

Kansas Administrative Regulations

Department of Insurance Assistant Commissioner, Securities Division

Article 14.—Investment Advisers and Investment Adviser Representatives

81-14-9. Custody of client funds or securities; safekeeping; financial reporting.

(a) Definitions. For the purposes of this regulation, the following definitions shall apply:

(1) "Custody" means holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them or the ability to appropriate them.

(A) Each of the following circumstances shall be deemed to constitute custody:

(i) Possession of client funds or securities unless received inadvertently and returned to the sender promptly, but in any case within three business days of receiving the funds or securities;

(ii) any arrangement, including a general power of attorney, under which an investment adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the adviser's instruction to the custodian; and

(iii) any arrangement that gives an investment adviser or its supervised person legal ownership of or access to client funds or securities, which may include an arrangement in which the investment adviser or its supervised person is the trustee of a trust, the general partner of a limited partnership, the managing member of a limited liability company, or a comparable position for a pooled investment vehicle.

(B) Receipt of a check drawn by a client and made payable to an unrelated third party shall not meet the definition of custody if the investment adviser forwards the check to the third party within three business days of receipt and the adviser maintains the records required under K.A.R. 81-14-4(b)(22).

(2) "Independent party" means a person that meets the following conditions:

(A) Is engaged by an investment adviser to act as a gatekeeper for the payment of fees, expenses, and capital withdrawals from a pooled investment;

(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.

(3) "Independent representative" means a person who meets the following conditions:

(A) Acts as an agent for an advisory client, which may include a person who acts as an agent for limited partners of a pooled investment vehicle structured as a limited partnership, members of a pooled investment vehicle structured as a limited liability company, or other beneficial owners of another type of pooled investment vehicle;

(B) is obliged by law or contract to act in the best interest of the advisory client or the limited partners, members, or other beneficial owners;

(C) does not control, is not controlled by, and is not under common control with the investment adviser; and

(D) does not have, and has not had within the past two years, a material business relationship with the investment adviser.

(4) "Qualified custodian" means any of the following independent institutions or entities:

(A) A bank or savings association that has deposits insured by the federal deposit insurance corporation;

(B) a broker-dealer registered under the act who holds client assets in customer accounts and complies with K.A.R. 81-3-7(d);

(C) a futures commission merchant registered under section 6f of the commodity exchange act, 7 U.S.C. § 6f, who holds 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 and options of the commodity for future delivery; and

(D) a foreign financial institution that customarily holds financial assets for its customers, if the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets.

(b) Safekeeping of client funds and securities.

(1) Requirements. An investment adviser registered or required to be registered under the act shall not have custody of client funds or securities unless the investment adviser meets each of the following conditions. "An act, practice, or course of business that operates or would operate as a fraud or deceit," as used in K.S.A. 17-12a502 and amendments thereto, shall include any violation of this subsection.

(A) Notice to administrator. The investment adviser shall notify the administrator promptly on form ADV that the investment adviser has or will have custody.

(B) Qualified custodian. A qualified custodian shall maintain the funds and securities in a separate account for each client under each client's name, or in accounts that contain only funds and securities of the investment adviser's clients under the name of the investment adviser as agent or trustee for each client.

(C) Notice to clients. If an investment adviser opens an account with a qualified custodian on behalf of its client, either under the client's name or under the investment adviser's name as agent, the investment adviser shall notify the client in writing of the qualified custodian's name, address, and the manner in which the funds or securities are maintained. The notice shall be given promptly when the account is opened and following any changes to the information.

(D) Account statements. The investment adviser shall ensure that account statements are sent to each client for whom the adviser has custody of funds or securities.

(i) Statements sent by the qualified custodian. If a qualified custodian maintains accounts containing funds or securities, the qualified custodian may send account statements to clients if the investment adviser has a reasonable basis for believing that the qualified custodian sends an account statement at least quarterly to each of the adviser's clients for whom the custodian maintains funds or securities and that the account statement sets forth all transactions in the account during the period and identifies the amount of funds and amount of each security in the account at the end of the period.

(ii) Statements sent by the adviser. If account statements are not sent by the qualified custodian in accordance with paragraph (b)(1)(D)(i), the investment adviser shall send an account statement at least quarterly to each client for whom it has custody

of funds or securities. The account statement shall set forth all transactions in the account during the period and identify the amount of funds and amount of each security of which it has custody at the end of the period.

At least once during each calendar year, a CPA firm that is registered and authorized to provide attest services in compliance with requirements of the state where the investment adviser is domiciled shall be engaged by the investment adviser to attest to the accuracy, in all material respects, of the account statements sent to clients by the investment adviser based on a comparison with records of transactions and balances of funds and securities maintained by the qualified custodian. The attest engagement shall be performed in accordance with attestation standards established by the AICPA and contained in the "AICPA professional standards," as specified in K.A.R. 74-5-2. The CPA firm shall perform the attest engagement without prior notice or announcement to the adviser on a date that changes from year to year as chosen by the CPA firm. The CPA firm shall file a copy of its independent accountant's report with the administrator within 30 days after the completion of the attest engagement. The CPA firm, upon finding any material exceptions during the course of the engagement, shall notify the administrator of the finding within two business days by means of a facsimile transmission or electronic mail, followed by first-class mail, directed to the attention of the administrator.

(iii) Special rule for pooled investment vehicles. If the investment adviser is a general partner of a pooled investment vehicle structured as a limited partnership, is a managing member of a pooled investment vehicle structured as a limited liability company, or holds a comparable position for another type of pooled investment vehicle, the account statements required under this subsection shall be sent to each limited partner, member, or other beneficial owner or that person's independent representative.

