

NOTICES OF FINAL RULEMAKING

The Administrative Procedure Act requires the publication of the final rules of the state's agencies. Final rules are those which have appeared in the *Register* first as proposed rules and have been through the formal rulemaking process including approval by the Governor's Regulatory Review Council or the Attorney General. The Secretary of State shall publish the notice along with the Preamble and the full text in the next available issue of the *Register* after the final rules have been submitted for filing and publication.

NOTICE OF FINAL RULEMAKING

TITLE 14. PUBLIC SERVICE CORPORATIONS; CORPORATIONS AND ASSOCIATIONS; SECURITIES REGULATION

CHAPTER 6. CORPORATION COMMISSION INVESTMENT MANAGEMENT

[R06-490]

PREAMBLE

- 1. Sections Affected**

A.A.C. R14-6-101	<u>Rulemaking Action</u>
A.A.C. R14-6-206	Amend
	Amend
- 2. The specific authority for the rulemaking, including both the authorizing statute (general) and the implementing statute (specific):**

Authorizing statute: A.R.S. § 44-3131
Implementing statute: A.R.S. § 44-3241
Constitutional authority: Arizona Constitution, Article XV, § 6
- 3. The effective date of the rule:**

February 12, 2007
- 4. A list of all previous notices appearing in the Register addressing the final rule:**

Notice of Rulemaking Docket Opening: 11 A.A.R. 5220, December 9, 2005
Notice of Proposed Rulemaking: 12 A.A.R. 637, March 3, 2006
- 5. The name and address of agency personnel with whom persons may communicate regarding the rulemaking:**

Name:	Abby Henig
Address:	Arizona Corporation Commission, Securities Division 1300 W. Washington, Third Fl. Phoenix, AZ 85007-2996
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- 6. An explanation of the rule, including the agency's reasons for initiating the rulemaking:**

A.A.C. R14-6-206 ("rule 206") regulates the custody of client funds and securities by investment advisers. A.A.C. R14-6-101 ("rule 101") provides definitions for the terms used in the rules promulgated under Arizona's Investment Management Act.

As reflected in SEC Release No. IA-2176, the Securities and Exchange Commission (the "SEC") amended its rule governing custody of client funds and securities by investment advisers, effective November 5, 2003 with a compliance date of April 1, 2004. The amended rule replaces a labyrinth of no-action letters and provides clear guidance on what constitutes custody and the actions an investment adviser must take when it has custody of client funds and securities.

Under the current set of definitions set forth in rule 101, the term "custody" is not defined. The Securities Division has relied upon federal rules and no-action letters for guidance. This amendment provides clarification as to when an investment adviser has custody of a client's funds or securities.

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Amended rule 206 sets forth procedures for investment advisers to follow once they have custody of a client's funds or securities, i.e. the funds or securities must be maintained by a "qualified custodian" (defined in rule 101), with quarterly statements to be sent to clients. Investment advisers are relieved from sending clients quarterly account statements and undergoing an annual surprise examination if qualified custodians send such quarterly account statement directly to clients.

With the introduction of qualified custodians, the protection of client assets is enhanced. Procedures to be followed by investment advisers once they have custody of client funds or securities are clarified, decreasing their recordkeeping burdens. The amended rules align state regulations with current industry practice and federal regulation.

The Commission amends rule 101 and rule 206 to benefit investors by providing clarity and transparency of information.

7. A reference to any study relevant to the rule that the agency reviewed and either relied on or did not rely on in its evaluation of or justification for the rule, where the public may obtain or review each study, all data underlying each study, and any analysis of each study and other supporting material:

None

8. A showing of good cause why the rule is necessary to promote a statewide interest if the rule will diminish a previous grant of authority of a political subdivision of this state:

Not applicable

9. A summary of the economic, small business, and consumer impact:

The economic, small business, and consumer impact statement for rules 101 and 206 analyzes the costs, savings, and benefits that accrue to the Commission, the regulated public, and the general public. The amendments to rule 101 and rule 206 should decrease Commission costs by reducing the amount of Commission resources expended on the review of annual surprise public accountant examinations of licensed investment advisers that maintain custody of client funds or securities. The costs experienced by the regulated public should also decrease because investment advisers that reasonably believe qualified custodians are providing quarterly account statements directly to clients will be relieved from obtaining surprise annual public accountant examinations and sending quarterly account statements to investors. The Commission does not anticipate that the rules will impose costs upon the general public.

