

CALIFORNIA DEPARTMENT OF BUSINESS OVERSIGHT  
ADDENDUM TO THE INITIAL STATEMENT OF REASONS  
FOR THE RULE CHANGES UNDER THE  
CORPORATE SECURITIES LAW OF 1968

The following statements supplement the Initial Statement of Reasons:

As required by Section 11346.2 of the Government Code, the California Department of Business Oversight's Commissioner ("Commissioner") sets forth below the reasons for the proposed amendments to Section 260.237 of Title 10 of the California Code of Regulations (10 C.C.R. Section 260.237).

This proposed regulatory action seeks to increase uniformity with investment adviser regulation in other states, as well as with recently amended Securities and Exchange Commission ("SEC") rules. (Rule 206-(4)-2 under the Investment Advisers Act of 1940, 17 CFR §275.206(4)-2; *see also* SEC Release No. IA-2968, March 12, 2010). The proposed regulation generally conforms to the North American Securities Administrators Association ("NASAA") Model Custody Rule (the "Model Rule"). (NASAA Custody Requirements for Investment Advisers Model Rule 102(e)(1)-1, Amended September 11, 2011).

Effective July 1, 2013, the Department of Corporations and the Department of Financial Institutions merged to form the Department of Business Oversight, in accordance with the Governor's Reorganization Plan 2 (GRP 2, 2012), a reorganization of state departments and agencies to provide services more efficiently and effectively. The Department of Business Oversight has all of the powers, authority, enforcement, jurisdiction, laws and regulations that were under the former Department of Corporations and former Department of Financial Institutions.

The Department of Business Oversight ("Department") licenses and regulates investment advisers under the Corporate Securities Law of 1968 (Corporations Code Section 25000 et seq., the "Corporate Securities Law"). Under the Corporate Securities Law, it is unlawful for an investment adviser to conduct business without first applying for and securing a certificate.

The purpose of this regulatory action is to increase safeguarding of investor funds and securities.

### **Specific Purpose, Problem and Rationale**

The specific purpose, problem and rationale for each subsection is described in greater detail below.

#### **260.237(a)(1) – Notice to Commissioner**

Specific purpose: The purpose of the notice to the Commissioner is to require an investment adviser to disclose if the adviser has or may have custody on form ADV, which is a registration form used by investment advisers to register with both federal and state securities regulators.

To be licensed in California, an investment adviser must complete form ADV. (Corporations Code Sec. 25612.3). The SEC, as well as the Department requires an investment adviser to update form ADV annually and amend any information on the form that has become inaccurate (CCR Sec. 260.241.4).

Problem: Under the current rule, it is difficult for the Department to readily identify which investment advisers have custody and thereby, identify any compliance issues because the current rule does not require that the Commissioner be put on notice about which investment advisers have custody.

Rationale: The proposed rule will provide the Department with adequate information about which investment advisers have custody and thereby, identify any potential compliance issues. Additionally, the SEC revised its custody rule to provide additional safeguards after several enforcement actions and the Madoff fraud. NASAA revised its corresponding Model Rule related to custody to provide needed uniformity between the regulation of federal-registered and non-federal registered investment advisers. The Department proposes to update its custody rules in light of the amendments by the SEC and NASAA to adequately reflect current industry practices and create greater regulatory consistency while ensuring adequate protection for investment advisory clients.

#### 260.237(a)(2)-260.237(a)(2)B) - Qualified Custodian

Specific purpose: This subsection of the proposed rule prohibits an investment adviser from commingling client funds by requiring an account that only contains client funds. The proposed rule requires that a qualified custodian maintain client funds and securities.

Problem: While the current rule does prohibit the commingling of client funds, it does not explicitly require that a qualified custodian maintain those funds. Under the proposed rule, qualified custodians include financial institutions such as banks, registered broker-dealers and registered futures commission merchants that are already subject to extensive state and federal regulation and oversight.

Rationale: By requiring a qualified custodian to maintain client funds provides additional safeguards necessary to protect client assets.

#### 260.237(a)(3) - (a)(4)- Notice to Clients and Account Statements

Specific purpose: An investment adviser that opens an account with a qualified custodian on the adviser's client's behalf is required to send written notice to the client with specific information about the qualified custodian and the client funds, when the account is first opened and any subsequent changes made to the qualified custodian or client funds. Moreover, the notice and any subsequent account statements provided to the client must inform the client to compare the account statements from the custodian with those from the investment adviser.

