

INITIAL STATEMENT OF REASONS
FOR RULE CHANGES UNDER THE
CORPORATE SECURITIES LAW OF 1968

As required by Section 11346.2 of the Government Code, the California Corporations 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 recently adopted 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).

The Department of Corporations (“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.

Section 260.237

The existing rule sets forth investor safeguards for investment advisers with custody or possession of clients’ funds or securities. In the context of securities regulation, the term “custody” generally refers to situations where an investment adviser holds, directly or indirectly, client funds or securities.

The amendments propose to revise the rule to incorporate changes under federal law and the NASAA Model Rule. By way of background, the SEC recently adopted amendments to the federal custody rule under the Investment Advisers Act of 1940, applicable to federally registered investment advisers. However, pursuant to the National Securities Markets Improvement Act of 1996, such federal changes are not applicable to investment advisers licensed solely in state jurisdictions.

The SEC rules define the term “custody” in Rule 206(4)-2 (17 C.F.R. §275.206(4)-2). The prior version of the NASAA Model Rule was drafted based on the predecessor version of the federal rule. Therefore, the SEC’s changes to the federal custody rule required amendments to the corresponding NASAA Model Rule to provide needed uniformity between the regulation of federal-registered and non-federal registered investment advisers, as well as to provide equivalent levels of investor protection. (Respectively, NASAA Custody Requirements for Investment Advisers Model

Rule 102(e)(1)-1, as amended April 18, 2004 (the “prior NASAA rule”); SEC Release No. IA-2176; File No. S7-28-02, October 3, 2003; and NASAA Custody Requirements for Investment Advisers Model Rule 102(e)(1)-1, as amended April 18, 2004 (the “prior SEC rule”).

A. Executive Summary

Generally, the proposed amendments to this rule strike the existing language and, subject to certain California-specific provisions, enact the proposed NASAA Model Rule. In general, the amendments define “custody,” and, subject to certain limited exceptions,¹ require that advisers with custody maintain the assets with a qualified custodian, as defined in the rule. The amendments also specify 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, subject to exceptions discussed in more detail below, the proposed rule requires investment advisers to comply with the following safeguards:

(1) Notifying the Commissioner that the investment adviser has custody of client funds or securities.

(2) Ensuring that a qualified custodian maintains funds and securities in specified manners.

(3) Notifying clients of the identity and location of the qualified custodian.

(4) Ensuring that clients receive account statements.²

(5) Retaining a certified public accountant to conduct a surprise examination of client assets.

¹ The Commissioner concurs with the SEC’s view, stated in the adopting release that “[w]hen a supervised person of an adviser serves as the executor, conservator or trustee for an estate, conservatorship or personal trust solely because the supervised person has been appointed in these capacities as a result of family or personal relationship with the decedent, beneficiary or grantor (and not as a result of employment with the adviser), we would not view the adviser to have custody of the funds or securities of the estate, conservatorship, or trust.” SEC Release No. IA-2968, Footnote 139. However, the Department emphasizes that this interpretive exclusion should be construed narrowly.

² The investment adviser must have a reasonable belief after due inquiry that the account statements are delivered to clients. For example, as explained in detail by the SEC staff, “in the context of statements delivered electronically, the adviser could be copied on the email notifications sent to clients in addition to having access to client statements on the custodian’s website.” SEC Release No. IA-2968, Footnote 21; see also *Staff Responses to Questions About the Custody Rule* (Updated as of April 1, 2011) available at: http://www.sec.gov/divisions/investment/custody_faq_030510.htm

B. Background and Discussion

In the context of securities regulation, the term “custody” generally refers to an investment adviser that holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them. For example, an investment adviser to a hedge fund would likely have custody, as the investment adviser to the fund has access to client funds and securities.

In California, section 260.237 sets forth investor safeguards for investment advisers with custody or possession of clients’ funds or securities. This includes the requirement that a certified public accountant (CPA) verify all client funds and securities on an annual basis, at a time chosen by the CPA without notice to the investment adviser.

By way of background, in 2003 the general surprise examination of client assets requirement was removed from the SEC’s custody rule. According to the SEC, the reestablishment of the surprise examination requirement in its most recent revisions to the rule was included in response to concerns raised by a number of SEC enforcement actions, including the Madoff fraud. (SEC Release No. IA-2876, p. 7, May 20, 2009). Since these enforcement actions included misappropriation or other misuse of investor assets (id.), the surprise verification requirement increases investor protections by requiring an independent CPA to verify the funds and securities at a time chosen by the CPA. Rule 260.237(e) already requires investment advisers to obtain a surprise verification.

A number of exceptions to specified provisions of the general safeguards, including in some circumstances from the surprise examination requirement, are included in the proposed rule. These include exceptions for investment advisers that (1) only have custody of certain privately held securities,³ (2) only have custody because they directly deduct advisory fees from client accounts, and (3) advise limited partnerships subject to an annual audit. Importantly, these exceptions to the general safeguards require the implementation of specified alternative safeguarding procedures.

