

October 20, 2004

**FINAL ORDER
WITH ANALYSIS AND RULE TEXT
OF THE
DIVISION OF SECURITIES
DEPARTMENT OF FINANCIAL INSTITUTIONS
STATE OF WISCONSIN
AMENDING, ADOPTING AND REPEALING RULES**

To repeal DFI-Sec 5.03(2); to renumber DFI-Sec 1.02(17), 1.02(18) through (21), and 5.03(3) through (8); to amend DFI-Sec 5.02(2) and 5.06(12); to repeal and recreate DFI-Sec 1.02(17) and 5.035; and to create DFI-Sec 5.035(4)(b), (c), and (d); relating to Wisconsin Securities Law licensing requirements for investment advisers having custody of customer funds or securities.

Pursuant to sections 551.32(1s), 551.33(6) and (8), and 551.63(1) and (2), Wis. Stats., the Division of Securities of the Department of Financial Institutions amends, adopts and repeals rules interpreting those sections as set forth below.

ANALYSIS:

Statutes Interpreted: 551.33(6) & (8), Wis. Stats.

Statutory Authority: 551.32(1s), 551.33(6) & (8), and 551.63(1) and (2), Wis. Stats.

Explanation of agency authority:

The agency has authority to license and regulate the business conduct of securities investment advisers doing business with Wisconsin customers. That authority includes the ability to establish rules for the conduct of business by investment advisers [551.33(6)], and to cooperate with the securities administrators of other states as well as the U.S. Securities & Exchange Commission (“SEC”) to achieve uniformity in regulatory requirements [551.32(1s) and 551.63(2)].

Related statute or rule: DFI-Sec 5.035, Wis. Adm. Code.

Plain language analysis:

The rulemaking procedures under Chapter 227 of the Wisconsin Statutes are being implemented for the purpose of replacing Wisconsin's existing Securities Law rule requirements applicable to Wisconsin-licensed investment advisers that have custody of customer funds and/or securities, with amended Model Rules on that subject recently developed and adopted by the North American Securities Administrators Association (“NASAA”).

Current rule DFI-Sec 5.035, Wis. Adm. Code, under the Wisconsin Securities Law sets forth the

regulatory requirements for state-licensed investment advisers who have custody of customer funds or securities. In 1999, NASAA previously developed Model Investment Adviser Custody Rules that could be used by any state jurisdiction in connection with their regulation of state-licensed investment advisers. (Wisconsin's current rule DFI-Sec 5.035, amended most recently in 2000, incorporated some of the elements of the NASAA Model Rules.)

Recently, the U.S. Securities & Exchange Commission adopted for effectiveness on September 25, 2003, amendments to the federal custody rule under the Investment Advisers Act of 1940 applicable to federally-registered investment advisers. However, pursuant to the National Securities Markets Improvement Act of 1996, such federal changes are not applicable to investment advisers licensed solely in state jurisdictions.

The amended SEC rules for the first time define "custody" and require federally-registered advisers having "custody" to maintain client funds or securities with a "qualified custodian." Because the prior NASAA Model Rules were drafted based on the predecessor federal rules that did not contain a definition of custody, the September 2003 federal custody rule changes necessitated changes in the NASAA Model rules to provide needed uniformity on that issue between the regulation of federal-registered and non-federal registered investment advisers, as well as to provide equivalent levels of investor protection.

Accordingly, the NASAA Investment Adviser Regulatory Policy and Review Project Group was charged with developing amendments to the NASAA Custody Rules to bring them into alignment with the September 2003 federal custody rule. That Project Group completed its development of needed amendments to the NASAA Custody Rules, and those amendments were adopted by vote of the NASAA state member jurisdictions at the 2004 NASAA Spring Conference in Washington D.C. on April 18, 2004.

