

Policy Statement

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

Summary Points

- An Investment adviser has custody if its supervised persons are appointed as executors, conservators or trustees of client account(s) and have the authority to withdraw client assets from the client's account(s) (other than for deduction of advisory fees). This is the case even if the executorship, conservatorship, or trusteeship arises as a result of family or personal relationship with the decedent, beneficiary or grantor.
- Advisers directly deducting advisory fees from client accounts will be deemed to have custody unless they comply with certain additional requirements outlined herein.

Custody as a Result of Trusteeships and Other Similar Relationships

During the administration of the Division's investment adviser examinations program, the staff has noted a frequent occurrence of registered investment adviser representatives or other staff of registered investment advisers (collectively, "supervised persons") serving as executors of estates, conservators, or trustees of trusts created by, or for the benefit of, clients. On occasion, these registered investment advisers report on Form ADV, Part 1, Item 9, that they are not maintaining custody of client funds or securities and have not conducted independent verification of client assets pursuant to 950 MASS. CODE REGS. 12.205(5)(b).

Massachusetts registered investment advisers must comply with 950 MASS. CODE REGS. 12.205(5)(b)(1), which provides that "[c]ustody shall have the meaning defined in Rule 206(4)-2(d)(2) under the Investment Advisers Act of 1940. Rule 206(4)-2¹ defines custody as follows:

"Custody" means 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: (i) 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

¹ "Custody of Funds or Securities of Clients by Investment Advisers" under the Investment Advisers Act of 1940,

within three business days of receiving them; (ii) 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 (iii) 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).

The instructions to Form ADV² define the term “client” as “[a]ny of your firm’s investment advisory clients. This term includes clients from which your firm receives no compensation, such as family members of your supervised persons. If your firm also provides other services (e.g., accounting services), this term does not include clients that are not investment advisory clients.”

The Division acknowledges that the United States Securities & Exchange Commission (the “SEC”) may provide limited exceptions from the definition of custody in certain circumstances. Footnote 139 of the adopting release for the most recent amendments to rule 206(4)-2 under the Investment Advisers Act of 1940 (dated December 30, 2009, the “Adopting Release”) provides the following:

When 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.

Federally registered investment advisers are significantly different in size and operations from Massachusetts-registered investment advisers. Most state registered investment advisers are small firms, many times with only one principal. Due to the differences between federal and state registered investment advisers and the subjective nature of the term “family or personal relationship,” the Division has not adopted the SEC’s position articulated in footnote 139 of the Adopting Release.

Investment advisers that have custody of client assets by virtue of trustee relationships (or other similar sorts of relationships) raise significant regulatory concerns because the trustee is generally granted legal authority over the assets held in trust, including the broad authority to

² Publicly available at <http://www.sec.gov/about/forms/formadv-instructions.pdf>.

withdraw or transfer funds from the client account for third party bill payment or for other reasons. These regulatory concerns exist whether the supervised person functions as a sole or co-trustee.

The Division has brought a number of administrative actions in which the victims of grievous financial harm were close acquaintances or family members of the perpetrators. The Division believes that a client who happens to be a family member or who has a personal relationship with an investment adviser's supervised person should be afforded the same protections otherwise provided to investors by the Massachusetts Uniform Securities Act and the regulations thereunder, including the independent verification provisions found in the custody rule.

The Division acknowledges that the independent verification of custodial assets³ entails additional cost to registrants. This cost is outweighed by the additional protections these measures afford to investors.

Custody as a Result of Deduction of Advisory Fees

The Division waives the requirement for independent verification of custodial assets in instances of advisory fee deduction where the only sign of custody is an adviser's withdrawal of advisory fees directly from clients' accounts, provided the adviser: (a) has written authorization from the client to deduct advisory fees from the account held with the qualified custodian; and (b) sends the qualified custodian and client an invoice or statement of the amount of the fee to be deducted from the client's account each time a fee is directly deducted.⁴ Non-compliance with these procedures will result in an adviser being deemed to have custody of client cash, bank accounts, or securities. Documentation demonstrating compliance with these procedures must be maintained and preserved for a period of not less than five (5) years, the first two (2) years in an appropriate office of the investment adviser.

The Division has determined this policy statement to be necessary and appropriate for the public interest, and for the protection of investors and consistent with the purposes fairly intended by the policy and provisions of the Massachusetts Uniform Securities Act and the regulations promulgated thereunder.

Effective November 14, 2013.

³ Specifically incorporated by 950 MASS. CODE REGS. 12.205(5)(b),

⁴ See 950 MASS. CODE REGS. 12.205(5)(b).