Furthermore, after due inquiry, the proposed rule requires that an investment adviser have a reasonable basis for believing that the qualified custodian send quarterly account statements to adviser clients, identifying specific information amount those

funds, including the amount of funds and all advisory fees and transactions during the statement period.

**Problem:** The current rule does not provide enough safeguards and checks against inaccurate or falsified account statements.

**Rationale:** Under the proposed rule, account statements must be sent to advisory clients. The proposed rule requires that all client funds be maintained by a qualified custodian. An investment adviser that acts as a qualified custodian and sends account statements directly to clients is subject to heightened scrutiny under 260.237(a)(7), which creates enhanced safeguards for client assets. However, an investment adviser that uses an independent qualified custodian, a reasonable belief, after due inquiry, that the qualified custodian provides account statements directly to clients is sufficient because the qualified custodian is subject to additional state and federal regulation and oversight.

#### 260.237(a)(5) - LLCs, Pooled Investments

**Specific purpose:** The proposed rule sets forth specific requirements for pooled investment vehicles that enhance safeguards of client assets, while ensuring proprietary trading models for such investments are maintained.

Under the proposed rule, an investment adviser to a pooled investment is required to send all limited partners a statement of all additions and withdrawals from the fund, so that the fund may be accounted for.

The proposed rule requires investment advisers of pooled investment to make disclosures according to U.S. financial reporting standards under Generally Accepted Accounting Principles (GAAP), which is a collection of rules, procedures and conventions that define accepted accounting practice nationwide, and Financial Accounting Standards Board (FASB), which is the designated private sector organization that establishes financial accounting and reporting standards in the U.S.

**Problem:** Different risks are associated with various groups of investment advisers, which require different safeguards. However, the current rule does not make this distinction. For example, the current rule does not provide specific rules for investment advisers that manage individual assets and those that manage a pool of private assets. This distinction is necessary to ensure that the various custody practices by investment advisers are adequately regulated.

**Rationale:** The proposed rule strikes a necessary balance of disclosure of transactions for private investment funds. There is a strong interest in ensuring that investors receive sufficient information regarding a private fund's investment performance to ensure that they make fully informed investment decisions. However, there is also a strong interest in ensuring that proprietary trading models developed by an adviser, and indirectly selected by the client, are maintained in a confidential manner. In certain circumstances, disclosure of fund strategies and transactions could ultimately financially harm investors in the fund. Rather than require a quarterly disclosure of all investment positions, the proposed rule requires disclosure that mirrors U.S. financial reporting standards for non-registered investment partnerships.

Thus, the proposed rule requires investment advisers of pooled investment vehicles to adhere to recognized financial standards as a way of ensuring safekeeping of client assets while maintaining the integrity and proprietary strategies of the fund. The GAAP and FASB standards, as well as other requirements in this proposed rule, in conjunction with the exceptions applicable to pooled investment vehicles under 260.237(b)(4), ensure adequate protection of client funds and securities.

Additionally, the proposed rule provides waiver of net worth and audited financial statements because adequate measures are set in place that would provide safeguards that the net worth and audited financial statement requirements currently provide.

#### 260.237(6) - Surprise examination

**Specific purpose:** The proposed regulation would require an investment adviser with custody of clients' assets to hire an independent public accountant to conduct an annual surprise inspection of the client funds and securities. The purpose of the surprise inspection would be to verify the existence of the assets in the client accounts, reconcile the information regarding the accounts with the books and records of the investment adviser and reconcile information contained in client account statements with the books and records of the investment adviser.

The independent certified public accountant would file a certificate on form ADV-E with the Commissioner confirming the examination. Additionally, an accountant would be required to report the resignation or any termination from the agreement with the investment adviser on Form ADV-E.

Form ADV-E is used for a certificate of accounting of securities and funds in the custody of an investment adviser. Form ADV-E contains both information about the adviser and the surprise exam conducted.

**Problem:** The current rule does not provide enough safeguards, specific reporting and examination timeframes and confirming the examination, as well as reporting any material discrepancies to the Commissioner.