Like the SEC and NASAA rules, advisers that have custody due to fee deduction, and advisers to private funds that comply with the PCAOB audit requirement set forth in subsection (b)(4) of the rule, are excepted from the independent verification requirement.

Commentators have suggested that prior proposed versions of the Department’s custody rule (see PRO 27/03) should be revised to fully clarify that compliance with the audit exception would except an adviser from the independent verification requirement. (Comment letter from Eric A. Brill, Esq., dated Feb. 4, 2011.) In this regard, the NASAA Model Rule fully clarifies that advisers to pooled investment vehicles who satisfy the audit requirement are excepted from the independent verification requirement.

³ As the SEC emphasized “because the privately offered securities exception provided in paragraph (b)(2) is not available with respect to assets of an unaudited pool, the adviser must maintain privately offered securities owned by the pool with a qualified custodian.” *Staff Responses to Questions About the Custody Rule* (Updated as of April 1, 2011) available at: http://www.sec.gov/divisions/investment/custody_faq_030510.htm

Similarly, when the adviser or its related person serves as qualified custodian for client assets, the adviser must ensure that the CPA is registered with, and subject to regular inspection by, the PCAOB. Additionally, such advisers are required to obtain an internal control report from that CPA.

As explained in more detail in the SEC's adopting release, PCAOB registration likely leads to "greater confidence in the quality of the surprise examination and the internal control report when prepared by an independent certified public accountant that is registered with, and subject to regular inspection by the PCAOB." (SEC Release No. IA-2968, p. 36.) Importantly, under the SEC rule, "an adviser's use of an independent public accountant that is registered with the PCAOB but not subject to regular inspection would not satisfy the rule's requirements." (*Id.* at footnote 122.) This requirement would also apply to the proposed California rule.

The proposed California rule would subject all advisers to pooled investment vehicles to a uniform account statement requirement. Specifically, advisers to pooled investment vehicles that select the independent gatekeeper option set forth in subsection (a)(5) would be subject to the same account statement requirements as advisers that select the audit exception set forth in subsection (b)(4). Since the independent gatekeeper option provides comparable investor protection to the audit option, it appears that the account statement requirements should be consistent for both classes of advisers.

Noteworthy is the fact that the proposed California rule relaxes certain of the fund account statement requirements set forth in the initial NASAA proposals. As noted in comment letters received by the Department and NASAA, there are significant questions regarding the proper balance of disclosure of transactions for private investment funds. (See comment letter from Jay B. Gould, Esq., to the Department, on behalf of the California Hedge Fund Association, July 27, 2011; comment letter from Jay B. Gould, Esq. to NASAA on behalf of the California Hedge Fund Association & Florida Alternative Investment Association, March 2, 2011, and comment letter from the Washington State Fund Managers). 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. 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. Such disclosures would also include any further interpretations published by FASB, or the American Institute for Certified Public Accountants (AICPA).

In summary, the Commissioner is proposing to adopt these amendments to increase client protections by providing additional safeguard measures for client funds and securities, including verification by independent third parties. Additionally, the

amendments provide further guidance to investment advisers by specifically defining the term “custody” and thus providing added predictability. Lastly, the amendments provide for added flexibility for advisers to pooled investment vehicles, by allowing advisers to private investment funds to select the audit exception in lieu of the independent gatekeeper requirement.

TECHNICAL, THEORETICAL AND/OR EMPIRICAL STUDIES, REPORTS OR DOCUMENTS

Other than the SEC Releases cited above, the Department did not rely upon any technical, theoretical, or empirical study, report, or other similar document in proposing this regulatory action. This regulatory cost is justified, as the potential for fraud is significantly increased when the custodian of securities is related to the investment adviser.

BENEFITS ANTICIPATED FROM THE PROPOSED REGULATORY ACTION

The proposed regulation would ensure that client funds and securities are safeguarded from misappropriation by their investment adviser.

ECONOMIC IMPACT ANALYSIS

The Commissioner has made an initial determination that the proposed regulatory action will not have a significant economic impact on business. With regard to registered investment advisers that would be impacted by the proposed custody rule, as of January 31, 2012, the Department had 3,127 state registered investment advisory firms. However, as discussed below, the requirements set forth in the proposed rule are either already in existence or will only be applicable in exceedingly rare circumstances.

A. Surprise Examination Requirement

Existing law requires investment advisers to obtain a surprise examination.⁴ Accordingly, the proposed rule does not create significant new costs with respect to this requirement. On the contrary, since certain advisers will be exempt from this requirement (e.g., investment advisers to pooled investment vehicles that are subject to an annual audit), the regulatory compliance cost with respect to this requirement may be reduced.

B. Internal Control Report

With regard to internal control reports, the S.E.C. has estimated that such reports will cost approximately \$250,000 per year for each adviser subject to the requirement.⁵ Importantly, the S.E.C. anticipates that this number will be lower for smaller advisers.⁶ However, the Department anticipates that only in exceedingly rare instances will investment advisers be subject to this provision. Anecdotally, the Department understands that California licensed investment advisers generally select unaffiliated

⁴ Cal. Code Regs. tit. 10, § 260.237(e).

