JACKO LAW GROUP, PC

Legal Risk Management Tip
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CALIFORNIA'S REVISED CUSTODY RULE SEEKS UNIFORMITY

Background

Recently, the California Department of Business Oversight ("DBO") officially adopted revisions to the California investment adviser custody rule, Section 260.237 of Title 10 of the California Code of Regulations (the "Rule"). According to the DBO, these changes were in response to, and incorporate provisions from, the recently adopted amendments to the Securities and Exchange Commission's ("SEC's") Custody Rule[1] and the North American Securities Administrators Association's ("NASAA's") Model Custody Rule.[2] Notably, changes to the federal custody rule in 2009 prompted changes to the Model Rule by NASAA, which in turn triggered the DBO to enact its recent revisions. According to the DBO, the goal of the Rule's enactment is to increase uniformity so that regardless of whether an investment adviser registers with the State of California or with the SEC, the adviser will have the same responsibilities with investors afforded the same protections.

This article is not intended to provide a comprehensive overview of the custody rule;[3] rather, it will highlight those aspects of the Rule that are either revisions of the previous California custody rule, or new entirely. Amendments to the new Rule strike the existing language in favor of NASAA's Model Custody Rule, subject to certain California-specific provisions which are outlined below. Several of the changes simply mandate what most California-registered advisory firms have already been doing as a "best practice." For instance, the revised rule requires that advisers with custody maintain those assets with a qualified custodian[4] to prevent commingling of funds, subject to certain limited exceptions. While California's previous custody rule prohibited commingling of funds, it did not explicitly require the adviser to use a qualified custodian to custody client assets. Other notable changes to the Rule are provided below.

Highlights of California's Revised Custody Rule

1. Notification Requirements

Similar to those revisions made within the SEC's custody rule, the Rule emphasizes disclosures and notifications by those advisers deemed to have custody.[5] Such notifications include:

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[1] http://www.sec.gov/rules/final/2009/ia-2968.pdf.
[2] http://www.nasaa.org/1794/new-model-rules-pertaining-to-investment-adviser-custody-and-brochure-requirements/.
[3] For more information on rules regarding custody, please visit websites operated by the SEC and DBO where additional materials and frequently asked questions are available.
[4] Per Rule 260.237(d)(6), a "qualified custodian" is now defined to include banks, broker-dealers, registered futures commission merchants and foreign financial institutions that customarily hold financial assets for its customers.
[5] Per Rule 260.237(d)(2), "custody" arises when an adviser (or related person) holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, or has the ability to appropriate them.

- Providing notice to the Commissioner, via Form ADV, if the adviser has (or may have) custody of client assets;
- Notifying clients in writing of the qualified custodian's name and address, and the manner in which the assets are maintained, and any changes to this information should the adviser open an account with a qualified custodian on the client's behalf; and
- Notifying clients on adviser-generated account performance statements and reports that the client is urged to compare the adviser's account statements with that which is generated and received from the client's qualified custodian.[6]

2. Surprise Examination

Unless otherwise specified or exempted,[7] the Rule generally[8] requires advisers with custody to undergo an annual surprise examination by an independent public accountant to verify the existence of the assets in the client accounts and to reconcile information contained within the adviser's books and records and in client account statements. Further, the Rule specifies that certain audits and independent verifications must be performed by Certified Public Accountants that are registered with and subject to regular inspection by the Public Company Accounting Oversight Board ("PCAOB").

Additionally, the Rule now creates a distinction between advisers using non-affiliated qualified custodians, and those who serve as qualified custodians, or have an affiliated person in such a role. In addition to mandating surprise examinations, the Rule now requires an investment adviser or a related person acting as a qualified custodian to undergo an internal control report prepared by an independent certified public accountant registered with the PCAOB. This report must include an opinion from the accountant with respect to the adviser's or related person's controls relating to custody of client assets, thus adding another layer of oversight to help decrease potential misuse of client assets.

3. Pooled Investment Vehicles/Private Fund Exception

Advisers to pooled investment vehicles are not required to undergo a surprise examination, provided that all provisions of section 260.237(b)(4) of the Rule are satisfied. To comply with this section, the adviser must:

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[6] The adviser must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends account statements at least quarterly to each client for which it maintains funds or securities. This is typically verified through requesting duplicates from the custodian, and asking the client for confirmation of their receipt of such statements.

[7] The Rule does not require a surprise examination in certain limited exceptions including: (i) the use of mutual funds as such funds are regulated at the federal level; (ii) certain privately offered restricted securities with limited transferability; and (iii) advisers deemed to have custody solely because of the adviser's authority to deduct advisory fees from client accounts assuming the client has authorized such billing practices, the adviser has notified the Commissioner in writing (via its Form ADV) that the adviser intends to use the safeguards provided under the Rule, and each time a fee is directly deducted from the client's account, the adviser concurrently sends the qualified custodian an invoice of the amount of the fee to be deducted and sends the client an invoice or statement itemizing the fee. Please also refer to Item 3, Pooled Investment Vehicles/Private Fund Exception of this Section for additional information.

[8] Advisers deemed to have custody due to their role as a trustee.

- Send all beneficial owners quarterly account statements (however, unlike the NASAA model rule, the California Rule relaxes account statement requirements for advisers to private funds[9] in an effort to maintain the confidentiality of any proprietary trading models developed by the adviser);
- Notify the Commissioner (via Form ADV) of the adviser's intent to employ the use of the statement delivery and audit safeguards described in this section of the Rule;
- Subject the fund to an annual audit and distribute audited financial statements prepared in accordance with generally accepted accounting principles ("GAAP") to all limited partners (or other beneficial owners) and the Commissioner within 120 days of the end of the fund's fiscal year. This audit must be performed pursuant to a written agreement with an independent certified public accountant registered with PCAOB;
- Upon liquidation, the adviser must distribute the fund's final audited financial statements – prepared in accordance with GAAP – to all limited partners (or other beneficial owners) and the Commissioner[10] promptly after the completion of the audit; and
- The written agreement with the independent public accountant must require that accountant notify the Commissioner within four (4) business days (by filing Form ADV-E) following the accountant's resignation, dismissal or termination.

Conclusion

It is imperative that California registered investment advisers have a solid understanding of what activities trigger the custody rule, and what guidelines and standards apply. Custody related deficiencies are consistently one of the most targeted areas of state regulatory examinations. In light of this revised Rule, California investment advisers should revise and enhance their firm's custody policies and procedures, provide training to personnel on custody related matters and enhance internal controls in order to detect custody. In addition, California advisers should conduct reasonable due diligence on applicable service providers to help ensure they are aware of and can comply with the new Rule's requirements.

For more information, please contact Jacko Law Group, PC at (619) 298-2880 or email us at info@jackolg.com.

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[9] In an effort to protect proprietary trading models developed by an adviser, rather than require a quarterly disclosure of all investment positions as stated in the NASAA model rule, the Rule requires disclosure that mirrors U.S. financial reporting standards for non-registered investment partnerships.

[10] Copies of the final audit's financial statements should be mailed to the adviser's nearest DBO office, which will vary depending on adviser's location. For more information on where to file such information, please contact the DBO at (866) 275-2677.