

NOTICE OF REQUEST FOR MEMBERSHIP AND PUBLIC COMMENT ON NEW MODEL RULES PERTAINING TO INVESTMENT ADVISER CUSTODY

NASAA's Investment Adviser Section ("IA Section") and Investment Adviser Regulatory Policy and Review Project Group ("Project Group") are rereleasing for comment from interested persons proposed changes to the NASAA model rule pertaining to investment adviser custody ("Proposed Rule"). In response to a prior solicitation for comments, NASAA received comments from both its membership and from the public concerning various provisions within the rule. However, most comments focused on the requirement contained in paragraph section (b)(4)(A) mandating advisers provide investors in private funds detailed quarterly account statements. After considering the comments both in favor and in opposition to this requirement, the IA Section and Project Group are proposing further changes to this provision. As more fully explained below, the Proposed Rule would continue to require quarterly statements, but the level of detail contained in the statements has been modified. The revisions to the Proposed Rule are limited to section (b)(4)(A). The Proposed Rule is being modified under both the Uniform Securities Act of 1956 ("1956 Act") and under the Uniform Securities Act of 2002 ("USA 2002").

The comment period will remain open for 30 days. Accordingly, all comments should be submitted on or before May 19, 2011. Comments should be submitted by email or in writing and addressed to:

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Copies of all comments should *ALSO* be sent to everyone listed below under the heading "Contact Information."

Background of Revisions to the Proposed Rule

NASAA published for comment proposed changes to its model custody rule and in response received several comment letters. Members of the Project Group and IA Section have reviewed all the comments received in response to the Proposed Rule. As mentioned above, these comments were primarily focused on the provision that would have required advisers to private investment funds to send detailed quarterly statements to individual fund investors. Comments submitted by individuals or entities that represent various private funds objected to this provision contending, among other things, that the disclosure of detailed trading information is contrary to how private funds are designed to operate. As explained in the comment letters, private funds are set up such that investor money is pooled and investors own a fractionalized interest in the structure of the pooled investment vehicle. An investor in such a vehicle who is provided with detailed trading information could in turn use that information to trade independently of the fund to the detriment of other investors in that fund. The commenters were also concerned that this requirement could lead to the misappropriation of the trading strategies engaged in by a private fund. Those in support of the provision believe strongly that regulators and investors should have access to detailed information on the investment activities of the fund in order to understand how the fund is being managed and to identify potential problem areas with the fund and fund adviser.

After further consideration of the comments both in support of and in opposition to the language in (b)(4)(A), the Project Group is proposing a revision that it believes would address the concerns expressed by the commenters while maintaining investor protection safeguards and improving transparency. The proposed revision would maintain the requirement for advisers to private funds to send quarterly statements to investors. These statements must disclose the opening and closing cash balances and the closing security positions of the fund as a whole for the quarterly statement period. In addition, the total amount of additions and withdrawals from the fund as a whole and for each investor must also be disclosed. Instead of a requirement to list all transactions during the quarter with specificity, the Project Group is proposing that an aggregate listing of transactions be included, with a breakdown by category rather than individual trade. The quantity could be stated in the trading unit of the security, such as shares or units, in total transaction value or stated as a percentage of the fund's holdings, as long as the descriptions are consistent for all transactions reported. This would take a form similar to listing the total quantity of buys and sells of stocks, mutual funds, limited partnership interests, promissory notes, etc., with non-traditional investments, such as participations in litigation fees or private businesses, being clearly identified. The Project Group believes the absence of trade dates, specific securities and execution prices would address industry concern over identification of trading strategies while providing regulators and investors important information about the activities of the fund.

A question has been raised that some transaction categories may not be clearly defined, such as small cap equity, which may be confusing for the reader. However, many such terms have a generally accepted meaning in the industry and will likely be understood by the investors in private funds. In addition to general comments, the Project Group is particularly interested in comments on the use of titles for categories used on the statements.

NOTE

- **[Bracketed language] indicates optional language to be adopted at the discretion of the administrator.**
- *Italicized language indicates drafters' comments.*

Summary of the Revisions to the Section (b)(4)(A) of the Proposed Custody Rules

Custody Rule Section (b)(4)(A)

- **Core Revisions.**
 - Maintain the requirement for advisers to private funds to deliver a quarterly statement to fund investors in order to perfect the exemption from the surprise examination requirement.
 - Require the statement to contain the opening and closing cash balances for the fund for the quarterly statement period.
 - Require the statement to contain the total amount of additions and withdrawals from the fund during the quarterly statement period.
 - Require the statement to contain a listing of the portfolio holdings as of the end of the quarterly statement period.
 - Require the statement to contain a listing of the aggregate purchases and sales for the fund, listed by security type.
 - Require the statement to contain each individual investor's total additions and withdrawals from the fund during the quarterly statement period.
 - Require the statement to contain the value of each individual investor's holding in the fund at the close of the quarterly statement period.

