



The Commonwealth of Massachusetts

William Francis Galvin, Secretary of the Commonwealth
Securities Division

PRELIMINARY REPORT – SWITCH INVESTMENT ADVISERS

Summary

The Registration, Inspections, Compliance and Examinations Section (the “RICE Section”) of the Massachusetts Securities Division of the Office of the Secretary of the Commonwealth (the “Division”) has issued this preliminary report (“Report”) to address the registration and examinations of Massachusetts Switch investment advisers. The “Switch” as used herein refers to the switch in registration of investment adviser firms from Federal to State registration pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act¹ (“Dodd-Frank Act”). As a result of the Switch, approximately 139 Switch investment advisers became registered with the Division.

Investment advisers have registered with the Division at an increased pace since the Switch. While 712 investment advisers were registered with the Division prior to the Switch, there are approximately 910 advisers registered with the Division currently. The secondary impact of the Switch is an increased number of Massachusetts-registered investment advisers who do not reasonably expect to manage enough assets in order to meet the Securities and Exchange Commission’s (“SEC”) registration requirements.

Of the 139 Switch investment advisers, 102 have principal offices in Massachusetts. Since the implementation of the Switch, the Division has examined approximately half of these 102 advisers. As highlighted in this Report, the SEC failed to examine an overwhelming majority of the 102 in the years preceding the Switch. In fact, the SEC examined only three (3) of the 102 Massachusetts-based Switch advisers in the three (3) years prior to the Switch. Furthermore, of the 50 Switch advisers examined by the Division, the SEC examined only one (1) of them in the three (3) years preceding the Switch. Many of the deficiency trends identified in the Division’s recent Switch examinations are consistent with the deficiencies documented by the North American Securities Administrators Association (“NASAA”) in the organization’s October 2013 report entitled “[NASAA 2013 Coordinated Investment Adviser Examinations](#).”

The Division’s recent examinations of Switch advisers identified a disconcerting number of advisers out of compliance with the Division’s custody rule. In many instances, advisers unknowingly had custody of clients’ trust assets due to the adviser or a related person’s position as trustee over the trust. Furthermore, the fact that the SEC examined so few of the Switch advisers in the years leading up to the Switch has presumably contributed to the advisers’ misunderstanding of the regulatory requirements that must be met when possessing custody of clients’ assets. In light of the custody-related deficiencies identified in the Division’s recent examinations of Switch advisers, the Division will release a policy statement on custody in conjunction with this Report.

¹ Pub. L. 111-203, H.R. 4173.

I. Background of the RICE Section of the Massachusetts Securities Division

The RICE Section relies on the authority articulated in Mass. Gen. Laws ch. 110A, the Massachusetts Uniform Securities Act (the “Act”) and 950 Mass. Code Regs. 10.00 *et seq.* (the “Regulations”). Specifically, the RICE Section focuses on the registration and regulation of broker-dealers and agents, investment advisers and investment adviser representatives, and exempt reporting advisers. The RICE Section was formed in March 2012 and it was created in part because of regulatory changes resulting from the Dodd-Frank Act.

In addition to registering individuals and firms in the securities industry in Massachusetts, among other functions, the RICE Section:

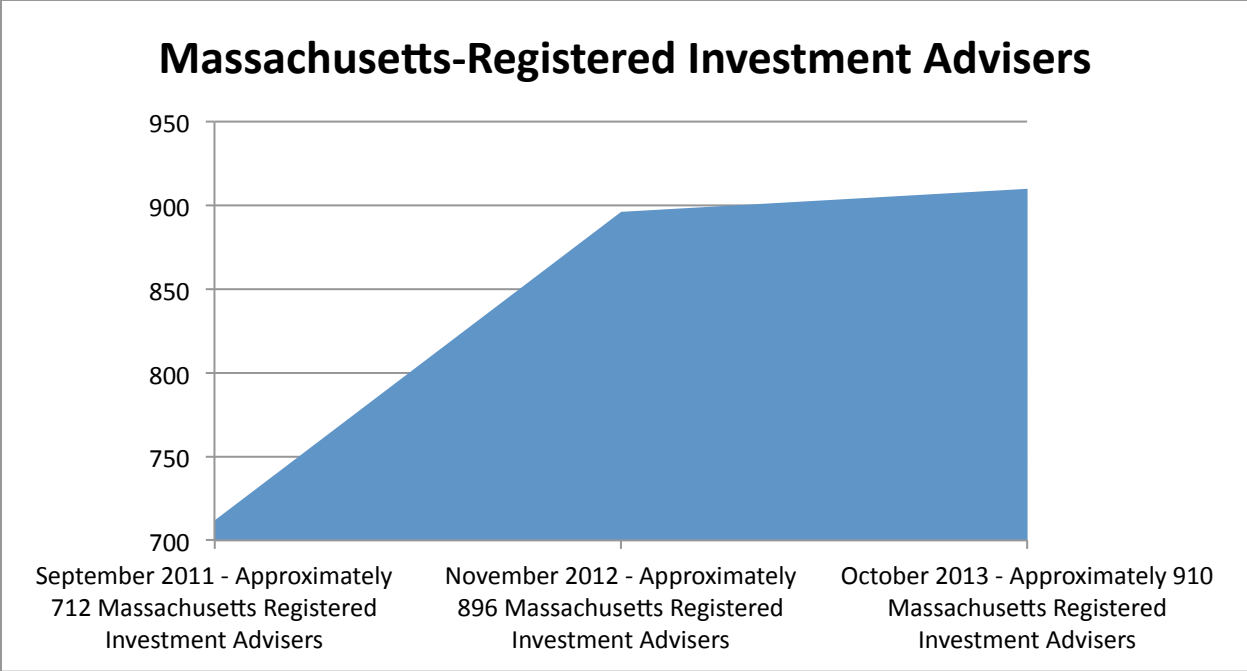
- Spearheads the Division’s books and records examinations program;
- Performs outreach to the registrant community;
- Implements compliance and regulatory policies applicable to Massachusetts registrants;
- Conducts investigations into potential violations of the Act and the Regulations; and
- Initiates adjudicatory proceedings against individuals and entities that have violated the Act and the Regulations.

Effective July 21, 2011, Section 410 of the Dodd-Frank Act amended Section 203A(a) of the Investment Advisers Act of 1940 to delegate registration authority to the states over investment advisers with between \$25 million and \$100 million in assets under management. As a result, it was anticipated that approximately 3,200 investment adviser firms nationwide would be required to switch from federal to state regulation. This process as a whole has been and will continue to be referred to in this document as the Switch.

II. The Switch and its Impact

The above-referenced modification of the Investment Advisers Act of 1940 went into effect on July 21, 2011, however most investment advisers subject to the Switch were required to file their application for Massachusetts registration by March 30, 2012. This is because investment advisers are required to update their Form ADV within 90 days after the end of their fiscal year and most investment advisers use the calendar year as their fiscal year. As a result, the Division began to experience the Switch’s impact by the end of March 2012.

