STATE OF CALIFORNIA
DEPARTMENT OF CORPORATIONS

TEXT OF PROPOSED CHANGES UNDER THE
CORPORATE SECURITIES LAW OF 1968
PURSUANT TO NOTICE
DATED: OCTOBER 18, 2012

1. Amend Section 260.237 to read:

§ 260.237. Custody or Possession of Funds or Securities of Clients.

~~It shall constitute a fraudulent, deceptive or manipulative act, practice or course of business, within the meaning of Section 25235 of the Code, for any investment adviser who has custody or possession of any funds or securities, except prepaid fees for periodic publications or other advisory services, in which any client has any beneficial interest to do any act or take any action, directly or indirectly, with respect to any such funds or securities, unless:~~

~~(a) all securities of each client are segregated, marked to identify the particular client who has the beneficial interest therein, and held in safekeeping in some place reasonably free from risk of destruction or other loss; and~~

~~(b)~~

~~(1) all funds of clients are deposited in one or more bank accounts which contain only clients' funds,~~

~~(2) the account or accounts are maintained in the name of the investment adviser as agent or trustee for the clients, and~~

~~(3) the investment adviser maintains a separate record for each account which shows the name and address of the bank where the account is maintained, the dates and amounts of deposits in and withdrawals from the account, and the exact amount of each client's beneficial interest in the account; and~~

~~(c) the investment adviser, immediately after accepting custody or possession of funds or securities from any client, notifies the client in writing of the place and manner in which the funds and securities will be maintained, and thereafter, if and when there is any change in the place or manner in which the funds or securities are being maintained, gives each client written notice thereof; and~~

~~(d) the investment adviser sends to each client, not less frequently than once every three months, an itemized statement showing the funds and securities in the custody or possession of the investment adviser at the end of the period, and all debits, credits and transactions in the client's account during the period; and~~

~~(e) all funds and securities of clients are verified by actual examination at least once during each calendar year by an independent certified public accountant or public accountant at a time which shall be chosen by the accountant without prior notice to the investment adviser. A certificate of the accountant stating that such person has made an examination of the funds and securities, and describing the nature and extent of the examination, shall be filed with the Commissioner promptly after each examination.~~

(a) Safekeeping required. It is unlawful and deemed to be a fraudulent, deceptive, or manipulative act, practice or course of business within the meaning of Section 25235 of the Code for an investment adviser licensed or required to be licensed, to have custody of client funds or securities unless:

(1) Notice to the Commissioner. The investment adviser notifies the Commissioner 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 the investment adviser opens an account with a qualified custodian on the investment adviser's client's behalf, under the client's name, under the investment adviser's name as agent or trustee, or under the name of a pooled investment vehicle, the investment adviser shall notify the client in writing of the qualified custodian's name and address, and the manner in which the funds or securities are maintained, promptly upon the opening of the account and following any changes to this information. If the investment adviser sends an account statement to a client to which the investment adviser is required to provide this notice, the investment adviser shall include in the notice provided to that client and in any subsequent account statement sent to 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 including investment advisory fees.

(5) Special rule for limited partnerships and limited liability companies. 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 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 securities positions on the closing date of the statement required to be disclosed under Generally Accepted Accounting Principles (GAAP) for investment companies that are non-registered investment partnerships, as required by Financial Accounting Standards Board (FASB) ASC 946-210-50-4 through 10.

(iii) a listing of all additions to and withdrawals from the fund by the investor, the total value of the investor's interest in the fund at the end of the quarter.

(B) The investment adviser:

(i) Enters 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) Sends 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:

I) determine that the payment is in accordance with the pooled investment vehicle standards (generally the partnership or membership agreement), and

II) forward to the qualified custodian approval for payment of the invoice, with a copy to the investment adviser.

(C) Waiver of Net Worth and Audited Financial Statements. An investment adviser having custody solely because it meets the definition of custody as defined in subparagraph (d)(2)(C) of this section and who otherwise complies with this section will

not be required to meet the custodial requirements as set forth in Section 260.237.2 and Section 260.241.2 of these rules.