**Rationale:** An annual surprise examination by an independent certified public accountant would provide additional review of client assets, and thus, additional protection against their misuse. Moreover, an independent certified public accountant may identify misuse that a client has not, which would result in the earlier detection of fraudulent activities and reduce client losses. Finally, the certified independent public accountant would be required to file mandated forms with the Department regarding the inspections or in the event of termination of the accounting firm in order for the Department to be promptly alerted in the event of any discrepancy discovered during the inspections or, in the event of any termination of an accounting firm, alerted to potential disagreements between the adviser and the independent public accountant regarding the custodial arrangements.

A limited partnership that selects an annual audit and meets specific requirements is not subject to the surprise examination.

Furthermore, the specific timeframes create timely measures to detect any material discrepancy and improve the Department's ability to identify potential misuse of clients' assets.

Additionally, the requirement for an independent certified public accountant to use Form ADV-E, as well as the specific timeframes set forth in 260.237(a)(6) of the proposed rule are requirements set forth in the SEC custody rules and the NASAA model rules. The SEC revised its custody rule to provide additional safeguards after several enforcement actions and the Madoff fraud. NASAA revised its corresponding Model Rule related to custody to provide needed uniformity between the regulation of federal-registered and non-federal registered investment advisers. The Department proposes to update its custody rules in light of the amendments by the SEC and NASAA to adequately reflect regulatory consistency and current industry practices while ensuring adequate protection for investment advisory clients. Setting forth procedures and timeframes that are different than the SEC custody rules and the NASAA model rules would create confusion and a higher compliance burden for the investment adviser industry.

#### 260.237(a)(7) – Investment Adviser as Qualified Custodian

Specific purpose: When an adviser or its related person serves as a qualified custodian, the adviser must obtain at least once every calendar year, a written report, which includes an opinion from an independent accountant with respect to the adviser's or related person's controls relating to custody of client assets, or the internal control report. The accountant issuing the internal control report, as well as the accountant performing the surprise examination must be registered with the Public Company Accounting Oversight Board, ("PCAOB"), is a private sector organization created by the Sarbanes-Oxley Act, a 2002 federal law, to oversee the auditors of public companies.

Problem: The current rule does not reflect, and include safeguards for, modern custody practices. For example, it does not make a distinction between independent qualified custodians that maintain client assets and investment advisers that act as qualified custodians. This distinction involves different risks and therefore, requires different levels of protection and compliance.

Rationale: The risks to clients are different when an investment adviser or related person serves as custodian versus an independent qualified custodian. In addition to mandating surprise exams, the proposed rule 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 requirement adds another layer of review to decrease the likelihood that client assets are misused and increase the likelihood that fraudulent activities are discovered earlier.

Many investment advisers perform in more than one state and use the services of public accountants in other states. However, the qualifications of certified public accountants vary from state to state. Requiring a certified public accountant that conducts the surprise exam and internal control report to be registered and subject to

regular inspection by the PCAOB, establishes uniform standards for regulators as well as the investment adviser and accounting industry.

#### 260.237(a)(8) – Independent Representative

Specific purpose: The purpose is to allow a client to designate a representative, typically in the case of a pooled investment vehicle, to receive notices and account statements.

Problem: The current rule does not provide flexibility for a client to make such a designation.

Rationale: The proposed rule ensures that there is no conflict of interest with an investment adviser and the representative. Additionally, this proposed change would update the custody rule, reflect current industry practices and create greater regulatory consistency.

#### 260.237(b)(1) – Exceptions: Mutual Funds

Mutual funds are regulated federally under the Investment Company Act of 1940, and therefore, adequate safeguards and protections are in place.

#### 260.237(b)(2) – Exceptions: Privately Offered Securities

The exception is only applicable to certain privately offered restricted securities with very limited transferability. The restrictions on transfer through the issuer add the necessary protection to ensure that such securities are not misappropriated. Thus, there is no need to add another layer of custody for these securities.

#### 260.237(b)(3) - Fee deduction

Specific purpose: An investment adviser that has custody solely because of the adviser's authority to deduct advisory fees from client accounts is exempt from the surprise examination requirement provided that specific requirements are met.

Problem: Requiring a surprise examination will not provide materially greater protection to advisory clients when the adviser has custody of client assets solely because of its authority to deduct advisory fees from client accounts.

Rationale: The principle risk associated with this limited form of custody is that a fee will be deducted to which the adviser is not entitled. The proposed rule addresses this risk by enabling the client to monitor the amount of advisory fees deducted by reviewing the account statements, which the proposed rule requires to be sent by the qualified custodian. Additionally, a surprise examination may not be an effective tool to identify inappropriate fee deductions as it requires the accountant to verify client assets, not determine the accuracy of fees paid.

