

NASAA Custody Requirements for Investment Advisers

Model Rule 102(e)(1)-1

Adopted April 3, 2000, Amended 4/18/04, 9/11/05; Amended 9/11/2011

Rule 102(e)(1)-1 Custody of Client Funds or Securities by Investment Advisers.

(a) **Safekeeping required.** It is unlawful and deemed to be a fraudulent, deceptive, or manipulative act, practice, or course of business for an investment adviser, registered or required to be registered, to have custody of client funds or securities unless:

- (1) **Notice to [Administrator].** The investment adviser notifies the [Administrator] promptly in writing that the investment adviser has or may have custody. Such notification is required to be given on Form ADV;
- (2) **Qualified Custodian.** A qualified custodian maintains those funds and securities:
 - (A) in a separate account for each client under that client's name; or
 - (B) in accounts that contain only the investment adviser's clients' funds and securities, under the investment adviser's name as agent or trustee for the clients, or, in the case of a pooled investment vehicle that the investment adviser manages, in the name of the pooled investment vehicle
- (3) **Notice to clients.** If an investment adviser opens an account with a qualified custodian on its client's behalf, under the client's name, under the name of the investment adviser as agent, or under the name of a pooled investment vehicle, the investment adviser must notify the client in writing of the qualified custodian's name, address, and the manner in which the funds or securities are maintained, promptly when the account is opened and following any changes to this information. If the investment adviser sends account statements to a client to which the investment adviser is required to provide this notice, the investment adviser must include in the notification provided to that client and in any subsequent account statement the investment adviser sends that client a statement urging the client to compare the account statements from the custodian with those from the investment adviser.
- (4) **Account Statements.** 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 client 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.
- (5) **Special rule for limited partnerships and limited liability companies. [ALTERNATIVE ONE]** *Without gatekeeper requirement.*

If the investment adviser or a related person is a general partner of a limited partnership (or managing member of a limited liability company, or holds a comparable position for another type of pooled investment vehicle), the account statements required under paragraph (a)(4) of this rule must be sent to each limited partner (or member or other beneficial owner).

[ALTERNATIVE TWO] *With additional gatekeeper requirement.*

If the investment adviser or a related person is a general partner of a limited partnership (or managing member of a limited liability company, or holds a comparable position for another type of pooled investment vehicle)

- (A) the account statements required under paragraph (a)(4) of this rule must be sent to each limited partner (or member or other beneficial owner), and
- (B) The investment adviser must:

- (i) enter into a written agreement with an independent party who is obliged to act in the best interest of the limited partners, members, or other beneficial owners to review all fees, expenses and capital withdrawals from the pooled accounts;
- (ii) send all invoices or receipts to the independent party, detailing the amount of the fee, expenses or capital withdrawal and the method of calculation such that the independent party can:
 - a. determine that the payment is in accordance with the pooled investment vehicle standards (generally the partnership agreement or membership agreement) and
 - b. forward, to the qualified custodian, approval for payment of the invoice with a copy to the investment adviser.

(6) **Independent Verification.** The client funds and securities of which the investment adviser has custody are verified by actual examination at least once during each calendar year, by an independent certified public accountant, pursuant to a written agreement between the investment adviser and the independent certified public accountant, at a time that is chosen by the independent certified public accountant without prior notice or announcement to the investment adviser and that is irregular from year to year. The written agreement must provide for the first examination to occur within six months of becoming subject to this paragraph, except that, if the investment adviser maintains client funds or securities pursuant to this rule as a qualified custodian, the agreement must provide for the first examination to occur no later than six months after obtaining the internal control report. The written agreement must require the independent certified public accountant to:

- (A) file a certificate on Form ADV-E with the [Administrator] within 120 days of the time chosen by the independent certified public accountant in paragraph (a)(6) of this rule, stating that it has examined the funds and securities and describing the nature and extent of the examination.
- (B) notify the [Administrator] within one business day of the finding of any material discrepancies during the course of the examination, by means of a facsimile transmission or electronic mail, followed by first class mail, directed to the attention of the [Administrator]; and
- (C) file within four business days of the resignation or dismissal from, or other termination of, the engagement, or removing itself or being removed from consideration for being reappointed, Form ADV-E accompanied by a statement that includes:
 - (i) The date of such resignation, dismissal, removal, or other termination, and the name, address, and contact information of the independent certified public accountant; and
 - (ii) An explanation of any problems relating to examination scope or procedure that contributed to such resignation, dismissal, removal, or other termination.