The NASAA Project Group determined that amendments were required to five NASAA Model Rules pertaining to Custody. Accordingly, substantive amendments were made to the Asset Audit Rule [Rule 102(e)(1)-1], a books and records-related rule [Rule 203(a)2], and to the Minimum Financial Requirements for Investment Advisers rule [Rule 202(d)-1]. Less substantive amendments were made to a separate rule regarding bonding requirements [Rule 202(e)-1, and an Unethical Practices provision [Rule 102(a)(4)-1]. The April 2004 amended NASAA Model Custody Rules incorporate the changes to all five of those rules and are included in the repealed and re-created rule DFI-Sec 5.035, Wis. Adm. Code.

Separately, with respect to the existing Wisconsin rules on this subject matter, the following revisions are being made:

1. The existing Wisconsin rule defining "custody" in DFI-Sec 1.02(17), Wis. Adm. Code, is renumbered, repealed and re-created.
2. New rules defining "independent party," "qualified custodian," and "independent representative" are created.

3. The existing Wisconsin net capital rule in DFI-Sec 5.02(2), Wis. Adm. Code, applicable to investment advisers having custody of customer assets is amended.
4. The existing Wisconsin rule in DFI-Sec 5.03(2), Wis. Adm. Code, prescribing certain books and recordkeeping requirements for investment advisers having custody of customer assets is repealed.
5. The existing Wisconsin investment adviser custody rule in DFI-Sec 5.035 is repealed and re-created.
6. The existing Wisconsin business practices rule in DFI-Sec 5.06(12), Wis. Adm. Code, applicable to investment advisers having custody of customer assets is amended.

Summary of, and comparison with, existing or proposed federal regulations:

Recently, the U.S. Securities & Exchange Commission adopted for effectiveness on September 25, 2003, amendments to the federal custody rule under the Investment Advisers Act of 1940 applicable to federally-registered investment advisers. However, pursuant to the National Securities Markets Improvement Act of 1996, such federal changes are not applicable to investment advisers licensed solely in state jurisdictions.

The amended SEC rules for the first time define "custody" and require federally-registered advisers having "custody" to maintain client funds or securities with a "qualified custodian." Because the prior NASAA Model Rules were drafted based on the predecessor federal rules that did not contain a definition of custody, the September 2003 federal custody rule changes necessitated changes in the NASAA Model rules to provide needed uniformity on that issue between the regulation of federal-registered and non-federal registered (state-licensed only) investment advisers, as well as to provide equivalent levels of investor protection.

Accordingly, the NASAA Investment Adviser Regulatory Policy and Review Project Group was charged with developing amendments to the NASAA Custody Rules to bring them into alignment with the September 2003 federal custody rule. That Project Group completed its development of needed amendments to the NASAA Custody Rules, and those amendments were adopted by vote of the NASAA state member jurisdictions at the 2004 NASAA Spring Conference in Washington D.C. on April 18, 2004.

Comparison with rules in adjacent states:

Similar to Wisconsin, the adjacent states of Iowa, Illinois and Minnesota have existing regulatory requirements for state licensed investment advisers that have custody over customer funds and/or securities based on the NASAA Model Custody Rules as they existed prior to the recent April 2004 amendments. Michigan does not have any custody rules because their regulations prohibit investment advisers from having custody of customer assets. Among the Midwest states in this region, Wisconsin is the first state to commence adoption of the newly-amended NASAA Custody Rules.

Summary of factual data and analytical methodologies:

No factual data or analytical methodologies were used because the proposed rules are revisions/amendments to existing Wisconsin Securities Law regulatory requirements applicable to Wisconsin-licensed investment advisers having custody of customer assets, and are necessary to reflect parallel changes recently made at the federal level to federally-regulated investment advisers.

Analysis and supporting documentation used to determine effect on small business:

Because the rules are revisions/amendments to existing Wisconsin Securities Law regulatory requirements applicable solely to Wisconsin-licensed investment advisers having custody of customer assets -- which requirements those licensees should already be in compliance with -- the rules will not have an effect on "small-business" in general (outside the investment advisory business).

Anticipated costs incurred by private sector:

Because the rules are revisions/amendments to existing Wisconsin Securities Law regulatory requirements applicable solely to Wisconsin-licensed investment advisers having custody of customer assets -- which requirements those licensees should already be in compliance with -- the rules should not trigger any increased costs for such licensees for compliance.