The Switch resulted in a significant number of investment advisers changing their registration from the SEC to Massachusetts. In September 2011, before the implementation of the Switch, there were approximately 712 investment advisers registered with the Division. Initially, the Switch resulted in approximately 139 additional investment advisers registering with the Division. However, the number of investment adviser registration applications received by the Division continued at an increased pace even after the months following the initiation of the Switch. As of November 2012, approximately 896 investment advisers were registered with the Division. As of the issuance of this report, approximately 910 investment advisers were registered with the Division.



The RICE Section considers the increased pace of investment advisers registering with the Division to be in large part due to registrants that, prior to the Dodd-Frank Act, would have forgone registration with the Division and directly registered with the SEC. Currently, investment adviser applicants are permitted to register with the SEC if they have a reasonable expectation that they will have \$100 million in assets under management within 120 days of their registration. Before the Dodd-Frank Act, investment adviser applicants were permitted to register with the SEC if they had a reasonable expectation that they would have \$25 million in assets under management within 120 days of their registration. While the months initially following the Switch resulted in approximately 139 additional investment advisers registering with the Division, the Switch’s secondary impact is still being felt due to the increased number of investment advisers registering with the Division who do not reasonably expect to have \$100 million in assets under management within 120 days of their registration.

III. Examinations Program Update

a. Who Conducts Examinations

The Division’s books and records examinations program, which is implemented by the RICE Section, is an essential component of the Division’s regulatory and investor protection mission. The examinations program involves the Division’s staff conducting comprehensive audits and inspections of Massachusetts registered investment advisers to determine compliance with state and federal securities laws and regulations and to ensure that these investment advisers meet the obligations they owe to their clients. As mentioned above, the Switch initially resulted in approximately 139 additional investment advisers registering with the Division. 102 of those 139 Switch advisers have principal places of business in Massachusetts. Since the implementation of the Switch, the number of investment advisers registered with the Division has risen from approximately 712 to over 900, a 26% increase. The RICE Section is dedicated to

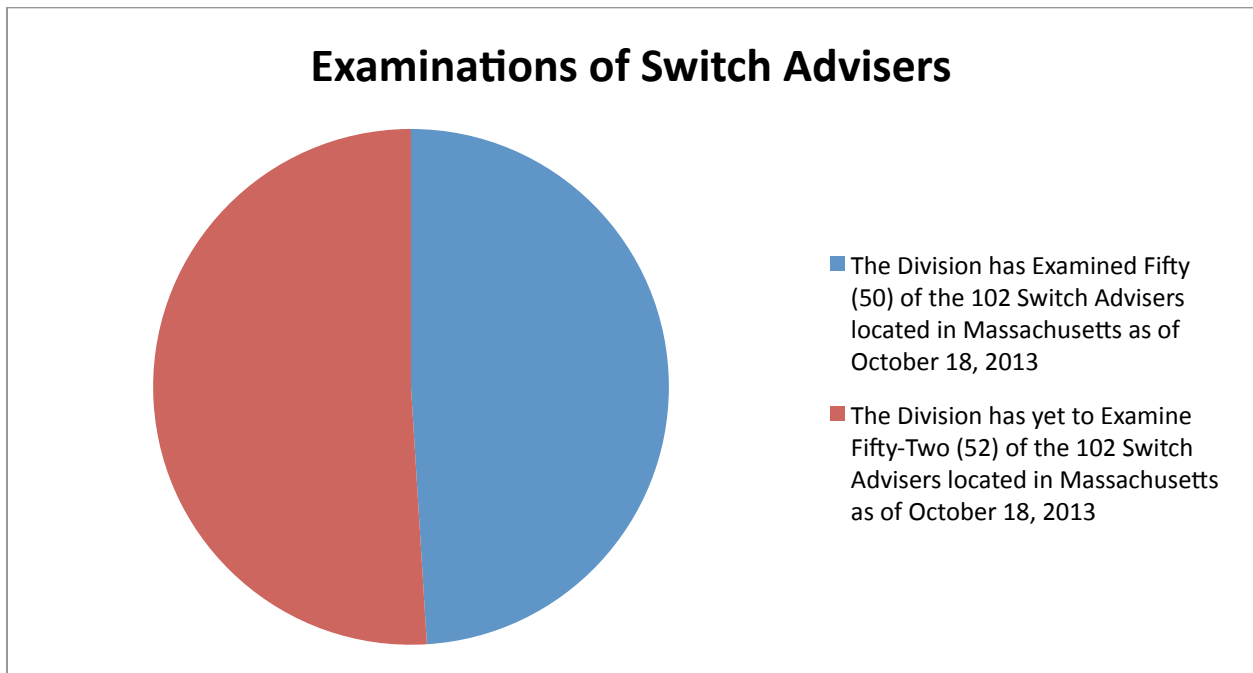
maintaining a robust examinations program that can sufficiently meet the challenges that come along with the growing number of registrants. One way of maintaining a vigorous program is by including all capable and trained staff members of the Division, not just RICE staff, to perform the function of an examiner; all members of the Division’s staff conduct examinations of state registered investment advisers.

b. Examinations of Switch Advisers

From August 2012 through mid-October 2013, the Division augmented its examinations program by concentrating on examining investment advisers that were registered with the Division directly because of the Switch. However, also during this period, the Division continued to examine non-Switch investment advisers. During the approximate fifteen month period, the Division examined approximately half of the Switch advisers. The chart below provides quantitative data regarding the Switch advisers most recently examined by the Division.

	<i>Switch Examinations</i>
<i>Time period</i>	August 2012 – October 2013
<i>Number of switch examinations</i>	50
<i>Total number of accounts</i>	10,908
<i>Approximate average of number of accounts per adviser</i>	220 accounts per adviser
<i>Approximate total number of assets under management</i>	\$3 billion
<i>Approximate average of assets under managers per adviser</i>	\$60 million per adviser