⁵ SEC Release No. IA-2968, March 12, 2010, p. 67.

⁶ *Id.* at 104.

custodians. The Department invites comments on whether this understanding is consistent with industry practices.

The SEC has determined that certain investment advisers are required to obtain an internal control report for reasons independent of custodial requirements.⁷ Thus, the proposed rule would not increase regulatory compliance costs for these advisers. The Department invites comments on whether this advisory structure, and resulting internal control report requirement, occurs frequently for California licensed investment advisers.

In any case, the regulatory cost would appear amply justified since the potential for fraud is significantly increased when the custodian of securities is related to the investment adviser. In this regard, the cost of an internal control report may encourage advisers to select independent custodians. As stated by the SEC in its adopting release, “*these advisers may simply advise their clients to select independent qualified custodians so that they will not be subject to the requirement of obtaining an internal control report.*”⁸

C. Audit of Pooled Investment Vehicles

Historically, the Department has waived certain custodial requirements for investment advisers to pooled investment vehicles that complied with the independent gatekeeper requirements. The proposed rule would continue to maintain the independent gatekeeper requirement, but would also allow investment advisers to elect to be audited annually instead.⁹ Accordingly, the audit exception is included as an alternative to existing requirements.

D. Government Code Section 11346.3(b)(1)

In accordance with Government Code Section 11346.3(b)(1), the Department has made the following assessments:

- (1) The proposed regulatory action is designed to amend the existing custody rule so that it is in conformity with investment adviser regulations in other states, as well as recently amended SEC rules, and there are better safeguards for investor funds and securities. In revising the existing custody rule, no jobs in California will be created or eliminated.
- (2) The proposed regulatory action is designed to amend the existing custody rule so that it is in conformity with investment adviser regulations in other states, as well as recently amended SEC rules, and there are better safeguards for investor funds and securities. In revising the existing custody rule, no new businesses in California will be created or existing businesses eliminated.
- (3) The proposed regulatory action is designed to amend the existing custody rule so

⁷ *Id.* at 91.

⁸ *Id.* at 104.

⁹ Anecdotally, the Department understands that many investment advisers to pooled investment vehicles would prefer to be audited.

that it is in conformity with investment adviser regulations in other states, as well as recently amended SEC rules, and there are better safeguards for investor funds and securities. In revising the existing custody rule, no existing businesses in California will be expanded or eliminated.

- (4) The proposed regulatory action is designed to amend the existing custody rule so that it is in conformity with investment adviser regulations in other states, as well as recently amended SEC rules. The Corporations Commissioner is proposing to adopt these amendments to increase client protections by providing additional safeguard measures for client funds and securities, including verification by independent third parties. Additionally, the proposed changes provide further guidance to investment advisers by specifically defining the term “custody” and thus providing added predictability. Furthermore, the proposed changes provide for added flexibility for advisers to pooled investment vehicles, by allowing advisers to private investment funds to select the audit exception in lieu of the independent gatekeeper requirement. Finally, the amendments incorporate nationwide changes to Investment adviser regulations to make the existing rule consistent with other states, as well as the SEC.

The proposed regulatory action will not adversely affect the health and welfare of California residents, worker safety, or the state’s environment. The proposed regulatory action will not benefit the health of California residents, worker safety, or the State’s environment. The proposed regulatory action will, as described above, benefit the general welfare of California investors by increasing safeguarding of investor funds and securities, including minimizing the risk of misappropriation or other misuse of investor assets by an investment adviser by ensuring greater protection of investor funds and securities.

ALTERNATIVES TO THE REGULATORY ACTION AND REASONS FOR REJECTING THOSE ALTERNATIVES

In accordance with Government Code section 11346.2, subdivision (b)(5)), The Department must determine that no reasonable alternative it considered to the regulation or that has otherwise been identified and brought to its attention would either be more effective in carrying out the purpose for which the action is proposed or would be as effective and less burdensome to affected private persons or would be more cost-effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposal described above. On July 8, 2011, in accordance with Government Code Section 11346(b), the Department invited interested parties to provide comments on a substantially similar proposed rule. In response to the invitation, the Department received a significant amount of comments. However, while commentors provided thoughtful suggestions and critiques regarding individual elements of the proposal (including important questions, such whether the definition of the term “custody” is overly broad, or whether a de minimis exemption should be permitted), none suggested a comprehensive alternative framework that would provide (1) equivalent investor safeguards, and (2) a uniform and consistent mechanism to regulate custody for all California licensed investment advisers.

ALTERNATIVES TO THE REGULATORY ACTION THAT WOULD LESSEN ANY
ADVERSE IMPACT ON SMALL BUSINESSES

No reasonable alternative considered by the Department or that have otherwise been identified and brought to the attention of the Department would be as effective and less burdensome to affected private persons, or would lessen any adverse impact on small business.