The benefits provided by the amendments to rule 101 and rule 206 are nonquantifiable. The regulated public should benefit from clarification of the definition of "custody" and the responsibilities of the investment adviser when it has custody of client funds or securities. In most cases, the regulated public will benefit from relief from obtaining annual surprise examinations by public accountants. The general public will benefit from the protection afforded by the fact that investor assets in the custody of investment advisers will be in the possession of qualified custodians and that the investor will receive quarterly statements prepared and distributed by the qualified custodian.

The Commission anticipates that the rulemaking may decrease and will not increase monitoring, recordkeeping, or reporting burdens on businesses or persons. The costs of implementation or enforcement are decreased or, if increased, are only marginally increased and such increase does not equal or exceed the reduction in burdens.

10. A description of the changes between the proposed rule, including supplemental notices, and the final rule:

None

11. A summary of the comments made regarding the rule and the agency response to them:

The Commission did not receive written comments to the rules.

12. Any other matters prescribed by statute that are applicable to the specific agency or to any specific rule or class of rules:

None

13. Any material incorporated by reference and its location in the text:

None

14. Whether the rule was previously made as an emergency rule and, if so, whether the text was changed between the making as an emergency and the making of the final rule:

Not applicable

15. The full text of the rule follows:

**TITLE 14. PUBLIC SERVICE CORPORATIONS; CORPORATIONS AND ASSOCIATIONS;
SECURITIES REGULATION**

**CHAPTER 6. CORPORATION COMMISSION
INVESTMENT MANAGEMENT**

ARTICLE 1. GENERAL PROVISIONS RELATING TO THE ARIZONA INVESTMENT MANAGEMENT ACT

Section

R14-6-101. Definitions

ARTICLE 2. DUTIES OF INVESTMENT ADVISERS AND INVESTMENT ADVISER REPRESENTATIVES

Section

R14-6-206. Custody of Client Funds or Securities by Investment Advisers

ARTICLE 1. GENERAL PROVISIONS RELATING TO THE ARIZONA INVESTMENT MANAGEMENT ACT

R14-6-101. Definitions

- A. The definitions set forth in A.R.S. §§ 44-1801 and 44-3101 shall apply to the rules promulgated under A.R.S. Title 44, Chapter 13.
- B. The following definitions shall apply to all rules promulgated under A.R.S. Title 44, Chapter 13, unless the context otherwise requires:
1. "Advertisement" means, except as set forth in subsections (d) and (e), any notice, circular, letter, or other written, oral, or electronically generated communication addressed to or reasonably designed by the investment adviser or investment adviser representative to be accessed by more than one person, or any notice or other announcement in any publication or by radio or television, that directly or indirectly offers:
 - a. Any analysis, report, or publication that either concerns securities, or is to be used in making any determination as to when to buy or sell any security or which security to buy or sell; or
 - b. Any graph, chart, formula, or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell; or
 - c. Any other investment advisory service with regard to securities;
 - d. A communication over a computer ~~on-line~~ online service including but not limited to an electronic bulletin board shall not be deemed to be an advertisement when an investment adviser or an investment adviser representative is either:
 - i. Engaged in a discussion regarding securities and does not receive compensation from any person for the discussion; or
 - ii. Responds to unsolicited inquiries regarding the provision of investment advisory services.
 - e. A communication by one or more investment advisers or investment adviser representatives shall not be deemed to be an advertisement when the communication is addressed solely to or is reasonably designed to be accessed solely by other investment advisers or investment adviser representatives.
 2. "Certified public accountant" or "CPA" means an accountant who has been registered or licensed to practice public accounting and is permitted to use the title "certified public accountant" and to use the initials "CPA" after the accountant's name.
 3. "Custody" means holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. Custody includes:
 - a. Possession of client funds or securities (but not of checks drawn by clients and made payable to third parties), unless received inadvertently and returned to the sender promptly, but in any case within three business days of receiving them;
 - b. Any arrangement (including a general power of attorney) under which the investment adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the investment adviser's instruction to the custodian; and
 - c. 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 the investment adviser or the investment adviser representative legal ownership of or access to client funds or securities.
 - 3-4. "Federal covered adviser" means an investment adviser registered under the Investment Advisers Act of 1940.
 - 4-5. "Fixed fee basis" means an investment advisory fee that at any given time can be precisely established in a dollar amount without regard to the investment performance or value of an account and that is not based on the purchase or sale of specific securities.
 - 5-6. "Form ADV" means the Uniform Application for Investment Adviser Registration, 17 CFR 279.1, as required by A.R.S. § 44-3153.
 - 6-7. "IM Act" means the Arizona Investment Management Act, A.R.S. § 44-3101 *et seq.*
 - 7-8. "Impersonal advisory services" means investment advisory services provided solely:
 - a. By means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts;
 - b. Through the issuance of statistical information containing no expression of opinion as to the investment merits of a particular security; or