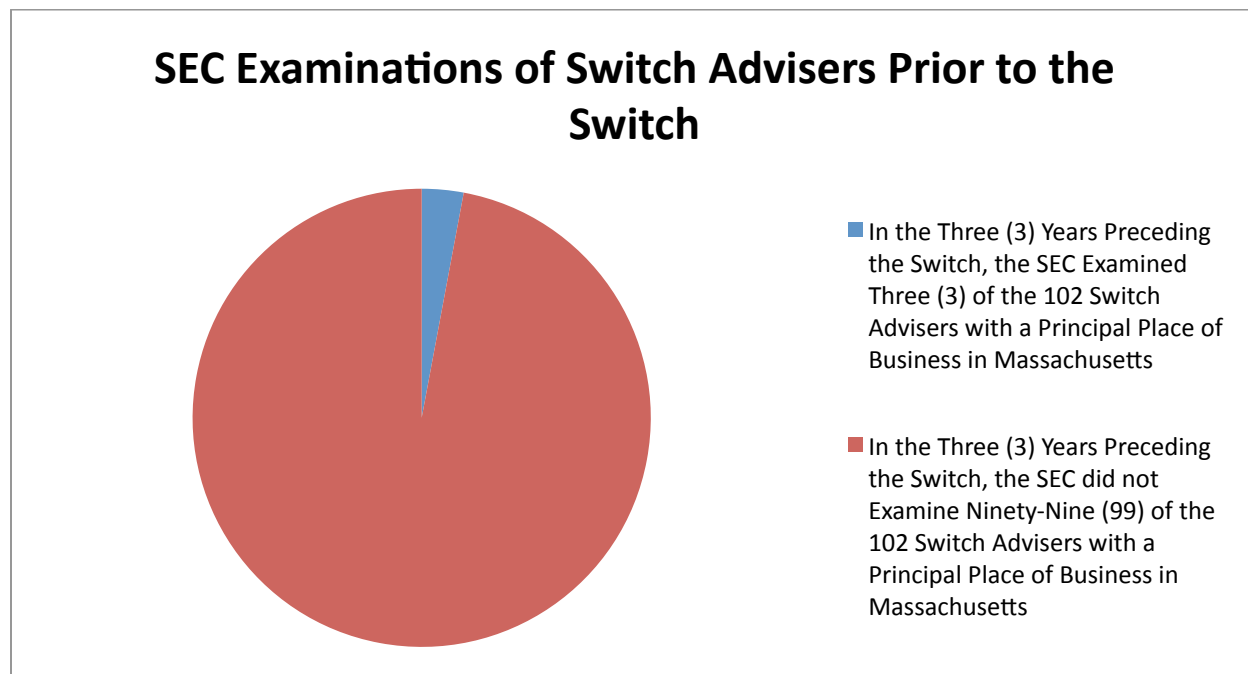
The graph below highlights the number of examinations of Switch advisers the Division has conducted in relation to the total number of Massachusetts-located Switch advisers.



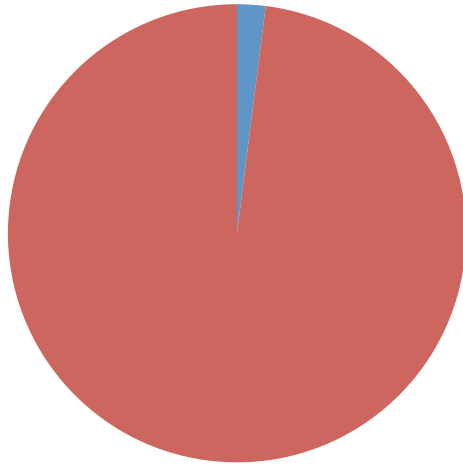
As noted above, the Division has examined nearly half of the Massachusetts-located Switch advisers that were part of the initial stages of the Switch. While the Division welcomes the additional responsibilities that come along with regulating the Switch advisers, the increased size of these advisers has caused the RICE Section to commensurately adjust its examinations program. The Division's staff has had to increase the amount of time spent on examining Switch advisers, in part because of the augmented managed assets and number of client accounts. The increased examination time is also due in part to the heightened sophistication level of many of the Switch advisers' practices. This increased examination time has emphasized the notion that the examinations program must maintain a pace that is appropriate and consistent with the size and scope of the advisers being audited, which may result in a more cautious pace than prior to the Switch.

c. SEC Review of Switch Advisers

Through its examinations, the Division determined that an overwhelming majority of Switch advisers had not been examined by the SEC in the years leading up to the Switch. As described in the graph below, the SEC examined only three (3) of the approximate 102 Switch advisers with a principal place of business in Massachusetts in the three years preceding the Switch. Furthermore, in the three (3) years leading up to the Switch, the SEC examined only one (1) of the fifty (50) Switch advisers that the Division examined between August 2012 and mid-October 2013.



