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**CUSTODY OF CLIENT FUNDS AND SECURITIES
BY OHIO INVESTMENT ADVISERS**

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The material in this outline is not intended to provide legal advice as to any of the subjects mentioned but is presented for general information only. Readers should consult knowledgeable legal counsel as to any legal questions they may have.

A. Introduction

Unless an investment adviser licensed or required to be licensed by the Ohio Division of Securities (“Division”), and its investment adviser representatives, follow the Division’s administrative rules regarding custody of client funds and securities, such custody constitutes a fraudulent practice in violation of the anti-fraud standards contained in the Ohio Securities Act.¹ Following the lead of the Securities and Exchange Commission (“SEC”),² the Division modernized its custody rules effective April 1, 2004.³

As used in the Ohio (and federal) investment adviser laws and rules, the concept of “custody” is broader than just physical possession. “Custody” means holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them.⁴ “Custody” includes:

- physical possession or control of client funds or securities (but not checks drawn by clients and made payable to third parties) unless the investment adviser or investment adviser representative receives the funds inadvertently and returns them to the sender within three business days of receipt;
- any arrangement (including a general power of attorney) under which the investment adviser or investment adviser representative are authorized or permitted to withdraw client funds or securities maintained with a custodian upon the investment adviser’s or investment adviser representative’s instruction to the custodian; and
- any capacity (including 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 investment adviser representative legal ownership of or access to client funds or securities.⁵

In general, for advisers with custody Division rules establish a three-part standard that requires: (i) safekeeping by a “qualified custodian;” (ii) notice of the custody arrangements to clients; (iii) and quarterly account statements to clients.⁶

¹ R.C. §1707.44(M)(2).

² 17 C.F.R. §275.206(4)-2 (eff. Apr. 1, 2004). *See also* SEC Release No. IA-2176 “Final Rule: Custody of Funds or Securities of Clients by Investment Advisers” (Sept. 25, 2003), available at <http://www.sec.gov/rules/final/ia-2176.htm>.

³ Ohio Administrative Code (“O.A.C.”) §1301:6-3-44(B) (eff. Apr. 1, 2004).

⁴ O.A.C. §1301:6-3-44(B)(3)(a).

⁵ *Id.*

⁶ O.A.C. §1301:6-3-44(B)(1).

B. The Three-Part Standard for Custody

1. Safekeeping by a Qualified Custodian

An adviser must make arrangements for a qualified custodian to maintain client funds and securities either: (i) in a separate account for each client under that client's name; or (ii) in accounts that contain only the investment adviser's or investment adviser representative's clients' funds and securities, under the investment adviser's or investment adviser representative's name as agent or trustee for the clients.⁷

"Qualified custodian" means:

- a bank;
- an SEC-registered broker-dealer holding the client assets in customer accounts;
- a CFTC-registered futures commission merchant 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; and
- a foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets.⁸

An entity may be both an investment adviser and a qualified custodian. In that case, the investment adviser-qualified custodian may maintain custody of its clients' funds and securities, provided that the investment adviser-qualified custodian complies with the account holding requirements described above, and the notice and quarterly account statement requirements described below. Also, advisers may maintain client funds and securities with affiliates that are qualified custodians.

a) Exception to Use of Qualified Custodian for Mutual Fund Shares

When a client or adviser purchases shares of a mutual fund directly from the fund's transfer agent (rather than through an intermediary such as a broker-dealer), the fund's transfer agent maintains the shares for the client on the mutual fund's books. However, the adviser may have "custody" if, for example, the adviser has check writing or fee deduction authority. In this case, Division rules provide that with respect to shares of an open-end investment company as defined in section 5(a)(1) of the Investment Company Act of 1940, an investment adviser or

⁷ O.A.C. §1301:6-3-44(B)(1)(a).

⁸ O.A.C. §1301:6-3-44(B)(3)(c). Note that the Ohio Securities Act defines "bank" in R.C. 1707.01(O) as "any bank, trust company, savings and loan association, savings bank, or credit union that is incorporated or organized under the laws of the United States, any state of the United States, Canada, or any province of Canada and that is subject to regulation or supervision by that country, state, or province."

investment adviser representative may use the open-end investment company's transfer agent in lieu of a qualified custodian.⁹ Note that there still must be compliance with the notice of custody arrangements and quarterly account statement requirements described below.

2. Notice of Custody Arrangements

Upon the opening of an account with a qualified custodian on a client's behalf, either under the client's name or under the investment adviser's or investment adviser representative's name as agent, the adviser must promptly notify the client in writing of the qualified custodian's name and address, and the manner in which the funds and securities are maintained.¹⁰ The adviser also must promptly notify the client in writing of any change in this information.¹¹

3. Quarterly Account Statements to Clients

Division rules require that clients receive an account statement, at least quarterly, that identifies: (i) the amount of funds and securities in the account at the end of the quarter; and (ii) all transactions effected in the account during the quarter.¹² The statement may be provided to the client by the qualified custodian or by the adviser. As described below, there is a special rule for limited partnerships and limited liability companies.

