

OPEN MEETING ITEM



0000050858

ORIGINAL



COMMISSIONERS
JEFF HATCH-MILLER - Chairman
WILLIAM A. MUNDELL
MARC SPITZER
MIKE GLEASON
KRISTIN K. MAYES

ARIZONA CORPORATION COMMISSION

22

DATE: June 1, 2006

DOCKET NO.: RS-00000A-05-0809

TO ALL PARTIES:

Enclosed please find the recommendation of Administrative Law Judge Marc E. Stern. The recommendation has been filed in the form of an Opinion and Order on:

RULEMAKING
(Amend R14-6-101 and R14-6-206)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and thirteen (13) copies of the exceptions with the Commission's Docket Control at the address listed below by **4:00 p.m.** on or before:

JUNE 12, 2006

The enclosed is NOT an order of the Commission, but a recommendation of the Administrative Law Judge to the Commissioners. Consideration of this matter has tentatively been scheduled for Open Meeting to be held on:

JUNE 22, 2006

For more information, you may contact Docket Control at (602)542-3477 or the Hearing Division at (602)542-4250. For information about the Open Meeting, contact the Executive Director's Office at (602) 542-3931.

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AZ CORP COMMISSION
DOCUMENT CONTROL

BRIAN C. McNEIL
EXECUTIVE DIRECTOR

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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

JEFF HATCH-MILLER Chairman
WILLIAM A. MUNDELL
MARC SPITZER
MIKE GLEASON
KRISTIN K. MAYES

IN THE MATTER OF THE PROPOSED
RULEMAKING TO AMEND A.A.C. R14-6-101
and R14-6-206.

DOCKET NO. RS-00000A-05-0809
DECISION NO. _____

OPINION AND ORDER

DATE OF HEARING: April 18, 2006
PLACE OF HEARING: Phoenix, Arizona
ADMINISTRATIVE LAW JUDGE: Marc E. Stern
APPEARANCES: Ms. Abby Henig, Assistant General Counsel, on behalf of the Securities Division of the Arizona Corporation Commission.

BY THE COMMISSION:

On January 19, 2006, the Securities Division ("Division") of the Arizona Corporation Commission ("Commission") forwarded a proposal recommending that the Commission amend A.A.C. R14-6-101 ("Rule 101") and A.A.C. R14-6-206 ("Rule 206").¹

On December 9, 2005, the Notice of Rulemaking Docket Opening was published in the Arizona Administrative Register ("Register").

On February 2, 2006, the Commission issued Decision No. 68458, which directed the Hearing Division to schedule a hearing on the Division's proposed amendment to Rules 101 and 206 for the purpose of taking public comment.

On February 7, 2006, by Procedural Order, a public comment hearing was scheduled for April 18, 2006.

On March 3, 2006, the Notice of Proposed Rulemaking was published in the Register.

¹ Rule 101 provides the definitions of terms used in the rules promulgated under Arizona's Investment Management Act ("IM Act"). Rule 206 contains the basic requirements for the regulation of an Arizona registered investment adviser ("IA") who has custody of a client's funds or securities.

1 On April 18, 2006, a public comment hearing on Rules 101 and 206 was held before a duly
 2 authorized Administrative Law Judge at the Commission's offices in Phoenix, Arizona. The Division
 3 appeared through counsel. There were neither any formal comment letters received nor any members
 4 of the public who appeared to make public comment on either Rule 101 or Rule 206 at the hearing
 5 following the Notice of Proposed Rulemaking.

6 * * * * *

7 Having considered the entire record herein and being fully advised in the premises, the
 8 Commission finds, concludes, and orders that:

9 **FINDINGS OF FACT**

10 1. Effective April 1, 2004, the Securities and Exchange Commission ("S.E.C.") amended
 11 17 C.F.R. § 275.206(4)-2, its rule governing custody of client funds and securities by IAs subject to
 12 the Investment Advisors Act of 1940, the provisions of which are incorporated by the IM Act.

13 2. On January 19, 2006, the Division forwarded to the Commission a proposal
 14 recommending that the Commission amend Rules 101 and 206.