SEC Examinations of Switch Advisers Examined by the Division



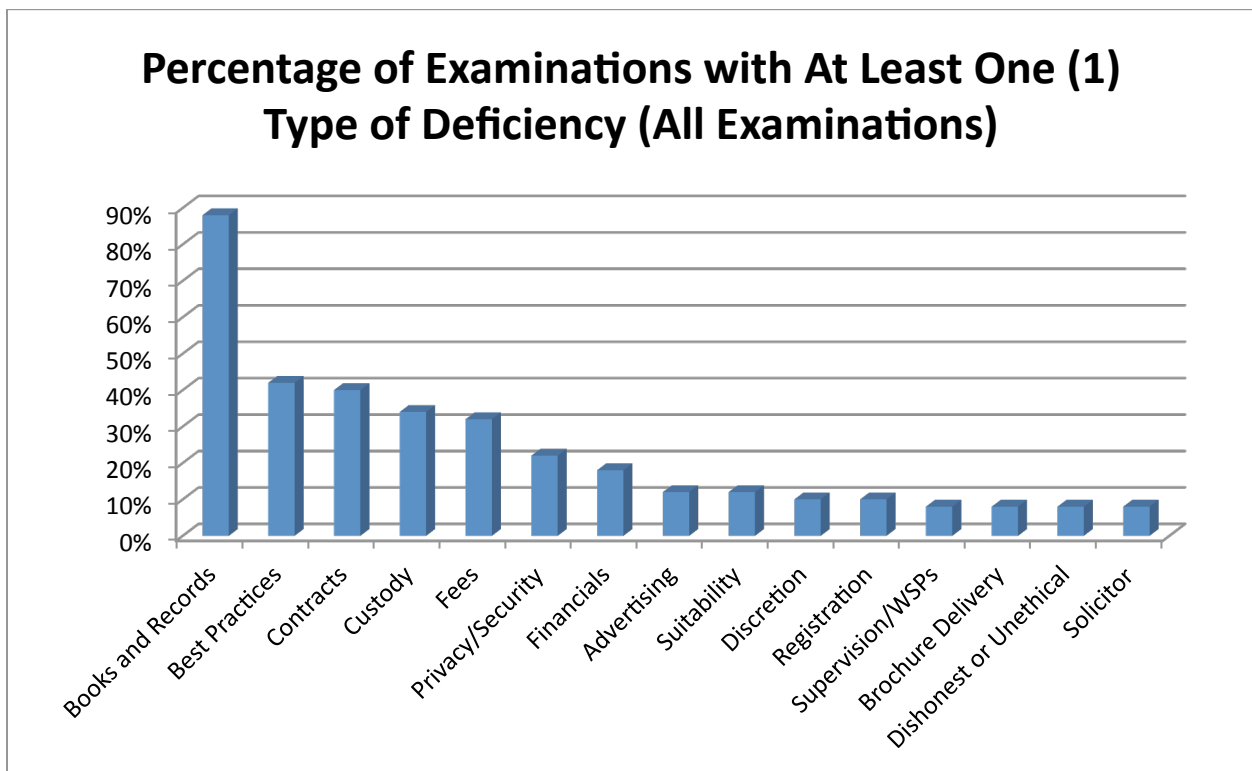
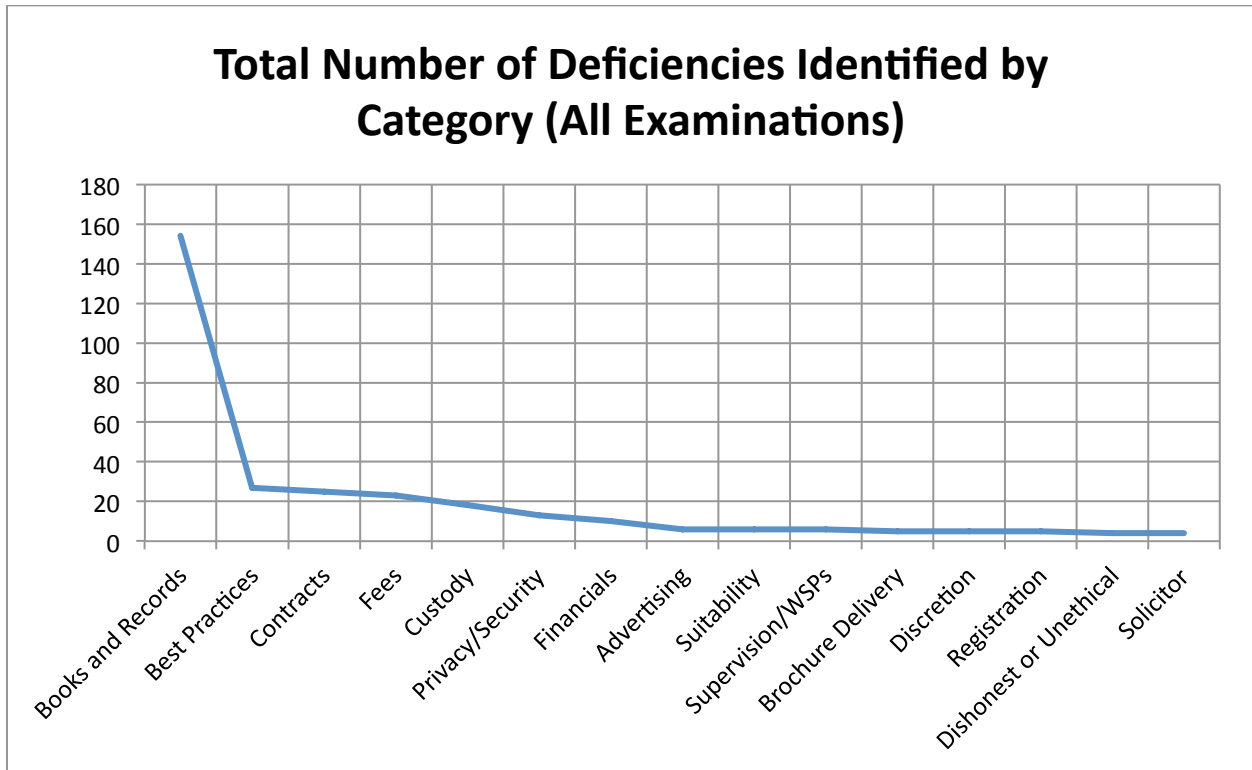
■ In the Three (3) Years Preceding the Switch, the SEC Examined One (1) of the Fifty (50) Advisers Examined by the Division during the period of August 2012 through Mid-October 2013