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- c. Any combination of the foregoing services.
- 9. “Independent representative” means a person that:
 - a. Acts as agent for a client, including in the case of a pooled investment vehicle, for limited partners of a limited partnership (or members of a limited liability company, or other beneficial owners of another type of pooled investment vehicle) and by law or contract is obliged to act in the best interest of the advisory client or the limited partners (or members, or other beneficial owners);
 - b. Does not control, is not controlled by, and is not under common control with the investment adviser; and
 - c. Does not have, and has not had within the past two years, a material business relationship with the investment adviser.
- ~~8-10.~~ “Internet” means all proprietary or common carrier electronic systems, or similar media.
- ~~9-11.~~ “Internet communication” means the distribution of information on the Internet.
- ~~10-12.~~ “Investment-related” means pertaining to securities, commodities, banking, insurance, or real estate, including but not limited to acting as or being associated with a broker-dealer, investment company, investment adviser, government securities broker or dealer, municipal securities dealer, bank, savings and loan association, entity, or person required to be registered under the Commodity Exchange Act, or a fiduciary.
- ~~11-13.~~ “Involved” means acting or aiding, abetting, causing, counseling, commanding, inducing, conspiring with, or failing reasonably to supervise another in doing an act.
- ~~12-14.~~ “Management person” means a person with power to exercise, directly or indirectly, a controlling influence over the management or policies of an investment adviser that is a company or to determine the general investment advice given to clients.
- ~~13-15.~~ “NASAA” means the North American Securities Administrators Association, Inc., or any successor organization.
- ~~14-16.~~ “NASD” means the National Association of Securities Dealers, Inc., or any successor or subsidiary organization.
- 17. “Qualified custodian” means:
 - a. A bank or a savings association that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act;
 - b. A broker or dealer registered under Section 15(b)(1) of the Securities Exchange Act of 1934, holding the client assets in customer accounts;
 - c. A futures commission merchant registered under Section 4f(a) of the Commodity Exchange Act, holding the client assets in customer accounts, but only with respect to clients’ funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; and
 - d. A foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the clients’ assets in customer accounts segregated from its proprietary assets.
- ~~15-18.~~ “Relative” means any relationship by blood, marriage, or adoption, not more remote than 1st cousin.
- ~~16-19.~~ “Rule 204-2” means United States securities and exchange commission Securities and Exchange Commission rule 204-2, 17 CFR 275.204-2 (1998), which is incorporated by reference, does not contain any later amendments or editions, and is on file in the office of the secretary of state Secretary of State. Copies of Rule 204-2 are available from the Division and from the Superintendent of Documents, Government Printing Office, Washington, D.C. 20402.
- ~~17-20.~~ “SEC” means United States Securities and Exchange Commission.
- ~~18-21.~~ “Securities Act” means the Securities Act of Arizona, A.R.S. § 44-1801 et seq.
- ~~19-22.~~ “Self-regulatory organization” or “SRO” means any national securities or commodities exchange, registered association, or registered clearing agency.
- ~~20-23.~~ “Unincorporated organization” includes a limited liability company for purposes of the definition of “person,” as defined in A.R.S. § 44-1801.
- ~~21-24.~~ “Wrap fee program” means a program under which any client is charged a specified fee or fees not based directly upon transactions in a client’s account for investment advisory services, which may include portfolio management or advice concerning the selection of other investment advisers, and execution of client transactions.

