Extended Answers from the November 1, 2010 Investment Adviser Workshop's Q & A Session

INTRODUCTION

During the Q&A Session following the Workshop, some confusion arose concerning the requirements for those advisers who will now have custody in Utah due to their direct withdrawal of advisory fees from clients' accounts. Some particular situations were mentioned in the discussion, which may have confused matters further. In an effort to fully address all these questions, the Division has prepared this document to answer:

- Questions on the "Surprise Audit" Requirements
- Questions on the Financial Requirements for:
    - Advisers with Custody (both in terms of outright custody or custody solely due to the direct withdrawal of fees) and
    - Advisers with Discretionary Authority
- Questions on Transferring Client Assets between Qualified Custodians

QUESTIONS ON SURPRISE AUDITS

The primary question involved the surprise audits (or "independent verification") requirements for advisers with custody. Now that those advisers who withdraw their fees are considered to have custody, one question raised was whether those advisers had to engage a PCAOB registered accountant to perform surprise audits.

SEC Rule 206(4)-2(b)(3) clearly addresses this situation:

> "…you are not required to obtain an independent verification of client funds and securities maintained by a qualified custodian if: (i) you have custody of the funds and securities solely as a consequence of your authority to make withdrawals from client accounts to pay your advisory fee; and (ii) if the qualified custodian is a related person, you can rely on paragraph (b)(6) of this section."

So for advisers who have custody solely due to their direct withdrawal of advisory fees from clients' accounts, no surprise audits are required. This would cover most advisers who withdraw advisory fees.

If the adviser is related to the qualified custodian, however, surprise audits would be required unless that qualified custodian is "operationally independent" of the adviser (see SEC Rule 206(4)-2(b)(6) for the exemption and SEC Rule 206(4)-2(d)(5) for the definition).

QUESTIONS ON FINANCIAL REQUIREMENTS

Another question raised during the Q&A Session involved the financial requirements for advisers who withdraw their fees directly from clients' accounts now that those advisers are considered to have custody. This question was further complicated by advisers who inquired whether having discretionary authority would change any of these requirements.

Broadly speaking, advisers have two types of financial requirements: those that apply to their initial application and those that apply as part of their ongoing books and records requirements.

INITIAL APPLICATION

When advisers initially license in Utah, they must identify whether they will have discretionary authority or custody. Advisers with custody (and those that charge fees in advance in certain circumstances) have greater financial requirements than advisers that simply have discretionary authority.

Going forward, advisers that intend on withdrawing advisory fees directly from clients' accounts will need to affirmatively state that they will have custody, ***but*** if this is the ***sole*** reason they have custody, the adviser will ***not*** be required to meet the corresponding financial requirements for custody. Separate from that determination, however, if such an adviser also has discretionary authority, they would still need to meet those related financial requirements for discretionary authority.

When licensing in Utah, the adviser has a few options to meet their financial requirements:

1. **Bonding.** Advisers may obtain a bond in the amount for $35,000 if they have custody (beyond the withdrawal of fees) or $10,000 if they have discretionary authority. The Division requires either the Division Form 4-5BIA or documents that contain the same information as the Form 4-5BIA to prove the adviser has obtained their bond. The Division may also accept proof of funds held in escrow in lieu of the bond in certain situations.
2. **Minimum Net Worth.** Advisers may opt to maintain a minimum net worth of $35,000 for custody (again, beyond the withdrawal of fees) or $10,000 for discretionary authority. To document the minimum net worth, the Division requires an audited balance sheet at the time of application.
3. **SIPC Membership.** Advisers also licensed as broker-dealers may be members of SIPC and the Division accepts proof of SIPC membership as fulfillment of the financial requirements.
4. **Home State's Financial Requirements.** If the adviser's home state is not Utah, the adviser must simply meet the financial requirements of their home state. The Division requires a citation of the financial requirements for that home state and documentation that the adviser has met those requirements upon application.

