FINAL STATEMENT OF REASONS
FOR THE ADOPTION OF RULES UNDER THE
CORPORATE SECURITIES LAW OF 1968

As required by Section 11346.9 of the Government Code, the California Department of Business Oversight Commissioner (Commissioner) sets forth below the reasons for the adoption of Section 260.237 of Title 10 of the California Code of Regulations (10 C.C.R. Section 260.237).

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 licenses and regulates businesses engaged in financial transactions that were under the former Department of Corporations, such as escrow agents, mortgage loan originators, finance lenders, securities broker-dealers, investment advisers and securities depositories.

UPDATED INFORMATIVE DIGEST [see Government Code section 11346.9(b)]

In response to the comments received during the 45-day comment period, as well as the need to make technical and substantive corrections, the Department submitted a Notice of Modification, Addendum to the Initial Statement of Reasons ("addendum"), and revised text for a 15-day comment period. All three documents are available at the Department's website www.dbo.ca.gov.

Among other things, the revisions submitted for the 15-day comment period incorporates by reference FORM ADV-E in the addendum as well as the revised text. Furthermore, the addendum for the proposed action clarifies and explains in detail the necessity for the proposed amendments to the custody rules.

This regulatory action seeks to increase uniformity with investment adviser regulation in other states, as well as with the 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 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 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 safeguards for 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 revise the rule to incorporate changes under federal law and the NASAA Model Rule. By way of background, the SEC 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 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").

[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.

Additionally, subject to exceptions discussed in more detail below, the 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.

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

[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 December 13, 2011) available at: http://www.sec.gov/divisions/investment/custody_faq_030510.htm

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.

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 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 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.

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[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 December 13, 2011) available at: http://www.sec.gov/divisions/investment/custody_faq_030510.htm

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 California 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 adopting 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.

DETERMINATION GOVERNMENT CODE SECTION 11346.9(a)(2)

The Commissioner has determined that the adoption of the amendments of the regulation does not impose a mandate on local agencies or school districts, which require reimbursement pursuant to Part 7 (commencing with Section 17500) of Division 4 of the Government Code.

ALTERNATIVES CONSIDERED

No alternative considered by the Department would be more effective in carrying out the purpose for which the regulation is proposed, would be as effective and less burdensome to affected private persons than the adopted regulation, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law.

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.

ECONOMIC IMPACT ANALYSIS/ASSESSMENT

The Commissioner has made an initial determination that this regulatory action will not have a significant economic impact on business. With regard to registered investment advisers that would be impacted by the 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 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, this 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 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. This rule would continue to maintain the independent gatekeeper

[4] Cal. Code Regs. tit. 10, § 260.237(e).
[5] SEC Release No. IA-2968, March 12, 2010, p. 67.
[6] *Id*. at 104.
[7] *Id.* at 91.
[8] *Id.* at 104.

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) This 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 existing businesses in California will be expanded or eliminated.

(4) This 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 Commissioner is adopting these amendments to increase client protections by providing additional safeguard measures for client funds and securities, including verification by independent third parties. Additionally, the changes provide further guidance to investment advisers by specifically defining the term “custody” and thus providing added predictability. Furthermore, the 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.

This regulatory action will not adversely affect the health and welfare of California residents, worker safety, or the state’s environment. This regulatory action will not benefit the health of California residents, worker safety, or the State’s environment. This regulatory action will, as described above, benefit the general welfare of California investors by increasing safeguarding of investor

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

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.

INCORPORATION BY REFERENCE [see Government Code section 11346.9(d)]

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

1. Form ADV-E, Expires January 31, 2016

The size and format of this document, as well as the propensity for the document to affect the clarity of the regulation text, result in it being impractical and cumbersome to publish this document in the California Code of Regulations. The Department of Business Oversight has made the document available upon request, and on the Department's website at http://www.dbo.ca.gov/.

ADDENDUM, REGARDING PUBLIC COMMENTS

No request for hearing was received during the 45-day public comment period, which ended on December 31, 2012. Accordingly, no hearing was scheduled or held.

COMMENTS RECEIVED DURING THE 45-DAY COMMENT PERIOD

The Department received seven public comment letters during the 45-day public comment period, two public comment letters not related to the proposed regulatory action, and an e-mail after the 45-day public comment period ended. Those comments are summarized below, together with the Department's response.

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

Comment No. 1: Commentor states that the proposed amendments to Section 260.237(b)(3)(C)(i) and (ii) 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.

Response: 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.

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

Comment No. 1: Commentor 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.[10]

Response: 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 the notice concurrently.

3. Commentor: E-mail dated November 3, 2012, from Jim McKeever with Registered Investment Adviser.

Comment No. 1: Commentor states the definition of custody is vague and overly broad and suggest removing the words "having the ability to appropriate" from the definition.

Response: The definition of custody used in the proposed rulemaking is the same definition that exits 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.

