

ORIGINAL



MEMORANDUM

57

Abby Henig, Assistant General Counsel  
Corporation Commission—Securities Division  
Direct line: 602-542-0187  
Facsimile: 602-594-7402  
E-mail: ahenig@azcc.gov

TO: Docket Control  
FROM: Abby Henig *QH*  
DATE: September 8, 2006  
RE: Docket # RS-00000A-05-0809

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Please file the attached letter to the office of the attorney general, notice of final rulemaking, and agency certificate in docket # RS-00000A-05-0809. No distribution is necessary.

Thank you.

Arizona Corporation Commission

DOCKETED

SEP 12 2006

DOCKETED BY	<i>QH</i>
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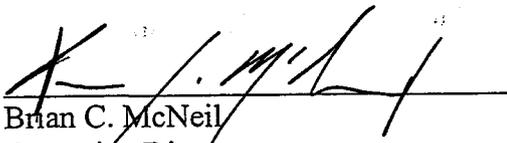
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2006 SEP 12 1 A 9 51  
AZ CORP COMMISSION  
DOCUMENT CONTROL

AGENCY CERTIFICATE  
NOTICE OF FINAL RULEMAKING

1. Agency name: Arizona Corporation Commission, Securities Division
2. Chapter heading: Chapter 6. Corporation Commission, Investment Management
3. Code citation for the Chapter: 14 A.A.C. 6
4. The Subchapters, if applicable; the Articles; the Parts, if applicable; and the Sections involved in the rulemaking, listed in numerical order:

<u>Subchapters, Articles, Parts, and Sections</u>	<u>Action</u>
Article 1, Section R14-6-101	Amend
Article 2, Section R14-6-206	Amend

5. The rules contained in this package are true and correct versions of the rules made by the agency.

6.  \_\_\_\_\_ 23 JUN 06 \_\_\_\_\_  
Date  
Brian C. McNeil  
Executive Director  
Arizona Corporation Commission

7. Exempt from Governor's Regulatory Review Council: A.R.S. § 41-1057

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

BRIAN C. McNEIL  
EXECUTIVE DIRECTOR



MATTHEW J. NEUBERT  
DIRECTOR

SECURITIES DIVISION  
1300 West Washington, Third Floor  
Phoenix, AZ 85007  
TELEPHONE: (602) 542-4242  
FAX: (602) 594-7470  
E-MAIL: securitiesdiv@azcc.gov

**ARIZONA CORPORATION COMMISSION**

June 27, 2006

The Honorable Terry Goddard  
Attorney General  
1275 West Washington  
Phoenix, Arizona 85007

Re: A.A.C. R14-6-101 and R14-6-206

Dear Mr. Goddard:

The above-referenced rules were amended on June 23, 2006, by the Arizona Corporation Commission ("ACC"), subject to approval by the Attorney General.

The following information is provided for your use in reviewing the enclosed rule for approval pursuant to A.R.S. § 41-1044:

I. Agency Rules Not Published in Code

To my knowledge, the only ACC rule not yet published in the Code, other than this rule, is revised R14-4-149, recently filed with the Secretary of State by your office and currently awaiting publication in the Code.

II. Procedures Followed

The ACC's rulemaking process was as follows:

- (1) A Notice of Rulemaking Docket Opening was published in the Arizona Administrative Register in 11 A.A.R. 5220, December 9, 2005.
- (2) A Notice of Proposed Rulemaking was published in the Arizona Administrative Register in 12 A.A.R. 637-642, March 3, 2006.
- (3) The Notice of Proposed Rulemaking provided notice of the public hearing (oral proceedings) for the rule. In addition, on April 5 and April 12, 2006, the ACC posted notice of the public hearing in compliance with Arizona open meeting laws.

- (4) No supplemental notices were made in this rulemaking proceeding.
- (5) Public participation pursuant to A.R.S. § 41-1023 was as follows:
  - (a) The ACC accepted written comments through April 18, 2006, the date of the public hearing.
  - (b) No request was made for an oral proceeding; however, the ACC scheduled an oral proceeding for the rules.
  - (c) A public hearing (oral proceeding) occurred on April 18, 2006.
- (6) The ACC closed the record on the rules at its June 22, 2006, open meeting.
- (7) The ACC amended the rules by unanimous vote during the June 22, 2006, open meeting. The signed order making the rules is dated June 23, 2006.
- (8) The ACC complied with the open meeting laws, where applicable.
- (9) The ACC's statutes do not specifically require any other procedures.

III. Supporting Documents

I have enclosed, for your information, the following documents:

- (1) Original and two copies of the Notice of Final Rulemaking, including the preamble and text of the new rules.
- (2) Original and two copies of the ACC's Agency Certificate.
- (3) Original and two copies of the ACC's Agency Receipt.
- (4) Original form for Attorney General's approval of final rules.
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- (8) One copy of the transcript of the public hearing on the rule.
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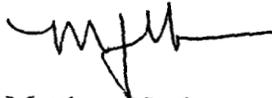
The Honorable Terry Goddard  
June 27, 2006  
Page 3

Under A.R.S. § 41-1055(D)(3), the ACC is not required to prepare an Economic, Small Business And Consumer Impact Statement for this rulemaking.

