What Florida Investment Advisers Need to Know about the Florida Office of Financial Regulation's Custody Rule

The Florida Office of Financial Regulation, Division of Securities ("OFR") has recently issued a significant number of administrative orders against Florida investment advisers for violations of its custody rule (69W-600.0132, F.A.C.). A review of OFR's administrative final orders reveals that there have been at least seven administrative orders issue relating to custody issues from January 1, 2014 to July 30, 2014. Administrative final orders issued by the OFR can be searched at the Office's website. Orders involving custody rule violations range in severity from a fine of $6,004 to a fine of $58,000. The majority of the orders also include findings of violations and Cease and Desist language. Some actions even resulted in suspensions, revocations, or bars from registration. It is important to note, however, that these orders also include other violations in addition to the custody rule violations. Florida based advisers, and dually registered broker-dealers subject to Florida's investment adviser regulations, would be well advised to review these orders, and make sure they are in compliance with Florida's custody rule.

Subsection (1)(a) of Florida's custody rule defines custody as follows:

> *(a) "Custody" means holding directly or indirectly, client funds or securities, or having any authority to obtain possession of them or has the ability to appropriate them.*
>
> *1. Custody includes:*
>
> *a. 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 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's supervised person legal ownership of or access to client funds or securities.*
>
> *2. Receipt of checks drawn by clients and made payable to unrelated third parties will not meet the definition of custody if forwarded to the third party within 24 hours of receipt and the adviser maintains the records required under subsections 69W-600.014(3)-(7), F.A.C.*

Subsection (2) of the rule sets forth "safekeeping" requirements for clients funds and securities, and says that it is "unlawful and deemed to be a fraudulent, deceptive, or manipulative act, practice or course of business for the investment adviser to have custody of client funds or securities" unless the adviser meets certain conditions. These conditions include:[1]

- Notice to OFR on Form ADV that the adviser has or may have custody;
- Use of a "qualified custodian" (defined by 69W-600.0132(1)(c), F.A.C.) to hold the clients funds and securities;
- Notice to clients of the custodian's name, address, and the manner in which the client's funds and securities will be held;
- Providing account statements to the client, at least quarterly, either from a qualified custodian or the adviser, identifying the amount of funds and of each security of which the adviser has custody at the end of the period and setting forth all transactions during that period. If the account statements are provided by the adviser, the adviser must have a surprise audit by a CPA to verify all funds and securities by actual examination.
- Meeting specific conditions if the adviser deducts fees directly from client accounts. These conditions include: written authorization from the client to have the custodian deduct the fees; an invoice reflecting the fee deduction sent concurrently to the custodian and the client (the invoice must include the formula used to calculate the fee, the amount of assets under

management the fee is based on, and the time period covered by the fee); and notice to the OFR on Form ADV that the adviser is directly deducting fees. Advisers who have custody because they directly deduct client fees, but comply with this provision, are exempt from the higher net capital requirements found in paragraph 69W-600.016(3)(a), F.A.C., and the requirement to file audited financial statements found in paragraph 69W-300.002(4)(b), F.A.C.

The most common custody rule violation found by OFR relates to the failure to comply with the requirements surrounding direct fee deductions. Since direct fee deduction is a common industry practice, the OFR encounters this practice on most of its investment adviser examinations. Unfortunately, many advisers fail to comply with one or more of the specific provisions for fee deduction, most commonly, the requirement to send an invoice reflecting the fee deduction concurrently to the custodian and the client.

Violating the custody rule becomes a serious matter for advisers because it creates a cascading effect resulting in the violation of other OFR rules. For example, an adviser who has inadvertent custody because it did not send clients a fee invoice, may also be charged with the following violations:

- Failure to maintain required net capital (rule 69W-600.016(3)(a), F.A.C.). Advisers with custody are required by this rule to maintain $25,000 in net capital, computed pursuant to SEC Rule 15c3-1, rather than the more typical $2,500 net worth (assets minus liabilities) requirement.
- Failure to notify OFR of deficient net capital (rule 69W-600.016(5), F.A.C.)
- Failure to suspend business while not maintaining required net capital (rule 69W-600.016(5), F.A.C.)
- Failure to amend Form ADV (rule 69W-600.001(2), F.A.C.)
- Failure to file audited financial statements (rule 69W-300.002(4)(b), F.A.C.)

Firms subject to these rules would be well advised to review their written policies and procedures to ensure that they adequately reflect the current rule requirements, and evaluate their practices to ensure that they are complying with these rules.

Recent communication with the OFR indicates that they are in the process of drafting amendments to their custody rule. Anyone wishing to monitor the progress of the rulemaking process, and comment on the rules, can subscribe for notifications on the Florida Department of State's website.

By: Rick White

Rick White is Managing Director for Regulatory Services at RRS. Mr. White formerly served as the Director for Florida Division of Securities and has over twenty-nine years of public/private sector regulatory and compliance experience as a senior state regulator and consultant. He can be reached by phone at (850) 443-4036, or by e-mail at RickWhite@RRSCompliance.com.

[1] This article does not discuss the requirements under Florida's custody rule for advisers to pooled investments, advisers who are trustees, or exceptions to the rule. These issues will be covered in a future article.