4. Commentor: E-mail dated November 2, 2012, from Bobby Nouredini.

Comment No. 1: Commentor requesting the Department to explain "what all this means". It appears that the Commentor is requesting that the Department summarize the rulemaking.

Response: The Department declines to respond to the commentor because the comment is vague. The Initial Statement of Reasons explains the proposed rulemaking. The Department is unable to provide legal advice regarding the proposed rulemaking.

5. Commentor: E-mail dated November 5, 2012, from Tim Kuns.

Comment No. 1: Commentor requesting Department to provide advice whether the proposed regulatory action will impact his business.

[10] 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).

Response: The Department declines to respond to commentor because the Department is unable to provide advice to licenses.

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

Comment No. 1: Commentor "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, commentor states that this requirement would not bring any new or useful information to the clients.

Response: 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.

7. Commentor: Letter dated December 27, 2012, from Stephen Johnson with Financial Planning Association (FPA).

8. Commentor: E-mail letter dated December 28, 2012, from Christopher Hayes on behalf of David Bellaire with Financial Services Institute, Inc. (FSI).

Comment No. 1: Commentor 7 and Commentor 8 both states 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

Response: 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".

9. Commentor: E-mail letter dated December 28, 2012, from Erin Compbell on behalf of Krista Zipfel with Advisor Solutions Group, Inc.

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

Comment No. 1: 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. Ms. Zipfel asks if the Department is willing to do the same.

Response: While the proposed regulation text requires a delivery timeframe of 120 days, the Department will assess whether or not to 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.

Comment No. 2: 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.

Response: 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. However, the proposed rules provide an exception to the "gatekeeper" and surprise examination" requirement for limited partnerships if an annual audit is conducted in accordance to the proposed Section 260.237(b)(4).

Comment No. 3: 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.

Response: 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.

Comment No. 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.

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

Comment No. 5: 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.

Response: 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.

10. Commentor: E-mail dated January 16, 2013, from Tad Borek with Borek Financial Management.

Comment No. 1: Commentor states that it is not practical to forward checks to the third party within 24 hours of receipt. In practice it takes one to three business days to forward checks to the third party. Commentor recommends that the Department amend this provision to three business days rather than the proposed within 24 hours of receipt.

Response: 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".

COMMENTS RECEIVED DURING THE 15-DAY COMMENT PERIOD

The addendum to the initial statement of reasons to clarify and explain in detail the necessity for the investment adviser custody regulations was posted for a 15-day public comment period. The Department received five public comment letters during the 15-day public comment period, which ended on September 28, 2013. Those comments are summarized below, together with the Department's response.

1. Commentor: E-mail dated September 13, 2013, from Ray Meadows with Berkeley Investment Advisors. Mr. Meadows submitted a second email on September 16, 2013 expanding on his comments from September 13. The responses below address both emails from Mr. Meadows.

Comment No. 1: Commentor states that the revised proposed amendments did not address his concerns in the letter he submitted during the 45-day comment period. Specifically Section 260.237(b)(3)(C)(i) and (ii) 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. Mr. Meadows suggests amending 260.237(b)(3)(C)(i) to include the following before the semicolon, "[...] or the custodian calculates and deducts the fee based upon a formula provided by the adviser […]."

Response: The Department understands Mr. Meadow's concerns. However, Mr. Meadows' suggested amendment in 260.237(b)(3)(C)(i) is not appropriate because there is no privity of contract between the investment adviser and custodian with regards to the formula used to calculate fees. The contract for fees is between the custodian and client. Therefore, changing the proposed language as Mr. Meadows suggests would not address his concerns.

Comment No. 2: Mr. Meadows suggests amending 260.237(b)(3)(C)(ii) to include the following after "Sends", "[…] or causes the custodian to send […]."

Response: The Department appreciates Mr. Meadows' suggested amendments. The Department may consider Mr. Meadows' suggestion for a future rulemaking action. Additionally, the Department may assess on a case-by-case basis whether a custodian providing an invoice or statement to the client is in compliance with section 260.237(b)(3)(C)(ii). However, the investment adviser must still maintain a copy of the invoice or statement delivered by the custodian for compliance with the books and records requirements under Section 260.241.3.

2. Commentor: E-mail dated September 13, 2013, from Keith Bishop.

Comment No. 1: Commentor believes the Notice of Modification and the proposed modified text does not comply with Title 1 of the California Code of Regulations, sections 20(c)(3) and 20(c)(4).

Response: The Department believes the Notice of Modification and proposed modified text are in compliance with Title 1, California Code of Regulations, Section 20(c)(3) and (c)(4), respectively. The documents that are incorporated by reference, Form ADV-E and Financial Accounting Standards Board Accounting Standards Codification 946-210-50-4 through 946-210-50-6, do not have a date of publication or issuance, but are otherwise in compliance. The Department will defer to the Office of Administrative Law (OAL) for further review.

Comment No. 2: Commentor points out that the Financial Accounting Standards Board ("FASB") requires registration in order to obtain access to its publications.