Please let me know if you would like any additional copies of these items. We have included a disk containing the Notice of Final Rulemaking in rich text format for the secretary of state. My understanding is that you will forward the final rulemaking packet (including the disk) to the secretary of state.

Please let me know if I can be of any assistance to you in your review process. My direct line is 542-0643. You should also feel free to contact Abby Henig, Assistant General Counsel for the Division, at 542-0187. Thank you for your cooperation.

Very truly yours,



Matthew Neubert  
Director of Securities

cc: Jeffrey Hatch-Miller, Chairman (w/o encl.)  
William A. Mundell, Commissioner (w/o encl.)  
Marc Spitzer, Commissioner (w/o encl.)  
Mike Gleason, Commissioner (w/o encl.)  
Kristin K. Mayes, Commissioner (w/o encl.)  
Brian C. McNeil, Executive Director (w/o encl.)  
Cheryl Farson, General Counsel (w/o encl.)

NOTICE OF FINAL RULEMAKING

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

CHAPTER 6. CORPORATION COMMISSION—INVESTMENT MANAGEMENT

PREAMBLE

1. 

<u>Sections Affected</u>	<u>Rulemaking Action</u>
A.A.C. R14-6-101	Amend
A.A.C. R14-6-206	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:  
The rule is effective 60 days after the date filed with the office of the secretary of state.
  
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 Floor  
Phoenix, AZ 85007-2996

Telephone: (602) 542-0187  
Fax Number: (602) 594-7402

E-mail: ahenig@azcc.gov

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.

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 advisors 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 record keeping 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:

Pursuant to A.R.S. § 41-1055(D)(3), the Commission is exempt from providing an economic, small business, and consumer impact statement.

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

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.

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MEMORANDUM

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Abby Henig, Assistant General Counsel  
Corporation Commission—Securities Division  
Direct line: 602-542-0187  
Facsimile: 602-594-7402  
E-mail: ahenig@azcc.gov

TO: Docket Control  
FROM: Abby Henig *QH*  
DATE: September 8, 2006  
RE: Docket # RS-00000A-05-0809

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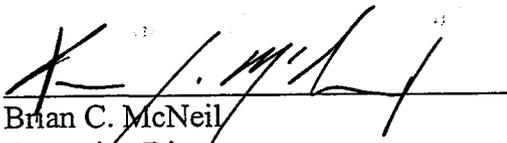
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Brian C. McNeil Date  
Executive Director  
Arizona Corporation Commission

7. Exempt from Governor's Regulatory Review Council: A.R.S. § 41-1057

**COMMISSIONERS**  
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SECURITIES DIVISION  
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**ARIZONA CORPORATION COMMISSION**

June 27, 2006

The Honorable Terry Goddard  
Attorney General  
1275 West Washington  
Phoenix, Arizona 85007

Re: A.A.C. R14-6-101 and R14-6-206

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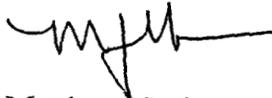
The Honorable Terry Goddard  
June 27, 2006  
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Under A.R.S. § 41-1055(D)(3), the ACC is not required to prepare an Economic, Small Business And Consumer Impact Statement for this rulemaking.

Please let me know if you would like any additional copies of these items. We have included a disk containing the Notice of Final Rulemaking in rich text format for the secretary of state. My understanding is that you will forward the final rulemaking packet (including the disk) to the secretary of state.

Please let me know if I can be of any assistance to you in your review process. My direct line is 542-0643. You should also feel free to contact Abby Henig, Assistant General Counsel for the Division, at 542-0187. Thank you for your cooperation.

Very truly yours,



Matthew Neubert  
Director of Securities

cc: Jeffrey Hatch-Miller, Chairman (w/o encl.)  
William A. Mundell, Commissioner (w/o encl.)  
Marc Spitzer, Commissioner (w/o encl.)  
Mike Gleason, Commissioner (w/o encl.)  
Kristin K. Mayes, Commissioner (w/o encl.)  
Brian C. McNeil, Executive Director (w/o encl.)  
Cheryl Farson, General Counsel (w/o encl.)

NOTICE OF FINAL RULEMAKING

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

CHAPTER 6. CORPORATION COMMISSION—INVESTMENT MANAGEMENT

PREAMBLE

1. 

<u>Sections Affected</u>	<u>Rulemaking Action</u>
A.A.C. R14-6-101	Amend
A.A.C. R14-6-206	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:  
The rule is effective 60 days after the date filed with the office of the secretary of state.
  
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
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Address: Arizona Corporation Commission, Securities Division  
1300 W. Washington, Third Floor  
Phoenix, AZ 85007-2996

Telephone: (602) 542-0187  
Fax Number: (602) 594-7402

E-mail: ahenig@azcc.gov

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.

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 advisors 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 record keeping 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:

Pursuant to A.R.S. § 41-1055(D)(3), the Commission is exempt from providing an economic, small business, and consumer impact statement.

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

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.