



STATE OF CALIFORNIA

Department of Financial Protection and Innovation

GOVERNOR Gavin Newsom · COMMISSIONER Clothilde V. Hewlett

IN REPLY REFER TO:
FILE NO: _____

February 27, 2024

VIA EMAIL ONLY

Re: _____ - Request for Interpretive Opinion

Dear _____:

This responds to your letter dated May 21, 2023, seeking an interpretive opinion from the Department of Financial Protection and Innovation (“Department”) as to whether _____, ____ (“_____”), a California-licensed investment adviser whose sole owner and investment adviser representative is also an accountant, partner, and minority shareholder of an accounting firm corporation (“Accounting Firm”), will be deemed to have “custody of client funds” pursuant to California Code of Regulations, title 10, section 260.237.2 (“Section 260.237.2”).

Background

_____ is a California-domiciled investment adviser whose license with the Department became effective in March 2023. _____’s limited liability company units are wholly owned by _____ (“_____”), who is also _____’s sole investment adviser representative.

In addition to his role with _____, _____ is an accountant, partner, and minority shareholder of Accounting Firm, whose stock is owned by three partners: Partner A owns 70%, Partner B owns 15%, and _____ owns 15%. Accounting Firm prepares income tax returns for individual clients and business entities (collectively, “Accounting Firm Clients”). Along with preparing tax returns, Accounting Firm provides payroll services (“Payroll Services”) to some of its Accounting Firm Clients (“Payroll Clients”) and bill pay services (“Bill Pay Services”) to some of its Accounting Firm Clients (“Bill Pay Clients”). To provide Payroll Services and Bill Pay Services, Accounting Firm has access to the bank accounts of Payroll Clients and Bill Pay Clients.

For the Payroll Services, Payroll Clients provide the hours worked by their employees and their hourly pay rate. Accounting Firm’s payroll department inputs this data into a computer system and generates paychecks. Accounting Firm reviews the outputs for accuracy before either delivering paper paychecks to Payroll Clients or electronically depositing the net payroll into designated accounts for Payroll Clients who have opted for direct deposit. Payroll Clients then sign their respective paper checks before distributing them to employees.

For the Bill Pay Services, Partner A physically signs a paper check for each bill. Only Partner A is authorized to sign checks on behalf of Bill Pay Clients; _____ is not authorized to sign these checks.

Accounting Firm asserts it has internal controls to prevent unauthorized access to the funds of Accounting Firm clients. For example, Accounting Firm deliverables must typically undergo multiple rounds of review to ensure there are no errors. Moreover, Accounting Firm's written compliance manual and code of ethics prohibit a person associated with Accounting Firm, including management, from controlling clients' funds without authorized access.

Some individual members of Accounting Firm's corporate Payroll Clients and corporate Bill Pay Clients have expressed interest in _____ serving as their individual investment adviser while Accounting Firm continues to handle their corporate or business entity accounting, payroll, and bill-pay matters. In addition, some individuals for whom the Accounting Firm provides Bill Pay Services have asked _____ to provide investment advisory services.

California Code of Regulations, title 10, section 260.237.2

Section 260.237.2 sets forth minimum financial requirements for investment advisers regulated by the Department. Pursuant to subdivision (a) of Section 260.237.2, every investment adviser who "has custody of client funds or securities" shall maintain at all times a minimum net worth of \$35,000, and every investment adviser who has discretionary authority over, but not custody of, client funds or securities shall maintain at all times a minimum net worth of \$10,000.¹ For purposes of this rule, a person will be deemed to have custody if said person 1) directly or indirectly holds client funds or securities, 2) has any authority to obtain possession of them, or 3) has the ability to appropriate them.²

Analysis

If _____ were to provide investment advisory services to Accounting Firm's Payroll Clients and Bill Pay Clients, _____ would have custody of those clients' funds because it could appropriate them through Accounting Firm. Because the applicable statutes and regulations do not define what it means to "appropriate" client funds within the meaning of Section 260.237.2, we look to the dictionary's definition of that term.³ The Merriam-Webster and Cambridge dictionaries define "appropriate (verb)" as "to take or make use of without authority or right"⁴ and "to take something for your own use, usually without permission."⁵ Here, to

¹ Cal. Code Regs., tit. 10, § 260.237.2. subd. (a).

² Cal. Code Regs., tit. 10, § 260.237.2. subd. (e).

³ When a statute does not define a term, courts give the term its ordinary meaning. *Taniguchi v. Kan Pacific Saipan, Ltd.* (2012) 566 U.S. 560. To determine a term's "ordinary meaning," courts regularly turn to general and legal dictionaries. *Freeman v. Quicken Loans, Inc.* (2012) 566 U.S. 624.

⁴ <https://www.merriam-webster.com/dictionary/appropriate>.

⁵ <https://dictionary.cambridge.org/us/dictionary/english/appropriate>.

perform the Payroll Services and Bill Pay Services, Accounting Firm would require access to the bank accounts of any Payroll Clients and Bill Pay Clients it shares with _____. As partner of Accounting Firm, _____ would have access to the funds in those accounts and could take them without authority, without permission, and despite the Accounting Firm's internal controls. Thus, _____, owned wholly by _____, would have custody of its clients' funds and would need to maintain at all times a minimum net worth of \$35,000 pursuant to subdivision (a) of Section 260.237.2.

Nevertheless, _____ requests a waiver from this requirement in Section 260.237.2 because Accounting Firm's access or control over shared clients' assets is "operationally independent." You cite an SEC release in support of your claim. However, even under federal law, Accounting Firm does not qualify as "operationally independent" because (1) _____, as partner of Accounting Firm, has both the power to control the disposition of client assets of which Accounting Firm has custody and the opportunity to misappropriate such assets, (2) _____ and Accounting Firm are under common supervision, and (3) _____ holds a position with Accounting Firm.⁶ Moreover, the requested waiver would undermine the purpose of Section 260.237.2, which the Department finds to be necessary or appropriate in the public interest and for the protection of investors.⁷ Therefore, the Department declines to issue the proposed waiver.

This opinion is limited to the facts and circumstances described above. Should any of the facts or circumstances change, the Department's opinion may also change.

Confidentiality

On October 19, 2023, you submitted a revised request only seeking confidential treatment of the parties' names identified by this letter. The Department grants confidentiality of the parties' names.

⁶ 17 C.F.R. § 275.206(4)-2(d)(5) (2010).

⁷ Corp. Code, § 25237.

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Please contact me at _____ with any questions.

Sincerely,

Clothilde V. Hewlett
Commissioner
Department of Financial Protection and Innovation

By

Senior Counsel

cc: Michael Nelson, DFPI