Contact Information

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**NASAA Custody Requirements for Investment Advisers
Model Rule USA 2002 411(f)-(1)**

(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) Upon finding any material discrepancies during the course of the examination, notify the [Administrator] 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 [Administrator]; and
- (C) Upon resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed, file within four business days 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 an invoice or statement of the amount of the fee to be deducted from the client's account; and
 - (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 Project Group recommends that, for consistency, states advise their applicants and registrants to check Item 9.A. on Form ADV Part 1A as "No" if the only reason they have custody is because they engage in direct fee deduction. Item 2.I. of Form ADV Part 1B asks detailed questions that are more useful in determining associated risk.

(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 holdings on the closing date of the statement;
- (iii) the aggregate buys and sells for the fund, listed by security type; and
- (iv) 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. (iii) can reflect the total purchases or sales of a particular security type, such as small cap equity stocks, real estate limited partnership interests, etc. For non-traditional investments, such as litigation award participations or investments in proprietary businesses, those categories should be clearly identified. The quantity can be expressed in the gross amount of the purchase or sale or as a percentage of the total value of the fund's investments.

- (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 your related persons.

(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 general partner or 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 411(c)-1(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.

NASAA Custody Requirements for Investment Advisers

Model Rule 102(e)(1)-1

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

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) Upon finding any material discrepancies during the course of the examination, notify the [Administrator] 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 [Administrator]; and
- (C) Upon resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed, file within four business days 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 an invoice or statement of the amount of the fee to be deducted from the client's account; and
 - (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 Project Group recommends that, for consistency, states advise their applicants and registrants to check Item 9.A. on Form ADV Part 1A as "No" if the only reason they have custody is because they engage in direct fee deduction. Item 2.I. of Form ADV Part 1B asks detailed questions that are more useful in determining associated risk.

- (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 holdings on the closing date of the statement;
- (iii) the aggregate buys and sells for the fund, listed by security type; and
- (iv) 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. (iii) can reflect the total purchases or sales of a particular security type, such as small cap equity stocks, real estate limited partnership interests, etc. For non-traditional investments, such as litigation award participations or investments in proprietary businesses, those categories should be clearly identified. The quantity can be expressed in the gross amount of the purchase or sale or as a percentage of the total value of the fund's investments.

- (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.

(b) **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 your related persons.

(c) **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 general partner or 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 411(c)-1(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.

NASAA Minimum Financial Requirements For Investment Advisers
Model Rule 202(d)-1

Adopted 9/3/87; Amended 4/3/00 and 4/18/04

Rule 202(d)-1 Minimum Financial Requirements For Investment Advisers

- (a) An investment adviser registered or required to be registered under the Act who has custody of client funds or securities shall maintain at all times a minimum net worth of \$35,000 except:
 - (1) Advisers having custody solely due to direct fee deduction and complying with the terms described under Rule 102(e)(1)-1(b)(3) and related books and records, as described in Rule 203(a)(2), shall not be required to comply with the net worth or bonding requirements of this Rule.
 - (2) Advisers having custody solely due to advising pooled investment vehicles and complying with the terms described under Rule 102(e)(1)-1(a)(5) or Rule 102(e)(1)-1(b)(4) and related books and records, as described in Rule 203(a)(2), shall not be required to comply with the net worth or bonding requirements of this Rule.

- (f) For purposes of this Rule, “custody” is defined in Rule 102(e)(1)-1(d)(2).

**NASAA Bonding Requirements for Investment Advisers
Model Rule 202(e)-1**

Adopted 9/3/87, amended 4/3/00, 4/18/04, 9/11/05

Rule 202(e)-1 Bonding Requirements for Certain Investment Advisers.

(b) For purposes of this Rule, “custody” is defined in Rule 102(e)(1)-1(d)(2).

**NASAA Recordkeeping Requirements For Investment Advisers
Model Rule 203(a)-2**

Adopted 9/3/87, amended 5/3/99, 4/18/04, 9/11/05

NOTE: Italicized information is explanatory and not intended for inclusion in the rule text. Language based on the Uniform Securities Act of 1956, as amended.

Rule 203(a)-2 Recordkeeping Requirements [ALTERNATIVE 1]:

(a) 1. If an investment adviser has custody, as that term is defined in NASAA Model Rule 102(e)(1)-1(d)(2), of the NASAA Custody Rules, the records required to be made and kept under paragraph (a) above shall include:

2. If an investment adviser has custody because it advises a pooled investment vehicle, as defined in Rule 102(e)(1)-1(d)(2)(A), the adviser shall also keep the following records:

(A) True, accurate and current account statements;

(B) Where the adviser complies with Rule 102(e)(1)-1(b)(4) the records required to be made and kept shall include:

i. the date(s) of the audit;

ii. a copy of the audited financial statements; and

iii. evidence of the mailing of the audited financial to all limited partners, members

or other beneficial owners within 120 days of the end of its fiscal year.

(C) Where the adviser complies with rule 102(e)(1)-1(a)(5) the records required to be made and kept shall include:

Delete section (b)(3) in its entirety because of the elimination of special custody rules relating to beneficial trusts.