If the quarterly account statement is provided by the qualified custodian, the statement must be delivered directly to the client by the qualified custodian, and the adviser must have a reasonable belief that the qualified custodian has sent the statement to the client.¹³ An adviser may form this reasonable belief by receiving a copy of the statement.¹⁴ A qualified custodian may use a third party service provider to deliver the quarterly account statements, provided that the statements are not routed through the adviser.¹⁵

If the quarterly account statement is provided by the adviser, the adviser must undergo an annual "surprise audit." Specifically, an independent public accountant must verify all of the funds and securities by actual examination at least once each calendar year (irregular from year to year) at a time chosen by the accountant without prior notice to the investment adviser or

⁹ O.A.C. §1301:6-3-44(B)(2)(a).

¹⁰ O.A.C. §1301:6-3-44(B)(1)(b).

¹¹ *Id.*

¹² O.A.C. §1301:6-3-44(B)(1)(c).

¹³ O.A.C. §1301:6-3-44(B)(1)(c)(i).

¹⁴ O.A.C. §1301:6-3-44(B)(1)(c)(iv).

¹⁵ O.A.C. §1301:6-3-44(B)(1)(c)(v).

investment adviser representative.¹⁶ Within thirty days after the audit, the accountant must file with the Division a certificate on Form ADV-E stating that it has examined the funds and securities and describing the nature and extent of the examination.¹⁷ If the independent public accountant finds any material discrepancies during the course of the examination, the accountant must notify the Division within one business day of the finding, by means of a facsimile transmission or electronic mail, followed by first class mail.¹⁸

If the investment adviser or investment adviser representative is a general partner of a limited partnership, managing member of a limited liability company, or holds a comparable position for another type of pooled investment vehicle, the quarterly account statements (whether provided by a qualified custodian or the adviser) must be sent to each limited partner or member or other beneficial owner.¹⁹

a) Exception to Quarterly Account Statement Requirement for Audited Limited Partnerships

A Division-licensed investment adviser or investment adviser representative is not required to comply with quarterly account statement requirement with respect to the account of a limited partnership, limited liability company, or other type of pooled investment vehicle, that is subject to an annual 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 within one hundred twenty days of the end of its fiscal year.²⁰ Note that compliance with the qualified custodian and notice of custody arrangements requirements remain applicable in this case.

C. Designation of an Independent Representative

Some advisory clients may not wish to receive the notices mandated by the Division's custody rules. In this situation, a client may designate an "independent representative" to receive on his, her or its behalf the required notices of custody arrangements and quarterly account statements.²¹ An "independent representative" is a person that:

- acts as agent for an advisory client (including in the case of a pooled investment vehicle, for limited partners of a limited partnership or members of a limited liability company, or other beneficial owners of another type of pooled investment vehicle)

¹⁶ O.A.C. §1301:6-3-44(B)(1)(c)(ii)(B).

¹⁷ *Id.*

¹⁸ O.A.C. §1301:6-3-44(B)(1)(c)(ii)(C).

¹⁹ O.A.C. §1301:6-3-44(B)(1)(c)(iii).

²⁰ O.A.C. §1301:6-3-44(B)(2)(c).

²¹ O.A.C. §1301:6-3-44(B)(1)(d).

and by law or contract is obliged to act in the best interest of the advisory client (or limited partner, member, or other beneficial owner);

- does not control, is not controlled by, and is not under common control with the investment adviser; and
- does not have, and has not had within the past two years, a material business relationship with the investment adviser.²²

D. Exceptions to Compliance with the Custody Rules

1. Exception to Custody Rules for Certain Privately Offered Securities

Compliance with the foregoing custody requirements may be difficult, if not impossible, with respect to certain privately offered securities. Consequently, an adviser need not comply with the Division's custody rules 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. All three of these characteristics must be present to avoid compliance with the custody rules.

Further, there are additional requirements if a limited partnership (or limited liability company or another type of pooled investment vehicle) holds the privately offered securities and wishes to avoid compliance with the custody rules. First, the privately offered securities must possess the three characteristics described above. Second, the limited partnership (or other entity) must be subject to an annual audit and distribute its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners or members or other beneficial owners, within one hundred twenty days of the end of its fiscal year.²³

2. Exception to Custody Rules for Investment Company Clients

A Division-licensed investment adviser or investment adviser representative is not required to comply with the Division's custody rules with respect to the account of an investment company registered with the SEC under the Investment Company Act of 1940.²⁴ It would seem that few, if any, Division-licensed advisers will be eligible for this exception since advisers to SEC-registered investment companies are eligible to register with the SEC.

²² O.A.C. §1301:6-3-44(B)(3)(b).

²³ O.A.C. §1301:6-3-44(B)(2)(b)(ii).

²⁴ O.A.C. §1301:6-3-44(B)(2)(d).