(E) Independent representatives. A client may designate an independent representative to receive, on the client's behalf, notices and account statements as required under paragraphs (b)(1)(C) and (b)(1)(D). Thereafter, the investment adviser shall send all notices and statements to the independent representative.

(F) Direct fee deduction. Each investment adviser who has custody, as defined in paragraph (a)(1)(A)(ii), by having fees directly deducted from client accounts held by a

qualified custodian shall obtain prior written authorization from the client to deduct advisory fees from the account held with the qualified custodian.

(G) Pooled investments. Each investment adviser who has custody, as defined in paragraph (a)(1)(A)(iii), and who does not meet the exception provided under paragraph (b)(2)(C) shall comply with each of the following requirements:

(i) Engage an independent party. The investment adviser shall hire an independent party to review all fees, expenses, and capital withdrawals from the pooled accounts.

(ii) Review of fees. The investment adviser shall send all invoices or receipts to the independent party, detailing the amount of the fee, expenses, or capital withdrawal and the method of calculation so that the independent party can determine that the payment is in accordance with the agreement governing the pooled investment vehicle and so that the independent party can forward to the qualified custodian approval for payment of an invoice with a copy to the investment adviser.

(iii) Notice of safeguards. The investment adviser shall notify the administrator on form ADV that the investment adviser intends to use the safeguards specified in this subsection.

(2) Exceptions.

(A) Shares of mutual funds. With respect to shares of a mutual fund that is an open-end company as defined in section 5(a)(1) of the investment company act of 1940, 15 U.S.C. 80a-5(a)(1), as adopted by reference in K.A.R. 81-2-1, any investment adviser may use the mutual fund's transfer agent in lieu of a qualified custodian for purposes of complying with paragraph (b)(1).

(B) Certain privately offered securities. An investment adviser shall not be required to comply with paragraph (b)(1) with respect to securities that meet the following conditions:

(i) Are acquired from the issuer in a transaction or chain of transactions not involving any public offering;

(ii) are uncertificated, with ownership of the securities recorded only on the books of the issuer or its transfer agent in the name of the client; and

(iii) are transferable only with the prior consent of the issuer or holders of the outstanding securities of the issuer.

(C) Limited partnerships subject to annual audit. An investment adviser shall not be required to comply with paragraph (b)(1) with respect to the account of a limited partnership, limited liability company, or other type of pooled investment vehicle that is subject to audit at least annually and that distributes its audited financial statements presented in conformity with GAAP to all limited partners, members, or other beneficial owners within 120 days after the end of its fiscal year. The investment adviser shall notify the administrator on form ADV that the investment adviser intends to distribute audited financial statements.

(D) Registered investment companies. An investment adviser shall not be required to comply with paragraph (b)(1) with respect to the account of an investment company registered under the investment company act of 1940, 15 U.S.C. 80a-1 et seq.

(E) Beneficial trusts. An investment adviser shall not be required to comply with the safekeeping requirements of paragraph (b)(1) if the investment adviser has custody solely because the investment adviser or an investment adviser representative is the trustee for a beneficial trust, if all of the following conditions are met for each trust:

(i) The beneficial owner of the trust is a parent, grandparent, spouse, sibling, child, or grandchild of the investment adviser representative, including "step" relationships.

(ii) The investment adviser provides a written statement to each beneficial owner of each account setting forth a description of the requirements of paragraph (b)(1) and the reasons why the investment adviser will not be complying with those requirements.

(iii) The investment adviser obtains from each beneficial owner a signed and dated statement acknowledging the receipt of the written statement.

(iv) The investment adviser maintains a copy of both documents described in paragraphs (b)(2)(E)(ii) and (iii) until the account is closed or the investment adviser or investment adviser representative is no longer trustee.

(F) Upon written request and for good cause shown, the requirement to use a qualified custodian may be waived by the administrator. As a condition of granting a waiver, the investment adviser may be required by the administrator to perform the duties of a qualified custodian as specified in paragraph (b)(1).

(c) Financial reporting requirements for investment advisers.

(1) Balance sheet. Each registered investment adviser shall prepare and maintain a balance sheet, as required by K.A.R. 81-14-4(b)(6), each month. The balance sheet shall be dated the last day of the month and shall be prepared within 10 business days after the end of the month. The investment adviser shall file the balance sheet with the administrator, for any month specified by the administrator, within five days after a request by the administrator.

(2) Exemptions. An investment adviser shall be exempt from the requirements of this subsection if the investment adviser has its principal place of business in a state other than Kansas, is properly registered in that state, and satisfies the financial reporting requirements of that state.

(d) Positive net worth requirement.

(1) Each investment adviser that is registered or required to be registered under the act shall maintain at all times a positive net worth.

(2) Notification. Each investment adviser registered or required to be registered under the act shall, by the close of business on the next business day, notify the administrator if the investment adviser is insolvent because its net worth is negative as determined in conformity with GAAP. The notification of insolvency shall include the investment adviser's balance sheet that states the insolvent financial condition on the date the insolvency occurred. Upon receiving the balance sheet, the administrator may require the investment adviser to file additional information by a specified date.

(3) Exception for out-of-state advisers. If an investment adviser has its principal place of business in a state other than Kansas and is properly registered in that state, the investment adviser shall be required to maintain the minimum capital required by the state in which the investment adviser maintains its principal place of business.

(Authorized by K.S.A. 17-12a502(b) and 17-12a605(a); implementing K.S.A. 17-12a411, as amended by L. 2013, ch. 65, sec. 3, and 17-12a502(a)(2); effective Aug. 18, 2006; amended Aug. 15, 2008; amended Oct. 25, 2013.)

***** Authenticated Kansas Administrative Regulation *****