#### 260.237(b)(4) - Pooled investment vehicles

Specific purpose: Adviser to pooled investment vehicles are required to deliver account statements and undergo a surprise examination under 260.237(a)(6), unless specific exceptions under 260.237(b) are satisfied. The exception for limited partnerships still provide adequate review of financial statements and ensure proper safeguard of client assets.

Problem: Different risks are associated with various groups of investment advisers, which require different safeguards. However, the current does not make this distinction. For example, the current rule does not provide specific rules for investment advisers that manage individual assets and those that manage a pool of private assets. This distinction is necessary to ensure that the various custody practices by investment advisers are adequately regulated.

Furthermore, protection of proprietary trade strategies by an investment adviser of a pooled investment fund is necessary to protect the fund. In some cases, quarterly disclosure of funds may be more detrimental to client assets, which requires exceptions to such disclosures with proper safeguards.

Rationale: This proposed rule strikes a necessary balance between disclosure of transactions for private investment funds and adequate protection of client assets by requiring, among other things, an annual audit conducted by an independent certified public accountant.

#### 260.237(c) – Delivery to Related Persons

Specific purpose: This subsection prohibits the account statements delivery requirements from being satisfied if the statements are delivered to related persons of the investment adviser.

Problem: Delivery of account statements to related persons may create a lack of independence and may interfere with necessary custody protections needed to ensure safeguards of clients' funds.

Rationale: By prohibiting delivery of account statements from satisfying the delivery requirement in the proposed rule, maintains independence, prevents conflicts of interest from arising and ensures adequate protections of client funds.

#### 260.237(d) – Definitions

Control – The term “control” is defined for the purposes of its use in the proposed rule. The Department works closely, and in some cases, in conjunction with federal regulations to regulate the investment adviser industry. This definition is consistent with the definition set forth in the SEC custody rules and NASAA model rules. Maintaining definitions consistent with federal regulations will allow for consistent regulation of the investment adviser industry. Additionally, maintaining consistent definitions may reduce compliance burdens for investment advisers that operate both federally and in this state.

Custody - The term “custody” is defined for the purposes of its use in the proposed rule. The Department works closely, and in some cases, in conjunction with federal regulations to regulate the investment adviser industry. This definition is consistent with the definition set forth in the SEC custody rules and NASAA model rules. Maintaining definitions consistent with federal regulations will allow for consistent regulation of the investment adviser industry. Additionally, maintaining consistent definitions may reduce compliance burdens for investment advisers that operate both federally and in this state.

Independent Certified Public Accountant – The term “independent certified public accountant” is defined for the purposes of its use in the proposed rule. The Department works closely, and in some cases, in conjunction with federal regulations to regulate the investment adviser industry. This definition is consistent with the definition set forth in the SEC custody rules and NASAA model rules. Maintaining definitions consistent with federal regulations will allow for consistent regulation of the investment adviser industry. Additionally, maintaining consistent definitions may reduce compliance burdens for investment advisers that operate both federally and in this state.

Independent party – The term “independent party” is defined for the purposes of its use in the proposed rule. The Department works closely, and in some cases, in conjunction with federal regulations to regulate the investment adviser industry. This definition, including the “two year” timeframe requirement is consistent with the definition set forth in the SEC custody rules and NASAA model rules. Maintaining definitions consistent with federal regulations will allow for consistent regulation of the investment adviser industry. Additionally, maintaining consistent definitions may reduce compliance burdens for investment advisers that operate both federally and in this state.

Independent designee – The term “independent designee” is defined for the purposes of its use in the proposed rule. The Department works closely, and in some cases, in conjunction with federal regulations to regulate the investment adviser industry. This definition, including the “two year” timeframe requirement is consistent with the definition set forth in the SEC custody rules and NASAA model rules. Maintaining definitions consistent with federal regulations will allow for consistent regulation of the investment adviser industry. Additionally, maintaining consistent definitions may reduce compliance burdens for investment advisers that operate both federally and in this state.