R14-6-206. Custody of Client Funds or Securities by Investment Advisers

- A. Except as otherwise provided in this Section, it shall constitute a fraudulent practice within the meaning of A.R.S. § 44-3241(A)(4) for any investment adviser to take or have custody of any securities or funds of any client unless:
 - 1. The investment adviser notifies the Commission in writing that the investment adviser has or may have custody of client funds or securities. Such notification may be given on Form ADV.
 - 2. ~~The securities of each client are segregated, marked to identify the particular client having the beneficial interest therein, and held in safekeeping in some place reasonably free from risk of destruction or other loss. A qualified custodian maintains those funds and securities:~~
 - a. In a separate account for each client under that client’s name; or
 - b. In accounts containing only clients’ funds and securities, maintained in the name of the investment adviser as agent or trustee for such clients.
 - 3. ~~All client funds are deposited in one or more bank or similar accounts containing only clients’ funds, such accounts~~

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are maintained in the name of the investment adviser as agent or trustee for such clients, and the investment adviser maintains a separate record for each such account showing the name and address of the bank or similar institution where the account is maintained, the dates and amounts of deposits into and withdrawals from the account, and the exact amount of each client's beneficial interest in the account. If opening an account with a qualified custodian, either under the client's name or under the investment adviser's name as agent, the investment adviser notifies the client in writing of the qualified custodian's name, address, and the manner in which the funds or securities are maintained, promptly when the account is opened and following any changes to this information.

4. Immediately after accepting custody or possession of funds or securities from any client, the investment adviser notifies the client in writing of the place where and the manner in which the funds and securities will be maintained and, subsequently, if and when there is a change in the place where or the manner in which the funds or securities are maintained, the investment adviser gives written notice to the client within ten business days. Account statements are sent to clients at least quarterly, either:
 - a. By a qualified custodian, if the investment adviser has a reasonable basis for believing that the qualified custodian sends the requisite account statement to each client for which it maintains funds or securities, identifying the amount of funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period; or
 - b. By the investment adviser, to each client for whom it has custody of funds or securities, identifying the amount of funds and of each security of which it has custody at the end of the period and setting forth all transactions in the account during that period if:
 - i. An independent certified public accountant verifies all of those client funds and securities by actual examination at least once during each calendar year, at a time chosen by the accountant, without prior notice or announcement to the investment adviser, that is irregular from year to year; and
 - ii. The independent certified public accountant files a copy of the auditor's report and financial statements with the Commission within 30 calendar days after the completion of the examination, along with a letter stating that it has examined the funds and securities, describing the nature and extent of the examination; and
 - iii. Upon finding any material discrepancies during the course of the examination, the independent certified public accountant notifies the Commission within one business day of the finding, by means of a fax transmission or electronic mail, followed by first-class mail.
5. At least once every three months, the investment adviser sends each client an itemized statement showing the client's funds and securities in the investment adviser's custody at the end of such period and all debits, credits, and transactions in the client's account during such period.
6. At least once every calendar year, an independent CPA or public accountant verifies all client funds and securities by actual examination at a time chosen by the independent CPA or public accountant without prior notice to the investment adviser. The independent CPA's or public accountant's report stating that such CPA or public accountant has made an examination of such funds and securities, and describing the nature and extent of the examination, shall be filed with the Commission within 30 calendar days after the examination.
- B.** If the investment adviser is a general partner of a limited partnership (or managing member of a limited liability company, or holds a comparable position for another type of pooled investment vehicle), the account statements required under subsection (A)(4) must be sent to each limited partner (or member or other beneficial owner).
- C.** A client may designate an independent representative to receive, on his behalf, notices and account statements as required under subsections (A)(3) and (A)(4).
- D.** With respect to shares of an open-end company, the company's transfer agent may be used in lieu of a qualified custodian for purposes of complying with subsection (A).
- E.** An investment adviser is not required to comply with this Section with respect to certain privately offered securities that are:
 1. Acquired from the issuer in a transaction or chain of transactions not involving any public offering; uncertificated, and ownership thereof is recorded only on books of the issuer to its transfer agent in the name of the client; and transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.
 2. Notwithstanding subsection (E)(1), the exception provided by subsection (E) is available with respect to securities held for the account of a limited partnership (or limited liability company, or other type of pooled investment vehicle) only if the limited partnership is audited, and the audited financial statements are distributed, as described in subsection (F).
- F.** The investment adviser is not required to comply with subsections (A)(4) and (B) with respect to the account of a limited partnership (or limited liability company, or another type of pooled investment vehicle) that is subject to audit at least annually and distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or members or other beneficial owners) within 120 days of the end of its fiscal year.
- G.** Compliance with this Section is not required with respect to the account of an investment company registered under the Investment Company Act of 1940.
- BH.** With respect to federal covered advisers, the provisions of this Section only apply to the extent permitted by Section 203A

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of the Investment Advisers Act of 1940.