d. Findings of Switch Adviser Examinations

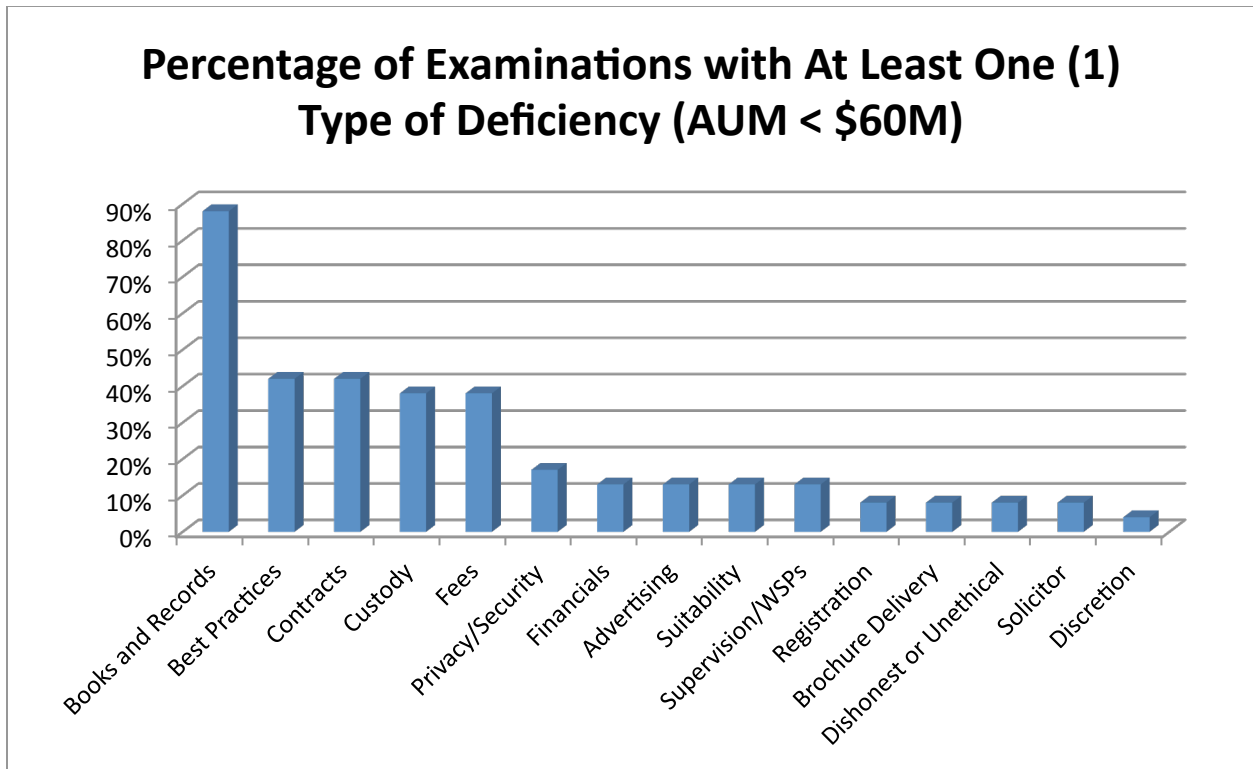
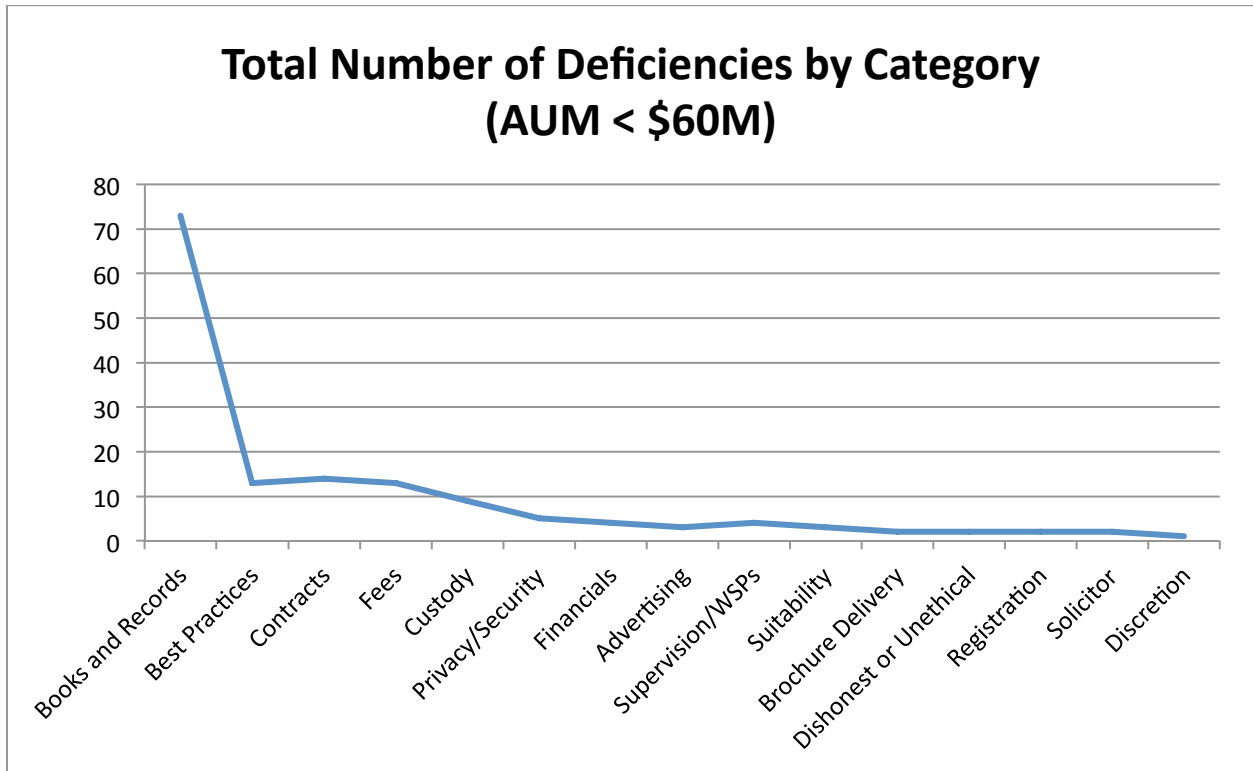
The Division conducted fifty (50) examinations of Switch advisers between August 2012 and mid-October 2013. These examinations, which amounted to nearly half of the Switch advisers with a principal place of business in Massachusetts, identified certain deficiencies. Many of the deficiency trends identified by the Division are consistent with the deficiencies documented by NASAA in the organization’s October 2013 report entitled “[NASAA 2013 Coordinated Investment Adviser Examinations](#).” In total, the Division identified nearly 300 deficiencies in fifteen (15) different categories. Those categories are identified as the following:

Advertising	Custody	Privacy/Security
Best Practices	Discretion	Registration
Books and Records	Dishonest or Unethical	Solicitor Registration
Brochure Delivery	Fees	Suitability
Contracts	Financials	Supervision/Written Supervisory Procedures