Qualified custodian – The term “qualified custodian” is defined for the purposes of its use in the proposed rule. The Department works closely, and in some cases, in conjunction with federal regulations to regulate the investment adviser industry. This definition is consistent with the definition set forth in the SEC custody rules and NASAA model rules. Maintaining definitions consistent with federal regulations will allow for consistent regulation of the investment adviser industry. Additionally, maintaining consistent definitions may reduce compliance burdens for investment advisers that operate both federally and in this state.

Related person – The term “related person” is defined for the purposes of its use in the proposed rule. The Department works closely, and in some cases, in conjunction

with federal regulations to regulate the investment adviser industry. This definition is consistent with the definition set forth in the SEC custody rules and NASAA model rules. Maintaining definitions consistent with federal regulations will allow for consistent regulation of the investment adviser industry. Additionally, maintaining consistent definitions may reduce compliance burdens for investment advisers that operate both federally and in this state.

### Forms Incorporated by Reference

Pursuant to Title 1, California Code of Regulations, Section 20, the following documents were incorporated by reference in the regulation text:

#### 1. FORM ADV-E

Specific purpose: Form ADV-E is a required form by the SEC pursuant to the Investment Adviser's Act of 1940. An investment adviser is required to complete this form and submit it to an independent accountant within 120 of the time chosen by the independent accountant for the surprise examination and upon the accountant's resignation, termination or removal.

The independent accountant is required to review and submit form ADV-E, along with a certificate of accounting confirming the surprise examination to the Commissioner. Additionally, an independent accountant is required to submit this form, as well as an explanation of any material discrepancies from the surprised examination to the Commissioner.

This is a federal form by the SEC that the Department cannot alter.

Problem: The current custody rule does not provide enough safeguards, compliance checks, specific reporting and examination requirements, as well as reporting any material discrepancies to the Commissioner.

Rationale: Form ADV-E is necessary to ensure accuracy, compliance and the proper handling of client funds by an investment adviser. Additionally, an independent accountant will be required to submit this form, as well as an explanation of any material discrepancies from the surprised examination to the Commissioner, which would enhance the Commissioner's ability to identify potential misuse of clients' assets.

#### 2. Financial Accounting Standards Board Accounting Standards Codification 946-210-50-4 through 946-210-50-6

Specific purpose: The Financial Accounting Standards Board (FASB) is the source of authoritative generally accepted accounting principles (GAAP). The FASB Accounting Standards Codification (Codification) contains authoritative standards that are applicable to both public nongovernmental entities and nonpublic nongovernmental entities.

FASB Codification 946-210-50-4 through 946-210-50-6 provide guidance about specific information to be included in the financial statements for investment companies that are nonregistered investment partnerships.

**Problem:** The current custody rule does not specify custody requirements for limited partnerships and limited liability companies, including a requirement for specific disclosures to investors that allow investors to make fully informed investment decisions.

**Rationale:** There is a strong interest in ensuring that investors receive sufficient information regarding a private fund's investment performance to ensure that they make fully informed investment decisions. However, there is also a strong interest in ensuring that proprietary trading models developed by an investment adviser, and indirectly selected by the client, are maintained in a confidential manner. In certain circumstances, disclosure of fund strategies and transactions could ultimately financially harm investors in the fund. Accordingly, rather than require a quarterly disclosure of all investment positions, the proposed rule requires disclosure that mirrors U.S. financial reporting standards for non-registered investment partnerships. Specifically, the proposed rule would require a quarterly disclosure of all securities in accordance with Generally Accepted Accounting Principles (GAAP), as interpreted by Financial Accounting Standards Board (FASB) ASC 946-210-50-4 through 6.

#### COMMENTS RECEIVED DURING THE 45-DAY COMMENT PERIOD

The Department received seven public comment letters during the 45-day public comment period and an e-mail after the 45-day public comment period ended. Those comments are summarized below by subject matter, along with the Department's response.

##### Definition of Custody (260.237(d)(2))

1. E-mail dated November 3, 2012, from Jim McKeever, registered investment adviser.

Mr. McKeever commented on the overly broad definition of "custody". Specifically, Mr. McKeever commented that the words, "having the ability to appropriate" in the custody definition as being too vague and overly broad.

The definition of custody used in the proposed rulemaking is the same definition that exists in current law under CCR Section 260.237.2(e). Additionally, to provide needed uniformity between the regulation of non-federal registered investment advisers, as well as to provide equivalent levels of investor protection, the Department's definition of "custody" is consistent with NASAA's model custody rule.