Effect on small business:

Investment adviser licensees under the Wisconsin Securities Law with fewer than 25 full-time employees who meet the other criteria of sec. 227.114(1)(a), Wis. Stats., are the type of small business that would be affected by the rule revisions. The revisions to the securities investment adviser custody requirements will be applicable equally to all licensed investment advisers because the requirements involved are for the protection and benefit of all Wisconsin customers of those firms. All Wisconsin customers of Wisconsin-licensed securities investment advisers are entitled to the public investor protection benefits of the licensing requirements and Rule of Conduct provisions, irrespective of the size of the firm providing the investment advisory services. Under the rule-making procedures used by the Division of Securities, a copy of the proposed rules is mailed to each investment adviser licensed or notice-filed in Wisconsin, as well as to each broker-dealer licensed in Wisconsin, notifying them of the proposed revisions and soliciting written comments or attendance at the public hearing regarding the proposed rules.

Also, repeating what was stated in a preceding section, because the rules are revisions/amendments to existing Wisconsin Securities Law regulatory requirements applicable solely to Wisconsin-licensed investment advisers having custody of customer assets -- which requirements those licensees should already be in compliance with -- the rules will not have an effect on "small-business" in general (outside the investment advisory business).

Rule Text:

Section 1. DFI-Sec 1.02(17) is renumbered 5.035(4)(a), and as renumbered is repealed and recreated to read:

DFI-Sec 5.035(4)(a) “Custody” for purposes of s. DFI-Sec 5.035, means holding directly or indirectly, customer funds or securities, or having any authority to obtain possession of them, or having the ability to appropriate them in the following contexts, without limitation:

1. Possession of customer funds or securities unless received inadvertently and returned to the sender promptly, but in any case within three business days of receiving them, except that receipt of checks drawn by customers and made payable to unrelated third parties will not meet the definition of custody if they are forwarded to the third party within 24 hours of receipt and the adviser maintains the records required under s. DFI-Sec 5.035(3)(a);
2. Any arrangement, including a general power of attorney, under which an investment adviser is authorized or permitted to withdraw customer funds or securities maintained with a custodian upon the investment adviser's instruction to the custodian; and
3. Acting in 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 provides an investment adviser or a supervised person out of the investment adviser, legal ownership of, or access to, customer funds or securities.

ANALYSIS: This SECTION both: (i) substitutes for the existing Wisconsin rule defining custody, the definition developed by NASAA for purposes of its revised Investment Adviser Custody Rules For Customer Assets being proposed for Wisconsin-licensed investment advisers as set forth in SECTION 6 below; and (ii) moves the definition to be part of the recreated IA Custody Rule DFI-Sec 5.035 in which the defined term “custody” is used.

Section 2. DFI-Sec 1.02(18) to (21) are renumbered DFI-Sec 1.02(17) to (20).

ANALYSIS: This SECTION renumbers the existing definitional rules in DFI-Sec 1.02(18) to (21) to reflect the renumbering of DFI-Sec 1.02(17) in SECTION 1.

Section 3. DFI-Sec 5.02(2) is amended to read:

DFI-Sec 5.02(2) ~~Each~~ Except as follows, each investment adviser licensed or required to be licensed under ch. 551, Stats., whose principal office is in this state who has custody of customer funds or securities shall maintain at all times a minimum net worth of \$35,000:

(a) Investment advisers having custody solely as a result of a direct fee deduction, as described in s. DFI-Sec 5.035(4)(a)2, who comply with all of the conditions in s. DFI-Sec 5.035(1)(f), and

who make and maintain the records required in s. DFI-Sec 5.035(3)(b), shall not be required to comply with the net worth requirement in this subsection.

