



California Corporate & Securities Law

Commissioner Invites Comments On Adopting New Custody Rule

July 11, 2011

Investment advisers frequently have custody, either directly or indirectly, of their clients assets. Obviously, custody of another's assets can lead to infidelity. In the words of the satirist Juvenal, the question necessarily becomes "*sed quis custodiet ipsos custodes?* (but who shall guard the guards?).

In the case of registered investment advisers, securities regulators are the guards. Unfortunately, these guards have not always been effective.

In 2000, the North American Securities Administrators Association (NASAA) adopted a model custody rule. NASAA amended the rule in 2004 and 2005. The current version of NASAA's model rule can be read [here](#).

In 2010, the Securities and Exchange Commission [amended](#) its custody rule to, among other things, require federally registered investment advisers to undergo an annual surprise examination by an independent public accountant to verify client assets; to have the qualified custodian maintaining client funds and securities send account statements directly to the advisory clients; and unless client assets are maintained by an independent custodian (*i.e.*, a custodian that is not the adviser itself or a related person), to obtain, or receive from a related person, a report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board (PCAOB).

The Department of Corporation's custody rule, 10 CCR § 260.237, has not kept pace with these changes. Last Friday, Commissioner [Preston DuFauchard](#), issued this [invitation for comments](#) regarding proposed amendments to California's custody rule. These changes will have greater impact due to the expected increase in the number of state licensed investment advisers as a result of the enactment of the Dodd-Frank Act last year.

In general, the Commissioner is proposing to follow the NASAA model, with some exceptions. In particular, the proposed rule will allow advisers to pooled investment vehicles that select the independent gatekeeper option to be subject to the same account statement requirements as advisers that select the audit exception.

Please contact [Keith Paul Bishop](#) at Allen Matkins for more information kbishop@allenmatkins.com

<http://www.calcorporatelaw.com/>

[Here](#) is the text of the proposed custody rule. Comments are due by August 5, 2011. If you miss that deadline, you can still submit comments if the Department decides to initiate formal rulemaking.

The recent regulatory breakdowns on the part of the SEC with respect to Bernie Madoff and others shows that the problem of who will monitor the monitors remains. As Glaucon remarked to Socrates in Plato's Republic: "γελοῖον γάρ, ἢ δ' ὄς, τὸν γε φύλακα φύλακος δεῖσθαι." ("For, it is risible - a guard to stand in need of a guard.").

Please contact **Keith Paul Bishop** at Allen Matkins for more information kbishop@allenmatkins.com

<http://www.calcorporatelaw.com/>