(7) **Investment advisers acting as qualified custodians.** If the investment adviser maintains, or if the investment adviser has custody because a related person maintains, client funds or

securities pursuant to this rule as a qualified custodian in connection with advisory services the investment adviser provides to clients:

- (A) The independent certified public accountant the investment adviser retains to perform the independent verification required by paragraph (a)(6) of this rule must be registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the Public Company Accounting Oversight Board in accordance with its rules; and
 - (B) The investment adviser must obtain, or receive from its related person, within six months of becoming subject to this paragraph and thereafter no less frequently than once each calendar year a written internal control report prepared by an independent certified public accountant:
 - (i) The internal control report must include an opinion of an independent certified public accountant as to whether controls have been placed in operation as of a specific date, and are suitably designed and are operating effectively to meet control objectives relating to custodial services, including the safeguarding of funds and securities held by either the investment adviser or a related person on behalf of the investment advisers clients, during the year;
 - (ii) The independent certified public accountant must verify that the funds and securities are reconciled to a custodian other than the investment adviser or the investment advisers related person; and
 - (iii) The independent certified public accountant must be registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the Public Company Accounting Oversight Board in accordance with its rules.
- (8) **Independent representatives.** A client may designate an independent representative to receive, on his behalf, notices and account statements as required under paragraphs (a)(3) and (a)(4) of this rule.

(b) **Exceptions.**

- (1) **Shares of mutual funds.** With respect to shares of an open-end company as defined in Section 5(a)(1) of the Investment Company Act of 1940 ("mutual fund"), the investment adviser may use the mutual fund's transfer agent in lieu of a qualified custodian for purposes of complying with paragraph (a) of this rule;
- (2) **Certain privately offered securities.**
 - (A) The investment adviser is not required to comply with paragraph (a)(2) of this rule with respect to securities that are:
 - (i) acquired from the issuer in a transaction or chain of transactions not involving any public offering;
 - (ii) uncertificated and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client; and

(iii) transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.

(B) Notwithstanding paragraph (b)(2)(A) of this rule, the provisions of this paragraph (b)(2) are available with respect to securities held for the account of a limited partnership (or 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 this rule and the investment adviser notifies the [Administrator] in writing that the investment adviser intends to provide audited financial statements, as described above. Such notification is required to be provided on Form ADV.

(3) **Fee Deduction.** Notwithstanding paragraph (a)(6) of this rule, an investment adviser is not required to obtain an independent verification of client funds and securities maintained by a qualified custodian if all of the following are met:

(A) The investment adviser has custody of the funds and securities solely as a consequence of its authority to make withdrawals from client accounts to pay its advisory fee;

(B) The investment adviser has written authorization from the client to deduct advisory fees from the account held with the qualified custodian;

(C) Each time a fee is directly deducted from a client account, the investment adviser concurrently:

(i) sends the qualified custodian [sends the independent party designated pursuant to section (a)(5)(B)(ii)] an invoice or statement of the amount of the fee to be deducted from the client's account; and

If the administrator has adopted the gatekeeper requirements of sub. (a)(5) Alternative Two, this subsection should refer to the bracketed language with regard to only sending the invoice to the independent party (not directly to the custodian) who will upon approval forward the invoice to the custodian for action.

(ii) sends the client an invoice or statement itemizing the fee. Itemization includes the formula used to calculate the fee, the amount of assets under management the fee is based on, and the time period covered by the fee.

(D) The investment adviser notifies the [Administrator] in writing that the investment adviser intends to use the safeguards provided above. Such notification is required to be given on Form ADV.

The bracketed language in (C)(i) is to be used when the administrator adopts ALTERNATIVE TWO of sub. (a)(5).

(4) **Limited partnerships subject to annual audit.** An investment adviser is not required to comply with paragraphs (a)(3) and (a)(4) and shall be deemed to have complied with paragraph (a)(6) of this rule with respect to the account of a limited partnership (or limited liability company, or another type of pooled investment vehicle) if each of the following conditions are met:

(A) The adviser sends to all limited partners (or members or other beneficial owners) at least quarterly, a statement showing:

- (i) the total amount of all additions to and withdrawals from the fund as a whole as well as the opening and closing value of the fund at the end of the quarter based on the custodian's records;
- (ii) a listing of all long and short positions on the closing date of the statement in accordance with FASB Rule ASC 946-210-50;
- (iii) the total amount of additions to and withdrawals from the fund by the investor as well as the total value of the investor's interest in the fund at the end of the quarter.

The listing in sub. (ii) follows FASB rule ASC 946-210-50-6 whereby, long and short positions representing more than 5% of the net assets of the fund must be reported as outlined in this subsection of the FASB rule. All provisions of subsection 50-6 apply to the position disclosure required on the quarterly customer statement. This is the same reporting format required by rule 13F under the Securities Exchange Act of 1934 for investment managers' annual reports.