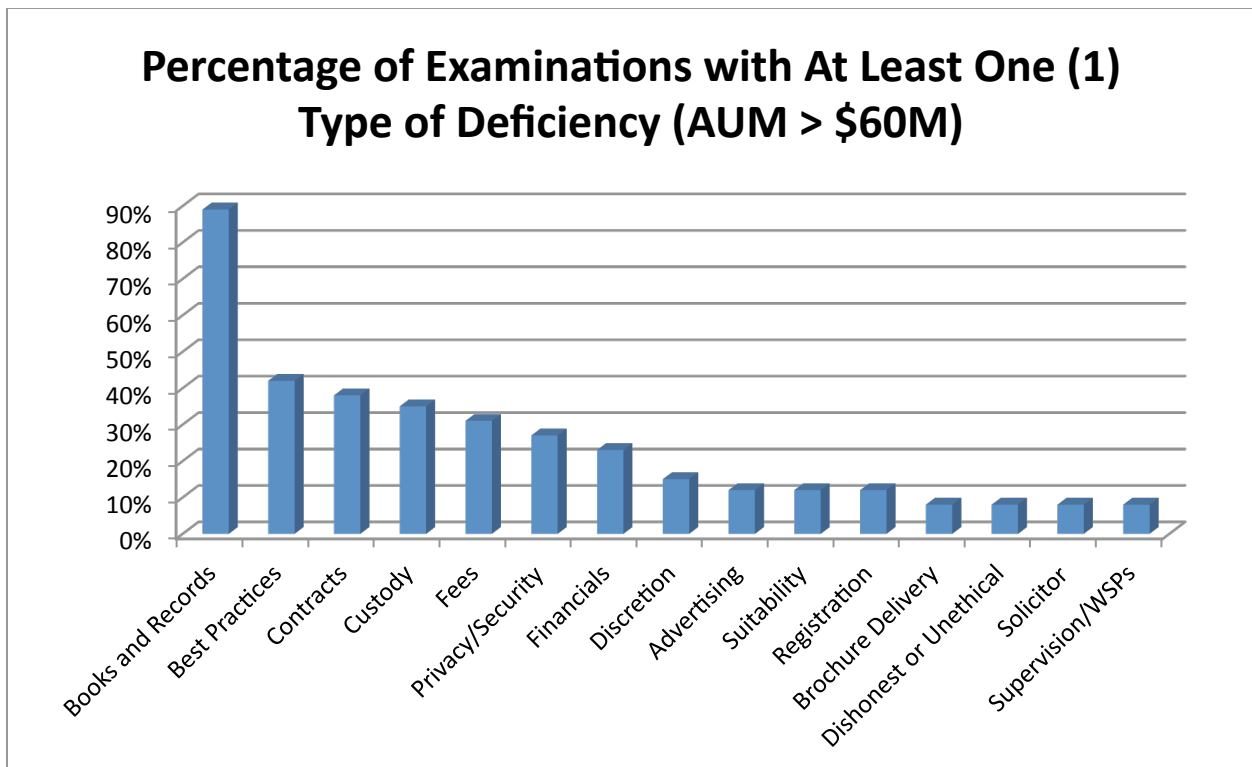
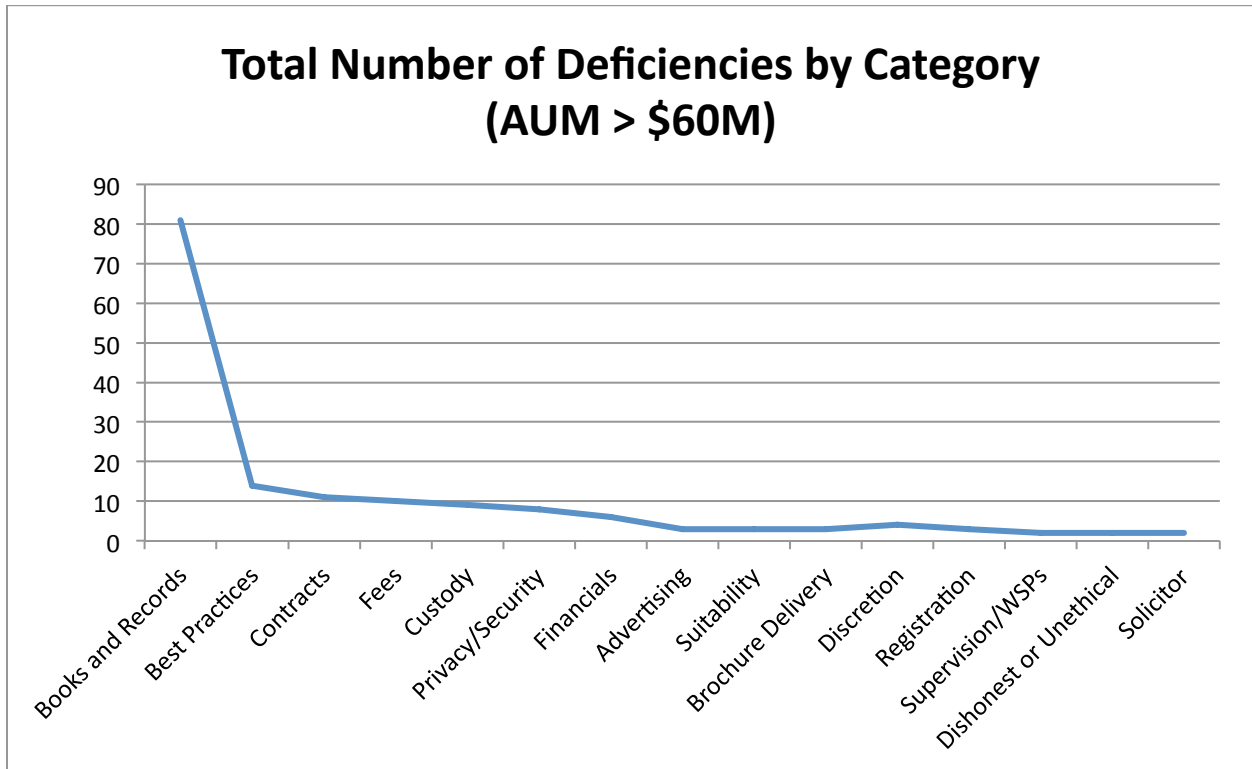
The graphs below detail the deficiencies identified in the Division's Switch adviser examinations:



The graphs below detail the deficiencies identified in the Division’s examinations of the twenty-four (24) of fifty (50) Switch advisers with less than \$60 million in assets under management:



The graphs below detail the deficiencies identified in the Divisions examinations of the twenty-six (26) of fifty (50) Switch advisers with more than \$60 million in assets under management:



IV. Red Flag Finding – Custody

a. Custody Concerns

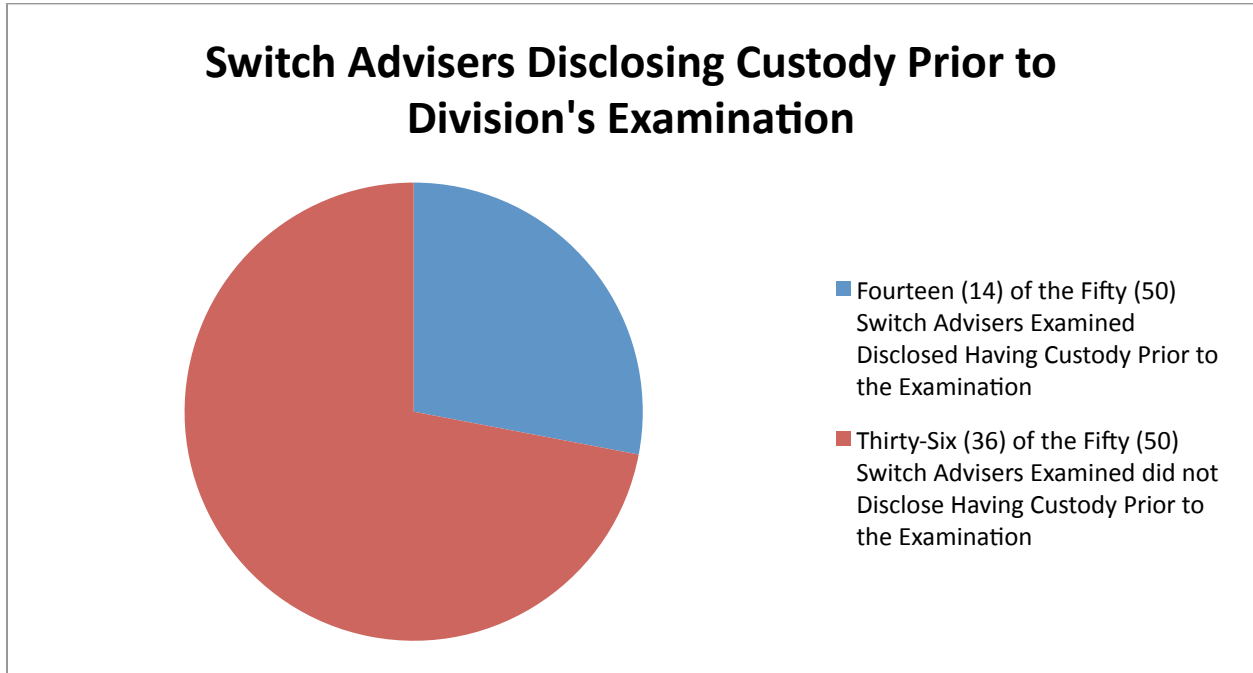
While the Division’s examinations program serves many purposes, its primary objective is the protection of Massachusetts investors. To meet that objective, the Division frequently identifies areas of concern that may increase the possibility of investor harm. Custody is of particular concern to the Division because investors who allow their advisers to maintain custody of their funds and securities are especially vulnerable to fraud and other types of financial harm.