##### One Business Day to Return Inadvertent Receipt of Client Funds (260.237(d)(2)(D))

1. Letter dated December 27, 2012, from Stephen D. Johnson with Financial Planning Association (FPA).

2. Letter dated December 28, 2012, from David T. Bellaire with the Financial Services Institute (FSI).
3. E-mail dated January 16, 2013, from Tad Borek, registered investment adviser.

The Department received two comment letters during the comment period and an e-mail from Tad Borek after the close of the comment period raising concerns about the one day timeframe an investment adviser would have to return funds inadvertently received so as to not be deemed to have custody.

FSI and FPA both support the proposed regulatory action. FSI and FPA suggested that an investment adviser should have three business days to return funds inadvertently received to not be deemed as having custody, instead of having one business day to return such funds. FSI and FPA maintain that changing “one business day” to “three business days”, is consistent with NASAA. Tad Borek similarly suggested that the timeframe to return inadvertently received funds by an investment adviser should be three business days.

While NASAA’s current model custody rule allows an investment adviser to return inadvertent possession of client funds or securities within three business days, the originally proposed model custody rule required an investment adviser to return such funds within one business day. NASAA subsequently changed its proposed custody rule from one business day to three business days after receiving comments and concerns that one business day was an insufficient period of time for an investment adviser to return funds inadvertently received, so as to not be deemed to have custody. Additionally, NASAA subsequently amended its proposed custody rule to a three business day timeframe to resolve a discrepancy between the model custody and recordkeeping rules.

In an effort to provide uniformity and regulatory consistency, the Department will amend the timeframe for an investment adviser to return inadvertently received funds from “one business day” to “three business days”.

#### Fees (260.237(b)(3))

Below is a summary of comments received related to fees under Section 260.237(b)(3)(C) of the proposed rule.

1. Letter dated November 16, 2012, from George Gordon with Western Annuity Services, Inc. (WASI).

Mr. Gordon “strongly oppose” the requirement in 260.237(b)(3)(C)(ii) because he states that this requirement would impose substantial costs and require additional time for the investment adviser firm to produce the individual bills in invoice or statement format. Additionally, Mr. Gordon states that this requirement would not bring any new or useful information to the clients.

The Department believes that the need for appropriate controls in the proposed custody rule, which includes notifying clients when fees are deducted, along with specific calculation disclosures outweighs the harm of potential increase in costs as a result of

adhering to the proposed rule. Additionally, an investment adviser that relies on the fee deduction exception to the proposed custody rule in Section 260.237(b)(3) is not required to obtain an independent verification. Therefore, notification requirements for fee deduction and specific information disclosing fee calculations provide adequate safeguards that are necessary to ensure that client funds are protected. Furthermore, Section 260.237(b)(3)(C)(ii) of the Department's proposed rule is consistent with NASAA's model rule to provide necessary uniformity between the regulation of non-federal registered investment advisers, as well as to provide equivalent levels of investor protection.

2. E-mail dated October 30, 2012, from Ray Meadows with Berkeley Investment Advisors.

Mr. Meadows comments that Section 260.237(b)(3)(C)(i) and (ii) of the proposed rulemaking would cause a material increase in compliance costs with no significant benefit to his clients because the requirements would be a significant departure from the way his firm calculates fees and notifies his clients.

The Department believes that the need for appropriate controls in the proposed custody rule, which includes notifying clients when fees are deducted, along with specific calculation disclosures outweighs the harm of potential increase in costs as a result of adhering to the proposed rule. Additionally, an investment adviser that relies on the fee deduction exception to the proposed custody rule in Section 260.237(b)(3) is not required to obtain an independent verification. Therefore, notification requirements for fee deduction and specific information disclosing fee calculations provide adequate safeguards that are necessary to ensure that client funds are protected. Furthermore, Section 260.237(b)(3)(C)(i) and (ii) of the Department's proposed rule is consistent with NASAA's model rule to provide necessary uniformity between the regulation of non-federal registered investment advisers, as well as to provide equivalent levels of investor protection.

3. E-mail dated October 30, 2012, from Robert Balopole with Balopole Investment Management Corporation.

Mr. Balopole suggests that instead of requiring an investment adviser to provide a customer with a notice of fee deduction concurrently with deducting the fee, notice should be required prior to deducting the fee, so that a client has an opportunity to question the fee if needed before it is deducted.<sup>1</sup>

While the Department appreciates Mr. Balopole's comments, the Department's proposed rule is consistent with NASAA's model custody rule, which is important for uniformity and regulatory consistency for non-federal registered investment advisers. Additionally, an investment adviser always has the option to send a notice of fee deduction prior to deducting fees instead of sending such notice concurrently.