Rule 203(a)-2 Recordkeeping Requirements [ALTERNATIVE 2] (*Language for states which incorporate by reference Rule 204-2 of the Investment Advisers Act of 1940*)

(a) *[Every investment adviser registered or required to be registered under this Act shall make and keep true, accurate and current the following books, ledgers and records:]*

13. For investment advisers who have custody, as that term is defined in Rule 102 (e) (1) -1 (d) (2), of client funds or securities, all records and evidence of compliance required by Rule 206(4)-2 under the Investment Advisers Act of 1940.

NASAA Brochure Rule Requirements for Investment Advisers

Model Rule 203(b)-1

Adopted 9/3/87

Rule 203(b)-1 Investment Adviser Brochure Rule

- (a) GENERAL REQUIREMENTS. Unless otherwise provided in this rule, an investment adviser, registered or required to be registered pursuant to Section 403 of the Act shall, in accordance with the provisions of this section, furnish each advisory client and prospective advisory client with:
- (1) a brochure which may be a copy of Part 2A of its Form ADV or written documents containing the information required by Part 2A of Form ADV;
 - (2) a copy of its Part 2B brochure supplement for each individual
 - (A) providing investment advice and having direct contact with clients in this state; or
 - (B) exercising discretion over assets of clients in this state, even if no direct contact is involved;
 - (3) a copy of its Part 2A Appendix 1 wrap fee brochure if the investment adviser sponsors or participates in a wrap fee account;
 - (4) a summary of material changes, which may be included in FORM ADV Part 2 or given as a separate document; and
 - (5) such other information as the [Administrator] may require.
 - (6) The brochure must comply with the language, organizational format and filing requirements specified in the Instructions to Form ADV Part 2.

Administrators should note that the SEC's Instructions for Part 2A of Form ADV exclude a change in advisory fee from its interpretation of "material change" such that it would not trigger an other than annual amendment of Form ADV Part 2A. The Administrator may wish to include a note or additional rule subsection to clarify fee changes constitute material changes requiring an update to all parts of Form ADV.

- (b) DELIVERY.
- (1) INITIAL DELIVERY. An investment adviser, except as provided in subsection (b)(3), shall deliver the Part 2A brochure and any brochure supplements required by this section to a prospective advisory client:
 - (A) Not less than 48 hours prior to entering into any advisory contract with such client or prospective client; or
 - (B) At the time of entering into any such contract, if the advisory client has a right to terminate the contract without penalty within five business days after entering into the contract.
 - (2) ANNUAL DELIVERY. An investment adviser, except as provided in subsection (b)(3), must:
 - (A) Deliver within 120 days of the end of its fiscal year a free, updated brochure and related brochure supplements which include or are accompanied by a summary of material changes; or
 - (B) Deliver a summary of material changes that includes an offer to provide a copy of the updated brochure and supplements and information on how the client may obtain a copy of the brochures and supplements.

Advisers do not have to deliver a summary of material changes or a brochure to clients if no material changes have taken place since the last summary and brochure delivery.

- (3) Delivery of the brochure and related brochure supplements required by subsections (b)(1) and (2) need not be made to:
 - (A) clients who receive only impersonal advice and who pay less than \$500 in fees per year; or
 - (B) An investment company registered under the Investment Company Act of 1940; or
 - (C) A business development company as defined in the Investment Company Act of 1940 and whose advisory contract meets the requirements of section 15c of that Act.
- (4) Delivery of the brochure and related supplements may be made electronically if the investment adviser:
 - (A) in the case of an initial delivery to a potential client, obtains a verification that a readable copy of the brochure and supplements were received by the client;
 - (B) in the case of other than initial deliveries, obtains each client's prior consent to provide the brochure and supplements electronically;
 - (C) prepares the electronically delivered brochure and supplements in the format prescribed in sub. (a) and instructions to Form ADV Part 2;
 - (D) delivers the brochure and supplements in a format that can be retained by the client in either electronic or paper form;
 - (E) establishes procedures to supervise personnel transmitting the brochure and supplements and prevent violations of this rule.
- (c) OTHER DISCLOSURES. Nothing in this rule shall relieve any investment adviser from any obligation pursuant to any provision of the Act or the rules and regulations thereunder or other federal or state law to disclose any information to its advisory clients or prospective advisory clients not specifically required by this rule.
- (d) DEFINITIONS. For the purpose of this rule:
 - (1) "contract for impersonal advisory services" means any contract relating solely to the provision of investment advisory services:
 - (A) by means of written material or oral statements which do not purport to meet the objectives or needs of specific individuals or accounts;
 - (B) through the issuance of statistical information containing no expression of opinion as to the investment merits of a particular security; or
 - (C) any combination of the foregoing services.
 - (2) "entering into," in reference to an advisory contract, does not include an extension or renewal without material change of any such contract which is in effect immediately prior to such extension or renewal.

USA 2002 cross reference to 411(g)