

New Custody Compliance Tasks for California Registered Advisers Effective April 1

By Ildiko Duckor and Jay B. Gould

The California Commissioner of Business Oversight (“Commissioner”) recently amended California’s custody rule 10 C.C.R. Section 260.237 (the “New Custody Rule”). The New Custody Rule will be effective on April 1, 2014.

All investment advisers licensed or required to be licensed in California must comply with the New Custody Rule. California Exempt Reporting Advisers are not affected.

What is “having custody:” holding or having authority to obtain possession of client funds or securities, for example:

- Possession of client funds or securities unless received inadvertently and returned to the sender promptly
- Any arrangement (such as a general power of attorney) that authorizes you to withdraw client funds or securities maintained with a custodian by instructing the custodian
- Any capacity with authority to access to client funds or securities (such as general partner of a limited partnership, managing member of a limited liability company or trustee of a trust)

If you “have custody” of assets:

- **Qualified Custodian.** You must maintain those assets with a “qualified custodian” such as a bank, trustee, or prime broker.
- **Notice on ADV.** You must notify the Commissioner on your ADV that you have or may have custody.
- **Notice to Clients*.** You must notify your client in writing of the custodian’s name and address, and the manner in which the assets are maintained, and any changes to this information.

- **Quarterly Custodian's Account Statement***. You must reasonably ascertain that the custodian sends quarterly account statements with specific information to each client (for example, by being cc-d on electronic statements the custodian sends).
- **Surprise Exam***. You must retain a CPA (by written agreement) to have an annual "surprise exam" of client assets, and report the examination and any resignation of the CPA on your ADV.
- **Internal Control Report**. If you or your affiliate serves as the qualified custodian,
 - the CPA firm conducting the surprise exam must be registered with and subject to examination by the PCAOB, and
 - you must obtain an annual internal control report with specified content.
- **Exceptions**. There are certain exceptions from some of the New Custody Rule's requirements for mutual fund shares, certain private securities, and for advisers that "have custody" only because they deduct fees (if certain conditions are also satisfied).

Fund Managers' Obligations

If you are a general partner of an investment limited partnership or a managing member of a limited liability company (or are in a similar position with respect to a pooled fund vehicle):

- **Quarterly Investor Account Statement**. You must send to all fund investors quarterly account statements showing:
 - the total amount of all additions to and withdrawals from the fund,
 - a listing of all additions to and withdrawals from the fund by an investor,
 - the opening and closing value of the fund at the end of the quarter,
 - the total value of an investor's interest in the fund at the end of the quarter, and
 - a listing of securities positions on the closing date of the statement pursuant to FASB Accounting Standards Codification 946-210-50-4 through 6.
- **Independent Expense Verification***. You must retain (by written agreement) an independent accountant or attorney obligated to act in your investors' best interests and send him/her all invoices or receipts with details regarding calculations, so the independent person can
 - review all fees, expenses and withdrawals from the fund,
 - determine that payments conform to the fund agreement and, and
 - forward to the custodian approval for payments of the invoices.

- **Audited Fund Exceptions.** You **need not* comply with the following requirements: **Notice to Clients; Quarterly Custodian’s Account Statement; Surprise Exam; and Independent Expense Verification, if**
 - Your fund is audited annually, in accordance with GAAP, by an independent CPA registered with and subject to examination by the PCAOB.
 - The audited financials are distributed to all investors and the Commissioner within 120 days of the end of the fund’s fiscal year.
 - A final liquidation audit is performed, in accordance with GAAP, upon the fund’s liquidation, and the audited financials are distributed to investors and the Commissioner promptly upon completion of the audit.
 - The independent CPA is required by agreement to notify the Commissioner on Form ADV if it resigns or is terminated.
 - You notify the Commissioner that you intend to use the audit exception route.

Links:**The amended Custody Rule****Final Statement of Reasons**

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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