(b) Investment advisers having custody solely as a result of advising pooled investment vehicles, as defined in s. DFI-Sec 5.035(4)(a)3, who comply with all of the conditions in s. DFI-Sec 5.035(1)(g) or s. DFI-Sec 5.035(2)(c) and who create and maintain the records required in s. DFI-Sec 5.035(3)(c), shall not be required to comply with the net worth requirement in this subsection.

ANALYSIS: This Section establishes two exceptions to the existing Wisconsin investment adviser net capital requirement rule in DFI SEC 5.02(2) for licensed investment advisers having custody of customer funds or securities, paralleling in par (a), the NASAA exception where custody is present solely as a result of a direct fee deduction, as described, and in par. (b), where custody is present solely as a result of the investment adviser advising pooled income vehicles, as defined.

SECTION 4. DFI-Sec 5.03(2) is repealed.

ANALYSIS: This SECTION repeals the existing Wisconsin books and records rule requirement in DFI-Sec 5.03(2) for investment advisers having custody of customer funds or securities to consolidate rules relating to investment advisers with custody of customer assets into one section for ease of reference by licensees.

SECTION 5. DFI-Sec 5.03(3) through (8) are renumbered DFI-Sec 5.03(2) through (7).

ANALYSIS: This SECTION renumbers current rules DFI-Sec 5.03(3) through (8) to reflect the repeal of DFI-Sec 5.03(2) in Section 4.

Section 6. DFI-Sec 5.035 is repealed and recreated to read:

DFI-Sec 5.035 Investment Advisers with Custody (1) Except as provided in sub. (2), and subject to the definitions in sub. (4), it shall be a prohibited business practice for an investment adviser licensed, or required to be licensed, to have custody of customer funds or securities unless the investment adviser complies with all of the following:

(a) The investment adviser notifies the division promptly in writing on Form ADV that the investment adviser has or may have custody.

[Note: Form ADV is available online at the website of the Investment Adviser Registration Depository, www.iard.com, and may be filled out and submitted electronically.]

(b) A qualified custodian maintains the funds and securities in a separate account for each customer under that customer's name or in accounts that contain only customer funds and securities, under the investment adviser's name as agent or trustee for the customers.

(c) When an investment adviser opens an account with a qualified custodian on a customer's behalf, either under the customer's name or under the investment adviser's name as agent, the investment adviser shall notify the customer 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.

(d) Account statements shall be sent to customers in compliance with one of the following:

1. If customer funds or securities are held by a qualified custodian, the investment adviser shall have a reasonable basis for believing that the qualified custodian sends an account statement, at least quarterly, to each customer 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.

2. If customer funds or securities are held by the adviser:

a. The investment adviser shall send an account statement, at least quarterly, to each customer for whom the investment adviser has custody of funds or securities, identifying the amount of funds and of each security of which the investment adviser has custody at the end of the period and setting forth all transactions during that period; and

b. The investment adviser shall engage an independent certified public accountant to verify all customer 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 adviser and that is irregular from

year to year. The accountant shall file a copy of the special examination report with the division within 30 days after the completion of the examination, stating that it has examined the funds and securities and describing the nature and extent of the examination; and

c. Within one business day of the finding of any material discrepancies identified during the course of the examination under subd. 2.b, the accountant shall notify the division of the discrepancy by means of a facsimile transmission or electronic mail, followed by first class mail, directed to the division.

3. If the investment adviser is a general partner of a limited partnership, is a managing member of a limited liability company, or holds a comparable position for another type of pooled investment vehicle, the account statements required under subparagraphs (d)1 or (d)2a., shall be sent to each limited partner, member or other beneficial owner or their independent representative.

(e) If a customer does not receive account statements and notices directly from the adviser or custodian, the investment adviser shall obtain from the customer a written designation of an independent representative to receive, on the customer's behalf, notices and account statements as required under paragraphs (1)(c) and (d).

(f) Unless exempt under subd. 4, an adviser who has custody as defined in s. DFI-Sec 5.035(4)(a) as a result of having fees directly deducted from customer accounts, as described in subd. (a)2, shall comply with all of the following:

1. The adviser shall obtain written authorization from the customer to deduct advisory fees from the account held with the qualified custodian.

