<u>Invitation to Comment on Proposed Rule-making by Office of Securities</u>

This rule-making would repeal and replace section 11 of Chapter 515 of the Rules of the Office of Securities. Section 11 establishes certain requirements when an investment adviser has custody of client funds.

The rule-making would clarify section 11, as well as make it more consistent with a similar rule promulgated by the Securities and Exchange Commission for federally registered advisers ("SEC rule") and with a model state rule adopted by the North American Securities Administrators Association ("NASAA rule").

To protect clients against possible abuses by an adviser with custody of client assets, the SEC and NASAA rules both rely on two basic safeguards, namely, that the assets be maintained by a qualified custodian, which must be bank or a broker-dealer, and that the client be sent an account statement at least every three months. The statement may be sent by the custodian or by the adviser, but if the latter approach is taken, an independent public accountant must conduct a surprise annual audit to verify all of the funds and securities in the account.

The current version of section 11 does not expressly mandate the use of a qualified custodian (although it does require that client funds be in a bank). In addition, it provides that the account statements be sent by the adviser, and it requires a surprise annual audit in all instances. The revised version of section 11 would mirror the approach taken by the SEC and NASAA, and in so doing, would eliminate the burden of the annual audit when the statements are sent by the qualified custodian, which we assume would be the usual practice.

The theory underlying the SEC and NASAA rules is that by receiving account statements from the qualified custodian on a timely basis, the client will be able to detect inappropriate activity by the adviser. This theory arguably does not apply when the client is a trust for which the adviser or someone affiliated with the adviser serves as the sole trustee, since the statements would go to the very person whose conduct is to be monitored. The SEC and NASAA rules take very different approaches to this situation, with the SEC not providing additional safeguards for trusts and NASAA establishing a

very detailed role for the qualified custodian with respect to the disbursement of trust funds.

In reviewing these alternative approaches, we have preliminarily concluded that the SEC does too little and NASAA too much. With respect to the latter, our concern is that the trustee may not be able to perform certain common and potentially important functions, such as writing checks for goods and services legitimately required by one or more beneficiaries. Accordingly, our draft rule seeks a safeguard that does not insert the custodian into the performance of trustee functions, but rather endeavors to make the account statement safeguard work for trusts. Specifically, subsections 5(D) and 5(E) of the revised section 11 would require that for revocable trusts, the account statements must go the grantor, and for irrevocable trusts, they would be sent to any beneficiary who is entitled under the law to receive the trustee's annual report and who requests the statements. At least annually, the trustee would be required to notify any beneficiary entitled to receive its annual report of the right also to receive account statements directly from the independent custodian.

We would welcome comments on our proposed approach to the situation in which an individual serves as both trustee of and adviser to a trust. We recognize the limitations of our approach when the grantor of a revocable trust or all of the beneficiaries of an irrevocable trust are incompetent, but we are inclined to think that rather than unduly limit the adviser's ability to perform traditional trustee functions through our rule, this problem should be addressed through trust law, especially since trustee abuses can occur when the trustee is not also the adviser. We would be interested to know whether others would strike a different balance or would address this in a different way.

For a large trust, there is also a potential cost issue if a significant number of beneficiaries desire account statements. To address this, if more than three beneficiaries requested statements, subsection 5(E)(4) would allow the custodian to charge a fee, reflecting its actual costs, to each beneficiary receiving statements. We invite comment on the reasonableness of that provision.

Finally, with respect to trusts, subsection 15 of the proposed rule would accord special treatment to trusts in which the adviser serves as the trustee and the beneficial owner of the trust is a close relative of the adviser. In these instances, the adviser would

have to comply with the custody rule, as well as with the net worth and bonding requirements established for custodial advisers by sections 12 and 13 of Chapter 515, but would not have to file an audited balance sheet on From ADV, Part II, Schedule G. The rationale behind this is that preparing an audited balance sheet may involve a level of expense that cannot be justified for a family trust, whereas the other requirements do not seem particularly onerous. We invite comment on whether this is the appropriate treatment of these trusts.

The SEC and NASAA rules also differ somewhat when an adviser serves as the general partner of a limited partnership or holds a comparable position for another type of pooled investment vehicle. In that situation, both rules require that copies of the account statements be sent directly to the investors in the vehicle unless the entity is subject to an annual audit and distributes to all its investors audited financial statements prepared in accordance with generally accepted accounting principles. However, for those pooled investment vehicles not subject to an annual audit and for which the adviser has custody of the assets, NAASA also requires that the adviser hire an independent party to review all fees, expenses and capital withdrawals from the pooled accounts.

We have incorporated the NAASA "independent party" requirement as subsection 9 of our draft rule, in part because we favor uniformity among the states whenever not outweighed by some countervailing policy. We are not certain, however, whether this additional safeguard for pooled investment vehicles is necessary, and we would welcome comments on whether the additional burden it would impose would outweigh the incremental benefits.

Needless to say, commenters are also encouraged to make their views known on any other aspect of the proposed rule.