Note: if an adviser has custody (beyond simply the withdrawal of advisory fees) and discretionary authority, the minimum amounts for net worth or bonding would be the higher amount (i.e. the $35,000 amount), not a compounded amount (i.e. ***not*** $35,000 + $10,000).

ONGOING FINANCIAL REQUIREMENTS (BOOKS AND RECORDS)

After licensing, investment advisers are required to maintain various books and records. Some of these requirements involve the adviser's ongoing financial requirements for having custody or discretionary authority. Again, if the adviser has custody solely due to the direct withdrawal of their advisory fees, they do not need to meet the ongoing custody financial requirements, but would still need to the meet the financial requirements for discretionary authority if applicable.

Advisers with Custody

For advisers with custody beyond the withdrawal of advisory fees (or charging advisory fees in advance in certain circumstances), the adviser may choose one of the following options to meet its ongoing financial requirements: (1) renew its bond; (2) continue maintaining the minimum net worth; (3) maintain its SIPC membership (only applicable to advisers that are also broker-dealers); or (4) continue meeting requirements of their home state (if other than Utah).

While an adviser with custody can meet their ongoing financial requirements by any of the four methods outlined above, they must also provide the Division with independently audited financial statements within 120 days following their fiscal year end (Rule 164-5-3 specifies the requirements for these financial statements).

Note: the audited financial statements for advisers with custody would likely be done by the same PCAOB registered accountant who conducts the surprise audits and prepares the internal control report for the adviser.

Advisers with Discretionary Authority

For advisers with discretionary authority (including those advisers that may also have custody solely due to the direct withdrawal of advisory fees), the financial requirements may depend on how the adviser met its financial requirements at the time of its initial application. The adviser may choose one of the following options to meet its ongoing financial requirements: (1) renew its bond; (2) continue maintaining the minimum net worth; (3) maintain its SIPC membership (only applicable to advisers that are also broker-dealers); or (4) continue meeting requirements of their home state (if other than Utah).

For advisers that maintain a minimum net worth, however, the Division also requires the same financial statements that advisers with custody must file. Similarly, these financial statements must reflect that the minimum net worth was maintained at all times. Again, these independently audited financial statements must be provided to the Division within 120 days following their fiscal year end (Rule 164-5-3 specifies the requirements for these financial statements).

Ongoing Bonding Amounts

All advisers should note that while the initial bonding amounts are $10,000 for advisers with discretionary authority and $35,000 for advisers with custody, the Division may increase these amounts for advisers based on their total number of advisory clients and assets under management.

QUESTIONS ON THE LIMITED AUTHORITY TO TRANSFER A CLIENT'S ASSETS BETWEEN THE CLIENT'S ACCOUNTS AT ONE OR MORE QUALIFIED CUSTODIANS

Another scenario discussed in the Q&A Session of the Workshop involved the transferring of clients' assets from one custodian to another. The SEC includes this scenario in its question and answer discussion on the custody rule. The SEC explains in its ***Staff Responses to Questions About the Custody Rule*** (online: *http://sec.gov/divisions/investment/custody_faq_030510.htm*):

> Under rule 206(4)-2(d)(2)(ii), an adviser has custody if it has the authority to withdraw client assets maintained with a qualified custodian upon the adviser's instruction to the custodian. We do not interpret the authority to withdraw assets to include the limited authority to transfer a client's assets between the client's accounts maintained at one or more qualified custodians if the client has authorized the adviser in writing to make such transfers and a copy of that authorization is provided to the qualified custodians, specifying the client accounts maintained with qualified custodians. (Modified May 20, 2010.)

As the SEC explains, this practice does not constitute custody so long as: (a) the client's name is on all the accounts; (b) the adviser has obtained written authorization from the client specifying the accounts in question; and (c) the adviser provides this authorization to the qualified custodians.

CONCLUSION

Hopefully this document answers all the questions raised at the Division's November 1, 2010 Investment Adviser Workshop. If another question needs to be addressed, please feel free to contact the Division at (801) 530-6600