2. Except as provided in subd. 4, each time a fee is directly deducted from a customer account, the adviser shall concurrently do both of the following:

a. Send the qualified custodian notice of the amount of the fee to be deducted from the customer's account; and

b. Send the customer an invoice itemizing the fee. Itemization includes 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.

3. The investment adviser notifies the division on Form ADV that the investment adviser intends to comply with subds.1. and 2.

4. An investment adviser having custody as described in s. DFI-Sec 5.035(4)(a)2 and who complies with the safekeeping requirements in section DFI-Sec 5.035(1)(a) thru (f), is not required to meet the financial requirements for custodial advisers prescribed in section DFI-Sec 5.02(2).

(g) An investment adviser who has custody as described in s. DFI-Sec 5.035(4)(a)3 and who does not meet the exception provided under s. DFI-Sec 5.035(2)(c) shall comply with each of the following:

1. The investment adviser shall hire an independent party as defined in s. DFI-Sec 5.035(4)(b) to review all fees, expenses and capital withdrawals from the pooled accounts.
2. 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 do both of the following:
 - a. Determine that the payment is in accordance with the pooled investment vehicle standards set forth in the partnership agreement or membership agreement.
 - b. Forward to the qualified custodian, written approval for payment of the fee, expense or capital withdrawal, and provide a copy to the investment adviser.
3. The investment adviser shall notify the division on Form ADV that the investment adviser intends to comply with subd. (g)1. and 2.
4. An investment adviser having custody as described in s. DFI-Sec 5.035(4)(a)3 and who complies with the safekeeping requirements in paragraphs DFI-Sec 5.035(1)(a) through (e), together with the requirements in paragraph (g), will not be required to meet the financial requirements for custodial advisers prescribed in s. DFI-Sec 5.02(2).

(2)(a) With respect to shares of an open-end investment company as defined in section 5(a)(1) of the investment company act of 1940, an investment adviser may use the investment company's transfer agent in lieu of a qualified custodian for purposes of complying with sub. (1).

(b) 1. An investment adviser is not required to comply with sub. (1) with respect to securities that meet all of the following requirements:

- a. The securities are acquired from the issuer in a transaction or series of transactions not involving a public offering.
- b. The securities are uncertificated, and ownership is recorded only on the records of the issuer or its transfer agent in the name of the customer.
- c. The securities are transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.

2. The exemptions contained in subd. (b)1 are available with respect to securities held for the account of a limited partnership, limited liability company, or other type of pooled investment vehicle, only if the entity has audited financial statements that are distributed in compliance with par. (c), and the investment adviser notifies the division on Form ADV that the investment adviser intends to distribute the audited financial statements as prescribed above.

(c) An investment adviser is not required to comply with par. (d) with respect to the account of a limited partnership, limited liability company, or another type of pooled investment vehicle that is subject to audit at least annually and distributes annually its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners, members, or other beneficial owners, within 120 days of the end of its fiscal year. The investment adviser shall notify the division on Form ADV that the investment adviser intends to comply with the audit safeguards described above.

(d) An investment adviser is not required to comply with sub. (1) with respect to the account of an investment company registered under the investment company act of 1940.

(e) An investment adviser is not required to comply with the safekeeping requirements of s. DFI-Sec 5.035(1) or the net worth requirements of s. DFI-Sec 5.02(2) if the investment adviser has custody solely because the investment adviser is the trustee for a beneficial trust, if all of the following conditions are met for each trust:

1. The beneficial owner of the trust is a parent, a grandparent, a spouse, a sibling, a child or a grandchild of the adviser. Those relationships shall include "step" relationships.

2. For each account under subd. 1., the investment adviser complies with each of the following:

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

b. The investment adviser obtains from each beneficial owner a signed and dated statement acknowledging the receipt of the written statement required under paragraph (e) 2.a. above.

c. The investment adviser maintains a copy of the documents required in paragraphs (e) 2 a. and b. until the account is closed or the investment adviser is no longer trustee.