There have been numerous instances in recent history where financial advisers maintaining custody of their clients’ funds or securities have misappropriated those assets. For example, it has been well documented that Bernie Madoff’s Ponzi scheme was accomplished, in part, by taking custody of his clients’ assets and generating his own fraudulent account statements. Additionally, the Division has brought a number of actions in the past several years against financial advisers that took custody of and subsequently misappropriated clients’ assets. In light of these frauds committed by financial advisers with custody, the Division updated its regulations in 2012 to create heightened regulatory requirements for Massachusetts registered investment advisers who maintain custody of client assets.

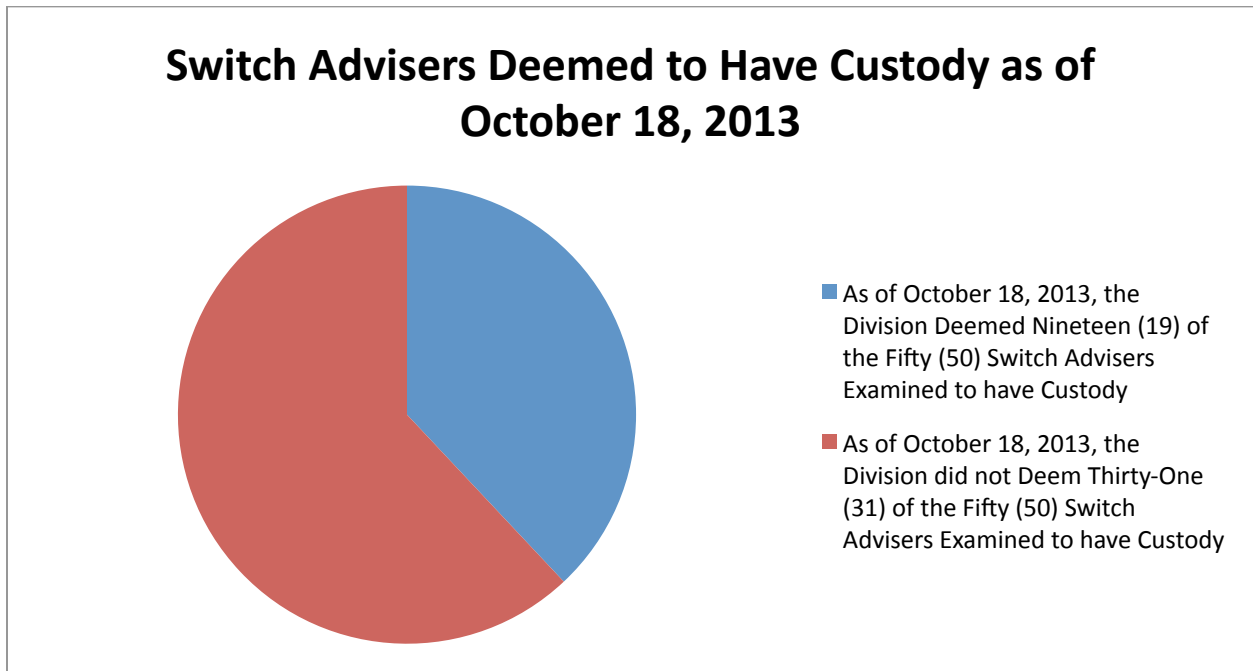
b. Custody Deficiencies

Investment advisers’ retention of custody of clients’ funds or securities has been a common deficiency identified since the Division began to examine Switch advisers. In many instances, advisers unknowingly possessed custody of clients’ trust assets due to the adviser or a related person’s position as a trustee of the trust. The SEC’s failure to examine a majority of the Switch advisers presumably contributed to the Switch advisers’ misunderstanding of the custody rule requirements. Furthermore, the Division’s recent examinations have demonstrated that many advisers do not have a complete understanding of what custody actually entails.

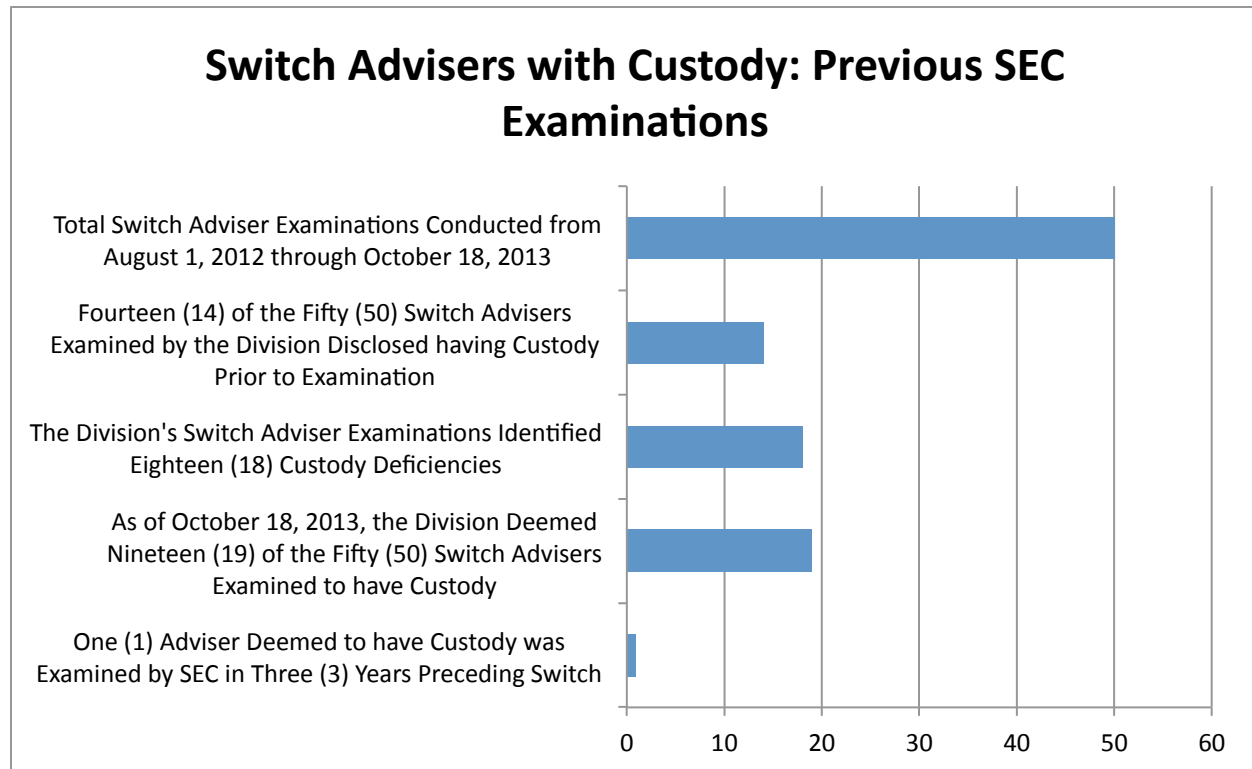
Only fourteen (14) of the fifty (50) Switch advisers examined by the Division disclosed having custody of clients' funds or securities prior to the examination:



As of October 18, 2013, the Division identified five (5) additional Switch advisers that maintained custody of clients' funds or securities without disclosing that they did so on their regulatory filings:



Through its examinations, the Division identified several Switch advisers that maintained custody of clients' funds or securities without disclosing having custody on their regulatory filings. This is especially problematic given the Division's strong concerns regarding investment advisers who maintain custody of clients' funds and securities.



c. Division's Interpretation of Custody

The Division has consistently taken the position that an adviser acting as trustee of a client's trust advisory account suffices as custody. The Form ADV Glossary defines "Custody" as the following:

Custody: Holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. You have custody if a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services you provide to clients. Custody includes:

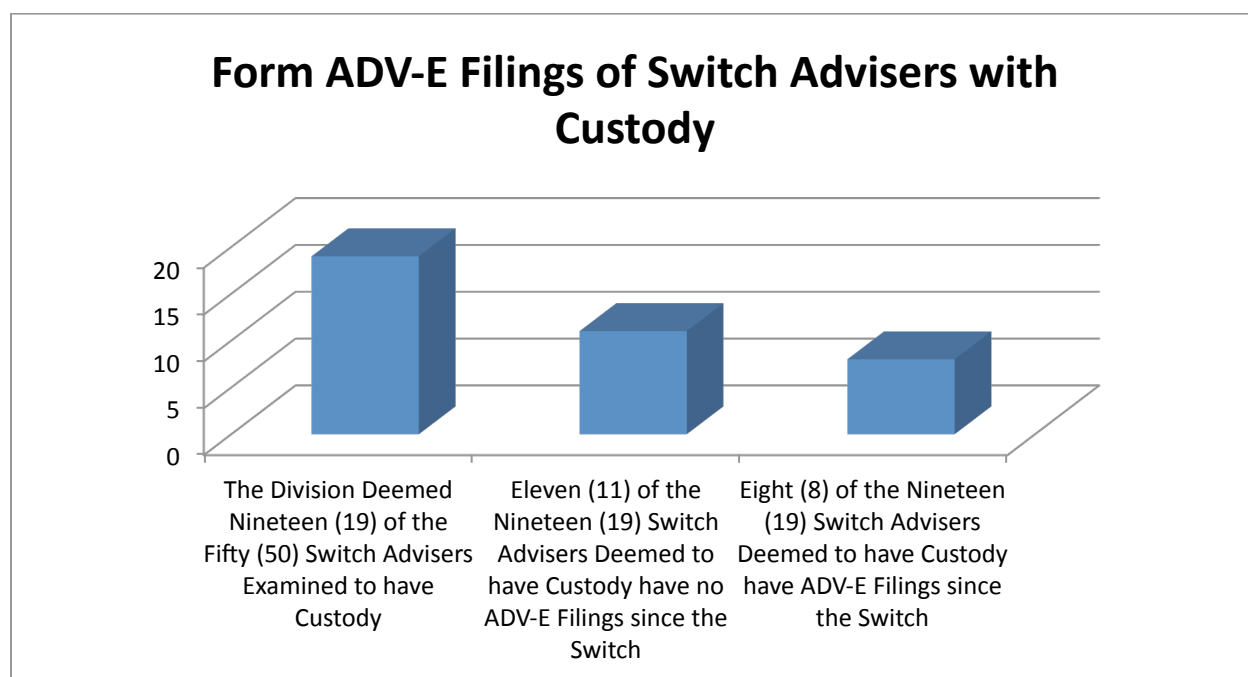
- Possession of client funds or securities (but not of checks drawn by clients and made payable to third parties) unless you receive them inadvertently and you return them to the sender promptly, but in any case within three business days of receiving them;
- Any arrangement (including a general power of attorney) under which you are authorized or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian; and

- Any capacity (such 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 you or your supervised person legal ownership of or access to client funds or securities.

(Emphasis added).

Given the breadth of this definition, the Division has continuously enforced its regulation requiring its registrants with custody to comply with the SEC’s custody rule. Pursuant to the regulation located at 950 Mass. Code Regs. 12.205(5)(b) (“Custody Regulation”), Massachusetts registered investment advisers who maintain custody of clients’ assets must comply with Rule 206(4)-2 under the Investment Advisers Act of 1940 (“Rule 206(4)-2”). Rule 206(4)-2 requires, among other things, that advisers annually undergo a surprise audit by an independent public accountant that is registered with the Public Company Accounting Oversight Board.

Compliance with the Division’s Custody Regulation and Rule 206(4)-2 requires the independent public accountant conducting the surprise examination of the adviser to file Form ADV-E and the certificate of accounting electronically through the Financial Industry Regulatory Authority’s Investment Adviser Registration Depository (“IARD”). The Division regularly monitors investment advisers’ ADV-E filings through the IARD to ensure their compliance with the Custody Regulation and Rule 206(4)-2. Form ADV-E acts as a cover page for a certificate of accounting of securities and funds of which the investment adviser maintains custody. Approximately half of the Switch advisers were examined by the Division and those inspections point out that many of the advisers the Division deems to have custody are not in compliance with the custody requirements because they do not have the required Form ADV-E filings on the IARD.



d. Division's Future Actions Towards Advisers with Custody

In light of the findings contained in this report and the Division's concerns regarding custody, the Division deems it necessary to provide additional guidance to its registrants on the issue of custody. Two points in particular need of clarification are (1) what actually constitutes custody and (2) what the regulatory requirements are for advisers who maintain custody. Accordingly, along with this Report, the Division is also releasing a policy statement on the topic of custody. The Division hopes to clarify issues commonly raised by advisers and to notify the Massachusetts-registered investment adviser community that the Division takes the maintenance of custody and the accompanying regulatory requirements seriously. If advisers are discovered to have custody but are not in compliance with the Division's rules, they will face the possibility of being the subject of an administrative action filed by the Division. Given the fact that custody creates a higher potential of investor harm, the Division believes a regulatory action to enforce the custody requirements would be appropriate and necessary for the protection of Massachusetts investors.

[Massachusetts-Registered Investment Adviser Compliance with Custody and Independent Verification Requirements \(November 14, 2013\)](#)