers**
  - The SEC is expecting increased cooperation from insiders
  - Auditors are expected to notify the SEC within one day of finding any missing assets or material discrepancies
- **Old mechanisms for charging fraud are still available**

Questions?

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