(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 section 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 required by paragraph (a)(7)(B). The written agreement must require the independent certified public accountant to:

(A) File a certificate on Form ADV-E with the Commissioner within 120 days of the time chosen by the independent certified public accountant in section (a)(6) of this section, 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 Commissioner 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 Commissioner; 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 section 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 section 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 every 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 adviser's 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 adviser's related persons; 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 representative. A client may designate an independent representative to receive, on his or her behalf, notices and account statements as required under paragraphs (a)(3) and (a)(4) of this section.

(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"), an 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 section.

(2) Certain privately offered securities.

(A) An investment adviser is not required to comply with subsection (a)(2) of this section 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 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 subparagraph (b)(2)(A), the provisions of subsection (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, the audited financial statements are distributed to the limited partners, as described in subsection (b)(4) of this section, and the investment adviser notifies the Commissioner in writing that the investment adviser intends to provide audited financial statements to the limited partners as described in this subparagraph. Such notification is required to be given on Form ADV.

(3) Fee Deduction. Notwithstanding paragraph (a)(6) of this section, an investment adviser is not required to obtain an independent verification of client funds and securities maintained by a qualified custodian, and will not be required to meet the custodial requirements set forth in Section 260.237.2 and Section 260.241.2 of these rules 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 value of the assets under management on which the fee is based, and the time period covered by the fee.

(D) The investment adviser notifies the Commissioner in writing that the investment adviser intends to use the safeguards provided in this paragraph (b)(3). Such notification is required to be given on Form ADV.

(4) Limited partnerships subject to annual audit. An investment adviser is not required to comply with paragraphs (a)(3), (a)(4), and (a)(5)(B) of this section and shall be deemed to have complied with paragraph (a)(6) of this section 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) Account statements required by paragraph (a)(5)(A).

(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 Commissioner 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 Commissioner 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 Commissioner within four business days by the filing of 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.

(F) The investment adviser must also notify the Commissioner in writing that the investment adviser intends to employ the use of the statement delivery and audit safeguards described above in this paragraph (b)(4). Such notification is required to be given on Form ADV.

(5) The investment adviser is not required to comply with this section 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 of financial statements are sent solely to limited partners (or members or other beneficial owners) that themselves are limited partnerships (or other limited liability companies, or another type of pooled investment vehicle) and are related persons of the investment adviser.

(d) Definitions. For purposes of this section:

(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. For purposes of this definition:

(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; or

(iii) Is an elected manager of the limited liability company; and

(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 having the ability to appropriate them. An 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, or has the ability to appropriate them, in connection with advisory services the investment adviser provides to clients. Custody includes:

(A) Possession of client funds or securities unless received inadvertently and returned to the sender promptly, but in any case within 3 (three) business days of receiving them.

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

(C) 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 the investment adviser's representative legal ownership of or access to client funds or securities.

(D) Receipt of checks drawn by clients and made payable to unrelated third parties will not meet the definition of custody if forwarded to the third party within one business day of receipt and the adviser maintains the records required under Section 260.241.3 of these rules.

(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 Regulations 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, is not controlled by, and is not under common control with the investment adviser;

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

(D) Does 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 designee” means a person who:

(A) Acts as agent for an advisory client, including in the case of a pooled investment vehicle, for limited partners of 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 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.

(6) “Qualified custodian” means any of 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 with the Commissioner and with the Securities and Exchange Commission holding the client assets in customer accounts insured by the Securities Investor Protection Corporation (SIPC).

(C) A registered futures commission merchant registered under Section 4f(a) of the Commodity Exchange Act (7 U.S.C. 6f(a)), 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.

(D) A foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory client's 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.

NOTE: Authority cited: Sections 25237 and 25610, Corporations Code. Reference: Sections 25235 and 25237, Corporations Code.