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<sup>1</sup> While Mr. Balopole cites Section "a(8)(B)(3)" in his email, this section does not exist in the proposed rulemaking. Mr. Balopole's comments match with Section 260.237(b)(3)(C).

## Private Funds, Due Inquiry and Books and Records

1. Letter dated December 28, 2012, from Krista S. Zipfel with Advisor Solutions Group, Inc.

Ms. Zipfel's comment letter sought clarification of specific subsections of the proposed custody rule that would affect investment advisers of private funds. The issues in her letter are addressed separately below.

- a. Audited Financials Delivered to Private Fund Investors within 180 days (260.237(b)(4))

Ms. Zipfel commented that while the SEC's rule contains the same delivery timeframe of 120 days to deliver audited financial statements to private fund investors as the proposed custody rule, the SEC staff has issued guidance indicating that it would not recommend an enforcement action if an adviser for a private fund that is a fund-of-fund distributes the audited financials to investors within 180 days from the end of the private fund's fiscal year.

To be consistent with the SEC, the Department apply the same interpretation as SEC, to not recommend an enforcement action if an adviser for a private fund that is a fund-of-fund distributes the audited financials to investors within 180 days instead of 120 days from the end of the private fund's fiscal year.

- b. "Gatekeeper" Provision and Surprise Custody Examination (260.237(a)(5)(B))

Ms. Zipfel requested clarification as to whether it was the intention of the Department to require all investment advisers who have custody of private funds to engage both a gatekeeper and an independent certified public accountant or whether the gatekeeper provision is an option for investment advisers to avoid surprise custody examinations.

It is the intention of the Department to have a "gatekeeper" (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) and a "surprise examination" (an independent verification through an independent certified public accountant pursuant to 260.237(a)(6)). However, the proposed rules provide an exception to the "gatekeeper" and surprise examination" requirement if an annual audit is conducted in accordance to Section 260.237(b)(4).

- c. Quarterly Reporting vs. Annual Reporting (260.237(a)(5)(A)(ii))

Ms. Zipfel further requests that the Department consider bringing the quarterly reporting frequency in line with FASB and SEC requirements. Ms. Zipfel indicates that the quarterly reporting frequency in the proposed custody rule is inconsistent with current industry standards and practice, as well as the FASB and SEC requirements of annual reporting.

While the Department appreciates Ms. Zipfel's comments, it is important for the Department to maintain uniformity and regulatory consistency, particularly for non-federal registered investment advisers by proposing a quarterly reporting requirement that is consistent with NASAA's model custody rule.

d. What Constitutes Reasonable Basis After Due Inquiry (260.237(a)(4))

Ms. Zipfel requests guidance as to what the Department would consider a standard letter confirming that the custodian has sent account statements to clients and that the investment adviser may obtain this letter at will or upon request as a reasonable step to satisfy the "due inquiry" obligation.

The Department would consider a standard letter proposed by Ms. Zipfel as a reasonable step to satisfy the "due inquiry" obligation.

e. Books and Records

Ms. Zipfel requests clarification as to how the requirement to maintain books and records under CCR Section 260.241.3(b) apply to the proposed custody rule. Specifically, Ms. Zipfel would like to know whether an investment adviser who has custody solely as a consequence of fee debiting authority, or solely because of private funds which are following the gatekeeper or fund audit provisions, is required to maintain books and records as required under 260.241.3.

An investment adviser that deducts fees is still considered to have custody and must comply with the requirements to maintain books and records under Section 260.241.3, but is exempt from the independent verification requirement in the proposed rule under Section 260.237(a)(6). Similarly, an investment adviser following the gatekeeper requirement is required to maintain books and records as required under Section 260.241.3.

Additionally, an investment adviser that follows the fund audit provisions in Section 260.237(b)(4) while may not be required to send notice to clients and account statements (but is still required to send account statements to all limited partners under Section 260.237(a)(5)(A)), nor enter into a written agreement with an independent party under and is deemed to have complied with the independent verification requirements, is still required to comply with the books and records requirement under Section 260.241.3.