(f) Any adviser who intends to have custody of customer funds or securities but is not able to utilize a qualified custodian as defined in s. DFI-Sec 5.035(4)(c) shall first obtain approval from the division and shall comply with all of the applicable safekeeping

provisions under sub. (1) of this rule, including taking responsibility for those requirements that are designated to be performed by a qualified custodian.

(3)(a) If an investment adviser receives or obtains a customer's securities or funds inadvertently, but returns them to the customer within three business days of receipt, or forwards third party checks within 24 hours of receipt, the adviser will not be considered to have custody, but shall keep the following records relating to the inadvertent custody:

1. 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 customer or sender.
- i. Form of delivery to customer or sender, or copy of the form of delivery to customer or sender.
- j. Mail confirmation number, if applicable, or confirmation by customer or sender of the fund's or security's return.

2. If an investment adviser obtains possession of securities that are acquired from an issuer in a transaction or series of transactions not involving any public offering that qualify for the exception from custody under par. (2)(b), the adviser shall keep the following records:

- a. A record showing the issuer or current transfer agent's name, address, telephone number and other applicable contact information pertaining to the party responsible for recording customer interests in the securities; and
- b. A copy of any legend, shareholder agreement or other agreement showing that those securities are transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.

(b) Each licensed investment adviser whose principal office is in this state who has custody or possession of securities or funds of any customer shall maintain and keep current the following books and records in addition to those required under sub. (1):

1. A copy of all documents required in sub. (1)(f) if the adviser is authorized or permitted to withdraw a customer's funds or securities maintained with a custodian upon the adviser's instruction to the custodian.
2. A journal or other record showing all purchases, sales, receipts and deliveries of securities, including certificate numbers, for all accounts and all other debits and credits to the accounts.
3. A separate ledger account for each customer showing all purchases, sales, receipts and deliveries of securities, the date and price of each purchase and sale, and all debits and credits.
4. Copies of confirmations of all transactions effected by or for the account of any customer.
5. A record for each security in which any customer has a position, which record shall show the name of each customer having any interest in each security, the amount or interest of each customer, and the location of each security.
6. A copy of each of the customer's quarterly account statements, as generated and delivered by the qualified custodian. If the adviser also generates a statement that is delivered to the customer, the adviser shall also maintain copies of such statements along with the date such statements were sent to the customers.
7. If applicable to the adviser's situation, a copy of the auditor's report and financial statements and letter verifying the completion of the examination by an independent certified public accountant and describing the nature and extent of the examination.
8. A record of any finding by the independent certified public accountant of any material discrepancies found during the examination.
9. If applicable, evidence of the customer's designation of an independent representative.

(c) If an investment adviser has custody because it advises a pooled investment vehicle, as defined in s. DFI-Sec 5.035(4)(a)3, the adviser shall also keep the following records:

1. True, accurate and current account statements;
2. If the investment adviser complies with s. DFI-Sec 5.035(2)(c), the investment adviser shall make and maintain each of the following records:

- a. A record of the date of the audit.
 - b. A copy of the audited financial statements.
 - c. A record evidencing the mailing by the issuer of its audited financial statements to all limited partners, members or other beneficial owners within 120 days of the end of its fiscal year.
3. If the adviser complies with s. DFI-Sec 5.035(1)(g), the investment adviser shall make and maintain the following records:
- a. A copy of the written agreement with the independent party reviewing all fees and expenses, indicating the responsibilities of the independent third party.
 - b. Copies of all invoices and receipts showing approval by the independent party for payment through the qualified custodian.

ANALYSIS: The requirements in subsection (1) include, in addition to the requirements in existing DFI-Sec 5.035(1) dealing with notification to the Division, establishing separate banking accounts for customer funds, providing notification to customers where accounts are located, having an independent accountant verify account balances at least annually, and providing itemized statements to customers at least quarterly, requirements that: (i) customer funds and securities not held by the adviser be held by a qualified custodian [as defined in new rule DFI-Sec 5.035(4)(c)]; and (ii) if advisory fees are deducted directly from customer accounts, the investment adviser is required to first obtain a written authorization from the customer, and must send the customer an itemized invoice each time fees are deducted from the account.