15 3. On December 9, 2005, pursuant to law, the Notice of Rulemaking Docket Opening
 16 was published in the Register.

17 4. On February 2, 2006, the Commission issued Decision No. 68458, which directed that
 18 a hearing be scheduled regarding Rules 101 and 206 for the purpose of taking public comment.

19 5. On February 7, 2006, by Procedural Order, the Commission scheduled a public
 20 comment hearing on April 18, 2006.

21 6. On March 3, 2006, the Notice of Proposed Rulemaking was published in the Register.

22 7. On April 18, 2006, the public comment hearing was held as scheduled. After the
 23 publication of the Notice of Proposed Rulemaking, no members of the public appeared to make
 24 comment on the proposed amendment of Rules 101 and 206 and no formal written comments
 25 concerning the amendment of Rules 101 and 206 were filed with the Commission.

26 8. Rule 101 sets forth the definition of terms used in rules promulgated under the IM Act,
 27 and Rule 206 regulates the customer practices of IAs in Arizona who are subject to the provisions of
 28 the IM Act when they have custody of a client's funds or securities, and Rule 101 sets forth the

1 definition of terms used in rules promulgated under the IMA.

2 9. The Division proposes the amendment to Rules 101 and 206 to incorporate the
3 S.E.C.'s recent amendments to the federal rule to clearly establish certain requirements which will
4 establish whether an IA has custody of a client's funds or securities.

5 10. Under the current set of definitions in Rule 101, the term "custody" is not defined and
6 the Division has relied upon the federal rules and "no-action" letters for a means to define the term.

7 11. With the S.E.C. amendment of 17 C.F.R. §275.206(4)-2, "custody" includes custody
8 by actual possession, custody by legal right and custody by legal capacity.

9 12. With the amendment of Rule 101, a definition of "custody" and also a definition of a
10 "qualified custodian" will be added defining who may lawfully hold a client's funds or securities.²

11 13. With the amendment of Rule 206, if an IA has custody of a client's funds:

- 12 • a "qualified custodian" must hold them either in a separate account for each client
13 under the client's name or in accounts under the IA's name as agent or trustee;
- 14 • the client must be notified of the location of the funds or securities;
- 15 • quarterly account statements are provided to clients or their representatives by
16 either the IA or the "qualified custodian"; and
- 17 • if the IA provides the quarterly statement, then it is subject to an annual
18 unscheduled verification of client funds or securities by an independent public
19 accountant employed by the "qualified custodian."

20 14. The approval of the Division's recommended amendments to Rules 101 and 206 by
21 the Commission will enhance an Arizona investor's protection under the IM Act.

22 15. The Division believes that the amendments of Rules 101 and 206 are in the public
23 interest and are reasonably necessary to carry out the provisions of the Arizona IM Act, and will
24 benefit the public and investors by defining what constitutes custody of a client's funds and securities
25 and clarifying how compliance can best be achieved by an IA who is holding the funds or securities
26 of a client.

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28 ² Generally, a federally insured bank or a registered broker or dealer.

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IT IS FURTHER ORDERED that the Commission's Securities Division is authorized to make non-substantive changes to the adopted rules, A.A.C. R14-6-101 and A.A.C. R14-6-206, in response to comments received from the Attorney General's office during the approval process under A.R.S. § 41-1044 unless, after notification of those changes, the Commission requires otherwise.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN

COMMISSIONER

COMMISSIONER

COMMISSIONER

COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive Director of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this ____ day of _____, 2006.

BRIAN C. McNEIL
EXECUTIVE DIRECTOR

DISSENT _____

DISSENT _____

MES:mj

1 SERVICE LIST FOR:

RULEMAKING TO AMEND RULES 101 AND 206

2 DOCKET NO.:

RS-00000A-05-0809

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4 Matt Neubert
5 Securities Division
6 ARIZONA CORPORATION COMMISSION
7 1200 West Washington Street
8 Phoenix, AZ 85007
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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 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
 - 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 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. 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 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.
- B.H. With respect to federal covered advisers, the provisions of this Section only apply to the extent permitted by Section 203A of the Investment Advisers Act of 1940.