

**NOTICE OF REQUEST FOR PUBLIC AND INTERNAL COMMENT:  
PROPOSED CHANGES TO MODEL CUSTODY AND RECORDKEEPING RULES  
UNDER THE UNIFORM SECURITIES ACTS OF 1956 AND 2002  
TO CLARIFY REQUIREMENTS RELATING TO INADVERTENT CUSTODY OF  
CLIENT FUNDS**

The Board of Directors of the North American Securities Administrators Association, Inc. (“NASAA”) has authorized release for internal and public comment the following proposed changes to Model Rules 102(e)(1)-1 and 203(a)-2 under the Uniform Securities Act of 1956 and Model Rules USA 2002 411(c)-1 and USA 2002 411(f)-(1) under the Uniform Securities Act of 2002 to clarify requirements relating to inadvertent custody of client funds.

**Public Comment Period**

The comment period will remain open to February 12, 2012. To facilitate consideration of comments, please send comments to Greg Abram (gregory.abram@sec.state.ma.us), Chair of the Investment Adviser Section Regulatory Policy and Review Project Group, and Joseph Brady (jb@nasaa.org) and A.Valerie Mirko (vm@nasaa.org), NASAA Legal Department. We encourage, but do not require, comments to be submitted by e-mail. Hard copy comments can be submitted at the address below. We also welcome any general comments on the model custody and recordkeeping rules.

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**Summary of Proposed Changes to Custody and Recordkeeping Model Rules**

We are proposing to modify Model Rule 102(e)(1)-1 and Rule USA 2002 411(f)-(1) (the “model custody rules”) promulgated pursuant to the 1956 and 2002 Uniform Securities Acts respectively, and Rule 203(a)-2(a) (Alternative 1) and Rule USA 2002 411(c)-1 (Alternative 1) (the “model recordkeeping rules”<sup>1</sup>), also promulgated pursuant to the 1956 and 2002 Uniform Securities Acts respectively,<sup>2</sup> in order to resolve an inconsistency in the rules related to inadvertent custody of client funds. The proposed amendment to the model custody rules

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<sup>1</sup> Both model recordkeeping rules include an Alternative 2 which provides language for states which incorporate by reference Rule 204-2 of the Investment Advisers Act of 1940. The language regarding inadvertent custody of clients funds only occurs in Alternative 1 of the model recordkeeping rules.

<sup>2</sup> Model rules under the 1956 Act do not include the year of the Act within the rule numbering scheme, whereas model rules under the 2002 Act do (e.g. Rule 102(e)(1)-1(B) versus Rule USA 2002 411(f)-(1)).

concerns identical language in both model rules, while the proposed amendments to the model recordkeeping rules also concern language identical in both rules' Alternative 1.

Both NASAA model custody rules, as written, deem custody to include possession of client funds or securities unless the investment adviser receives them inadvertently and returns them to the sender promptly but in any case within three business days. Rule 102(e)(1)-1(B) and Rule USA 2002 411(f)-(1) further note that receipt of checks drawn by clients and made payable to third parties will not meet the definition of custody if forwarded to the third party *within three (3) business days of receipt*, provided the adviser maintains the records required under the recordkeeping rule.

By contrast, both model recordkeeping rules provide that certain recordkeeping requirements related to inadvertent possession of client funds include situations in which the adviser held or obtained a client's securities or funds and forwarded third party checks *within 24 hours*. As noted above, this same requirement in the custody rule is three (3) days.

The proposed rule amendment resolves the discrepancy between the custody and recordkeeping rules by changing the recordkeeping rule to conform to the requirements in the custody rule. Specifically, the proposal aligns paragraph 203(a)-2(a)(22) and Rule USA 2002 411(c)-(1)(a)(22) to be consistent with Rule 102(e)(1)-1(d)(2) and Rule USA 2002 411(f)-1(d)(2), respectively, by changing the timeframe for forwarding checks to third parties from 24 hours to three (3) days.

The proposal would also more closely align the language of the recordkeeping rule to that of the custody rule. Such language changes include clarifications that timeframes for determining whether inadvertent possession constitutes custody is measured from the time of *receipt* of the securities or funds, changing a reference to "third party" checks to more closely conform to model custody rule language by stating checks must be drawn by clients and made payable to third parties, and minor non-substantive grammatical changes. These changes are intended to more closely align the language of the model recordkeeping rule to the model custody rules.

**Proposed Rule 102(e)(1)-1 and 203(a)-2(a)(22)**

Rule 102(e)(1)-1(d)(2)(a) and 2002 411(f)-1(d)(2)(A)

(A) Custody includes:

(i) Possession of client funds or securities unless the investment adviser receives them inadvertently and returns them to the sender ~~promptly but in any case~~ within three business days of receiving them and the investment adviser maintains the records required under [ Rule 203(a)-2(a)(22) or 2002 411(c)-(1)(a)(22)];

(ii) Any arrangement (including a general partner 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

(iii) 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 its supervised person legal ownership of or access to client funds or securities.

Rule 203(a)-2(a)(22) and 2002 411(c)-(1)(a)(22)

22. Where the adviser inadvertently held or obtained a client's securities or funds and returned them to the client within three business days of of receiving them or has forwarded ~~third party~~ checks drawn by clients and made payable to third parties within ~~24 hours~~ three business days of receipt the adviser ~~will be considered as not having custody but~~ shall keep the following records ~~relating to the inadvertent custody~~:

A ledger or other listing of all securities or funds held or obtained including the following information:

- (A) Issuer;
- (B) Type of security and series;
- (C) Date of issue;
- (D) For debt instruments, the denomination, interest rate and maturity date;

(E) Certificate number, including alphabetical prefix or suffix;

(F) Name in which registered;

(G) Date given to the adviser;

(H) Date sent to client, sender, or third party;

(I) Form of delivery to client, sender, or third party, or a copy of the form of delivery to client, sender or third party; and

(J) Mail confirmation number, if applicable, or confirmation by client, sender or third party of the fund's or security's return.

(K) Date each check was received by the adviser.