- (B) At least annually the fund is subject to an audit and distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or members or other beneficial owners) [and the Administrator] within 120 days of the end of its fiscal year;
 - (C) The audit is performed by an independent certified public accountant that is registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the Public Company Accounting Oversight Board in accordance with its rules;
 - (D) Upon liquidation, the adviser distributes the fund's final audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or members or other beneficial owners) and the Administrator promptly after the completion of such audit;
 - (E) The written agreement with the independent certified public accountant must require the independent certified public accountant to, upon resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed, notify the [Administrator] within four business days accompanied by a statement that includes:
 - (i) The date of such resignation, dismissal, removal, or other termination, and the name, address, and contact information of the independent certified public accountant; and
 - (ii) An explanation of any problems relating to audit scope or procedure that contributed to such resignation, dismissal, removal, or other termination.
 - (F) The investment adviser must also notify the [Administrator] in writing that the investment adviser intends to employ the use of the statement delivery and audit safeguards described above. Such notification is required to be given on Form ADV.
- (5) **Registered Investment Companies.** The investment adviser is not required to comply with this rule with respect to the account of an investment company registered under the Investment Company Act of 1940.

(c) **Delivery to Related Persons.** Sending an account statement under paragraph (a)(5) of this rule or distributing audited financial statements under paragraph (b)(4) of this rule shall not satisfy the requirements of this rule if such account statements or financial statements are sent solely to limited partners (or members or other beneficial owners) that themselves are limited partnerships (or limited liability companies, or another type of pooled investment vehicle) and are related persons of the investment adviser.

(d) **Definitions.** For purposes of the rule:

(1) "Control" means the power, directly or indirectly, to direct the management or policies of a person whether through ownership of securities, by contract, or otherwise. Control includes:

(A) Each of the investment adviser's officers, partners, or directors exercising executive responsibility (or persons having similar status or functions) is presumed to control the investment adviser;

(B) A person is presumed to control a corporation if the person:

(i) directly or indirectly has the right to vote 25 percent or more of a class of the corporation's voting securities; or

(ii) has the power to sell or direct the sale of 25 percent or more of a class of the corporation's voting securities;

(C) A person is presumed to control a partnership if the person has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital of the partnership;

(D) A person is presumed to control a limited liability company if the person:

(i) directly or indirectly has the right to vote 25 percent or more of a class of the interests of the limited liability company;

(ii) has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital of the limited liability company;

(iii) is an elected manager of the limited liability company; or

(E) A person is presumed to control a trust if the person is a trustee or managing agent of the trust.

(2) "Custody" means holding directly or indirectly, client funds or securities, or having any authority to obtain possession of them [or has the ability to appropriate them]. The investment adviser has custody if a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services the investment adviser provides to clients.

(A) Custody includes:

(i) Possession of client funds or securities unless the investment adviser receives them inadvertently and returns them to the sender promptly but in any case within three business days of receiving them;

(ii) Any arrangement (including a general partner of attorney) under which the investment adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the investment adviser's instruction to the custodian; and

(iii) Any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives the investment adviser or its supervised person legal ownership of or access to client funds or securities.

(B) Receipt of checks drawn by clients and made payable to third parties will not meet the definition of custody if forwarded to the third party within 3 business days of receipt and the investment adviser maintains the records required under Rule 203(a)-2(a)(22);

(3) "Independent certified public accountant" means a certified public accountant that meets the standards of independence described in rule 2-01(b) and (c) of Regulation S-X (17 CFR 210.2-01(b) and (c)).

[(4) "Independent party" means a person that:

(A) is engaged by the investment adviser to act as a gatekeeper for the payment of fees, expenses and capital withdrawals from the pooled investment;

(B) does not control and is not controlled by and is not under common control with the investment adviser; and

(C) does not have, and has not had within the past two years, a material business relationship with the investment adviser.

(D) shall not negotiate or agree to have material business relations or commonly controlled relations with an investment adviser for a period of two years after serving as the person engaged in an independent party agreement.]

(5) "Independent representative" means a person who:

(A) acts as agent for an advisory client, including in the case of a pooled investment vehicle, for limited partners or a limited partnership, members of a limited liability company, or other beneficial owners of another type of pooled investment vehicle and by law or contract is obliged to act in the best interest of the advisory client or the limited partners, members, or other beneficial owners;

(B) does not control, is not controlled by, and is not under common control with investment adviser; and

(C) does not have, and has not had within the past two years, a material business relationship with the investment adviser.

(6) "Qualified custodian" means the following:

(A) A bank or savings association that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act;

(B) A broker-dealer registered in this jurisdiction and with the SEC holding the client assets in customer accounts;

(C) A registered futures commission merchant registered under Section 4f(a) of the Commodity Exchange Act, holding the client assets in customer accounts, but only with respect to clients' funds and security futures, or

other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; and

(D) A foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets.

(7) "Related person" means any person, directly or indirectly, controlling or controlled by the investment adviser, and any person that is under common control with the investment adviser.