Under subsection (2), an investment adviser can use a mutual fund's transfer agent in lieu of a qualified custodian for mutual fund shares, and exclusions are provided from the safekeeping requirements for the securities of limited partnerships and other pooled investment vehicles meeting specified criteria, as well as where the adviser is the trustee

for a beneficial trust and the adviser complies with specified conditions.

Subsection (3) contains: (i) [in paragraph (a)] provisions dealing with inadvertent custody, and recordkeeping requirements for securities obtained by the adviser from an in a non-public offering; (ii) books and recordkeeping requirements for those licensed investment advisers whose principal office is located in Wisconsin; and (iii) special records that are required for advisers having custody as a result of advising a pooled investment vehicle as described in DFI-Sec 5.035(4)(a)3.

Section 7. DFI-Sec 5.035(4)(b), (c) and (d) are created to read:

DFI-Sec 5.035(4)(b) “Independent party” for purposes of s. DFI Sec 5.035(1)(g), means a person that meets all of the following:

1. The person is engaged by the investment adviser to act as an intermediary for the payment of fees, expenses and capital withdrawals from a pooled investment.
2. The person does not control, is not controlled by, and is not under common control with, the investment adviser.
3. The person does not have, and has not had within the past two years, a material business relationship with the investment adviser.

(c) “Qualified custodian” for purposes of s. DFI Sec 5.035(1), includes a broker-dealer licensed under ch. 551, Stats, or any of the following independent institutions or entities:

1. A bank or savings association whose deposits are insured by the federal deposit insurance corporation under the federal deposit insurance act;
2. A registered futures commission merchant registered under section 4f(a) of the commodity exchange act, holding the customer assets in customer accounts, but only with respect to customers’ funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery or options thereon.
3. A foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory customers’ assets in customer accounts segregated from its proprietary assets.

(d) "Independent representative" for purposes of s. DFI-Sec 5.035, means a person that satisfies the requirements in each of the following paragraphs:

1. The person acts as an agent for an advisory customer, and the person by law or contract is obliged to act in the best interests of the advisory customer. An advisory customer includes, in the case of a pooled investment vehicle, a limited partner of a limited partnership, a member of a limited liability company, or a beneficial owner of another type of pooled investment vehicle.
2. The person does not control, is not controlled by, and is not under common control with, the investment adviser.
3. The person does not have, and has not had within the past two years, a material business relationship with the investment adviser.

ANALYSIS: This SECTION both: (i) creates separate rules defining "independent party," "qualified custodian," and "independent representative" as developed by NASAA for purposes of its revised Investment Adviser Custody rules being proposed for Wisconsin-licensed investment advisers as set forth in SECTION 6; and (ii) places the 3 definitions to be part of the recreated IA Custody Rule DFI-Sec 5.035 in which the defined terms are used.

SECTION 7. DFI-Sec 5.06(12) is amended to read:

DFI-Sec 5.06(12) Taking or having custody of client funds or securities without being in compliance with ~~rule 206(4)-2 of the investment advisers act of 1940~~ DFI-Sec 5.035 and the net ~~capital~~ worth requirement in DFI-Sec 5.02(2).

ANALYSIS: This SECTION amends the existing prohibited business practice rule in DFI-Sec 5.06(12) applicable to licensed investment advisers having custody of customer assets to provide that compliance is required of the repealed and recreated DFI-Sec 5.035 rather than the federal investment adviser custody rule 206(4)-2 under the Investment

Advisers Act of 1940.

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The rules and amendments contained in this Order shall take effect as provided in s. 227.22(2)(intro.), Stats., on the first day of the month following the date of publication in the Wisconsin Administrative Register.

DATED at Madison Wisconsin, this ____ day of _____, 2004.

[SEAL]

PATRICIA D. STRUCK
Administrator
Division of Securities