Response: Mr. Bishop is correct that the FASB Accounting Standards Codification requires registration. However, registration for the basic view, which allows one to access to the FASB codification is at no cost and simply requires an email address and password.

3. Commentor: E-mail dated September 18, 2013, from Christopher Olin with Alesia Asset Management. Second e-mail dated September 18, 2013 from Christopher Olin is an additional comment to his first e-mail to the Department.

Comment No. 1: Commentor states that the proposed requirement to have both an independent gatekeeper and a surprise verification each year by a CPA that is subject to inspection by the Public Company Accounting Oversight Board ("PCAOB") would be extremely burdensome to comply because the services of the PCAOB costs tens of thousands of dollars. Commentor suggests that the independent gatekeeper systems is sufficient for safeguarding investors.

Response: The proposed regulation requires an independent gatekeeper (260.237(a)(5)(B)(i)) and a surprise verification (260.237(a)(6)). However, the CPA that conducts the surprise verification is not required to be registered with the PCAOB, as Mr. Olin contends. The proposed regulation provides an investment adviser the option of having an independent gatekeeper and being subject to surprise examinations by a CPA or having an annual audit conducted by a CPA that is registered with, and subject to regulation inspection by the PCAOB.

Both an independent gatekeeper and a surprise examination by a CPA are necessary to enhance safeguards and protection of client assets. Existing law requires investment advisers to obtain a surprise examination.[11] Accordingly, this rule does not create significant new costs with respect to this requirement. Furthermore, a surprise examination may identify misuse that a client has not, which would result in the earlier detection of fraudulent activities and reduce client losses. Additionally, the CPA would be required to file mandated forms with the Department regarding the inspections in order for the Department to be promptly alerted in the event of any discrepancy discovered during the inspections.

[11] Cal. Code Regs. tit. 10, § 260.237(e).

Comment No. 2: Commentor suggest the Department could have de minimus levels of assets under management (or "AUM") or annual fee revenues amounts below which advisers would not have to comply with the audit or independent verification requirements and instead would only have to comply with the independent gatekeeper requirement. Commentor expands on this comment in his second email dated September 18, 2013 and explains further that the assets under management to be registered with the SEC is at least $25 million.

Response: The assets under management by an investment adviser is not the driving force to determine custody. Rather, the concern is that an investment adviser has access to a client's funds, regardless of the amount of assets under management. Additionally, the assets under management threshold to register with the SEC is $100 million. Therefore, an investment adviser with less than $100 million in assets under management must be state registered.

As indicated above, both an independent gatekeeper and a surprise examination by a CPA, as well as the option to choose an annual audit by a PCAOB registered CPA instead, are necessary safeguards to protect client assets.

Comment No. 3: Commentor further suggest the Department allow any CPA to perform the surprise inspection rather than only those that are inspected by the Public Company Accounting Oversight Board, which would reduce the cost and be manageable for new start-up businesses.

Response: The proposed regulation allows for any independent CPA to conduct the surprise examination.

4. Commentor: Letter dated September 19, 2013, from George Gordon with WASI (Western Annuity Services, Inc).

Comment No. 1: Commentor states that the additional requirement in 260.237(b)(3)(C)(ii) will add substantial cost to our business with additional expenses of time and equipment to produce the individual bills in invoice or statement format, and the expense of mailing, but will not add any "usable" information to what the commentor already provides his clients.

Response: The Department does not indent to be prescriptive as to who delivers the requisite information in Section 260.237(b)(3)(C)(ii) or the exact format of the invoice or statement. Thus, Section 260.237(b)(3)(C)(ii) is satisfied, so long as the requisite information is delivered to the client when a fee is deducted.

Comment No. 2: Commentor further states prior to the SEC increase in assets under management was increased from $25 million dollars to $100 million dollars, the SEC did not require this type of regulation. Commentor believes this regulatory action discriminate against small advisory firms.

Response: 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. Additionally, the Department's proposed regulation is consistent with NASAA's model rule, to adequately reflect regulatory consistency and current industry practices while ensuring adequate protection for investment advisory clients. Setting forth procedures that are different from the NASAA model rule would create confusion and a higher compliance burden for the investment adviser industry.

5. Commentor: E-mail letter dated September 28, 2013, from Steve Johnson with Johnson Lyman Wealth Advisors on behalf of Financial Planning Association of California.

Comment No. 1: Commentor supports the revised proposed amendments made to the custody regulations and the effort being made to achieve consistency with NASAA's model custody rule for non-federally registered investment advisers. Commentor further states that setting procedures and timeframes that are different from the SEC custody rules and the NASAA model rules would create confusion and a higher compliance burden for the investment adviser industry.

Response: The Department appreciates Mr. Johnson's comments. The Department concurs with Mr. Johnson that establishing procedures and timeframes in the proposed rulemaking that are different from the SEC custody rules and the NASAA model rules would create confusion and a higher compliance burden for the investment adviser industry.

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