2876.4116 CUSTODY REQUIREMENTS FOR INVESTMENT ADVISERS.

Subpart 1. **Safekeeping required.** It is unlawful and deemed to be a fraudulent, deceptive, or manipulative act, practice, or course of business for an investment adviser to have custody of client funds or securities unless:

A. The investment adviser notifies the administrator promptly in writing that the investment adviser has or is authorized to have custody of client funds or securities. The notification is required to be given on Form ADV.

B. A qualified custodian maintains those funds and securities:

(1) in a separate account for each client under that client's name; or

(2) in accounts that contain only the investment adviser's clients' funds and securities, under the investment adviser's name as agent or trustee for the clients.

C. If an investment adviser opens an account with a qualified custodian on its client's behalf, either under the client's name or under the name of the investment adviser as agent, the investment adviser must notify 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.

D. Account statements must be sent to clients, either:

(1) by a qualified custodian. The investment adviser must have a reasonable basis for believing that the qualified custodian sends an account statement, at least quarterly, 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;

(2) by the investment adviser.

(a) The investment adviser must send an account statement, at least quarterly, to each client 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.

(b) An independent certified public accountant retained by the investment adviser must verify all 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 and that is irregular from year to year, and file a copy of the special examination report with the administrator within 30 days after the completion of the examination, along with a letter stating that it has examined the funds and securities and describing the nature and extent of the examination.

(c) The independent certified public accountant, upon finding any material discrepancies during the course of the examination, must notify the administrator within one business day of the finding, by means of a facsimile transmission or electronic mail, followed by first class mail, directed to the attention of the administrator; or

(3) 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 this item must be sent to each limited partner, or member or other beneficial owner or their independent representative.

E. A client may designate an independent representative to receive, on the client's behalf, notices and account statements as required under items C and D.

F. An investment adviser who has custody as defined in subpart 3, item A, subitem (1), unit (b), by having fees directly deducted from client accounts must also provide the following safeguards:

(1) the investment adviser must have written authorization from the client to deduct advisory fees from the account held with the qualified custodian;

(2) each time a fee is directly deducted from a client account, the investment adviser must concurrently:

(a) send the qualified custodian an invoice of the amount of the fee to be deducted from the client's account; and

(b) send the client 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 must notify the administrator in writing that the investment adviser intends to use the safeguards provided above. Notification is required to be given on Form ADV; and

(4) an investment adviser having custody solely because it meets the definition of custody as defined in subpart 3, item A, subitem (1), unit (b), and who complies with the safekeeping requirements in items A to F, will not be required to meet the financial requirements for custodial advisers in parts 2876.4112 and 2876.4113, subpart 1, or the bonding requirement in part 2876.4115.

G. An investment adviser who has custody as defined in subpart 3, item A, subitem (1), unit (c), and who does not meet the exception provided under subpart 2, item C, must, in addition to the safeguards in items A to E, also comply with the following:

(1) hire an independent party to review all fees, expenses, and capital withdrawals from the pooled accounts;

(2) send all invoices or receipts to the independent party, detailing the amount of the fee, expenses, or capital withdrawal and the method of calculation such that the independent party can:

(a) determine that the payment is in accordance with the pooled investment vehicle standards (generally the partnership agreement or membership agreement); and

(b) forward, to the qualified custodian, approval for payment of the invoice with a copy to the investment adviser;

(3) for purposes of this item, "independent party" means a person that:

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

(b) does not control and 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;

(4) the investment adviser notifies the administrator in writing on Form ADV that the investment adviser intends to use the safeguards provided in subitems (1) and (2); and

(5) an investment adviser having custody solely because it meets the definition of custody as defined in subpart 3, item A, subitem (1), unit (c), and who complies with the safekeeping requirements in items A to E and G will not be required to meet the financial requirements for custodial investment advisers in parts 2876.4112 and 2876.4113, subpart 1, or the bonding requirement in part 2876.4115.

H. When a trust retains an investment adviser or employee, director, or owner of an investment adviser as trustee and the investment adviser acts as the investment adviser to that trust, the investment adviser will:

(1) notify the administrator in writing on Form ADV that the investment adviser intends to use the safeguards provided in subitems (2) and (3);

(2) send to the grantor of the trust, the attorney for the trust if it is a testamentary trust, the cotrustee (other than the investment adviser or employee, director, or owner of the investment adviser) or a defined beneficiary of the trust, at the same time that it sends any invoice to the qualified custodian, an invoice showing the amount of the trustees' fee or investment management or advisory fee, the value of the assets on which the fees were based, and the specific manner in which the fees were calculated;

(3) enter into a written agreement with a qualified custodian that specifies:

(a) that the qualified custodian will not deliver trust securities to the investment adviser or employee, director, or owner of the investment adviser, nor will transmit any funds to the investment adviser or employee, director, or owner of the investment adviser, except that the qualified custodian may pay trustees' fees to the trustee and investment management or advisory fees to the investment adviser, provided that:

i. the grantor of the trust or attorneys for the trust, if it is a testamentary trust, the cotrustee (other than the investment adviser or employee, director, or owner of the investment adviser), or a defined beneficiary of the trust has authorized the qualified custodian in writing to pay those fees;

ii. the statements for those fees show the amount of the fees for the trustee and, in the case of statements for investment management or advisory fees, show the value of the trust assets on which the fee is based and the manner in which the fee was calculated; and

iii. the qualified custodian agrees to send to the grantor of the trust, the attorneys for a testamentary trust, the cotrustee (other than the investment adviser or employee, director, or owner of the investment adviser), or a defined beneficiary of the trust, at least quarterly, a statement of all disbursements from the account of the trust, including the amount of investment management fees paid to the investment adviser and the amount of trustees' fees paid to the trustee; and

(b) except as otherwise set forth in subunit i, that the qualified custodian may transfer funds or securities, or both, of the trust only upon the direction of the trustee, who may be the investment adviser or employee, director, or owner of the investment adviser, who the investment adviser has duly accepted as an authorized signatory. The grantor of the trust or attorneys for the trust, if it is a testamentary trust, the cotrustee (other than the investment adviser or employee, director, or owner of the investment adviser), or a defined beneficiary of the trust must designate the authorized signatory for management of the trust. The direction to transfer funds or securities, or both, can only be made to the following:

i. a trust company, bank trust department, or brokerage firm independent of the investment adviser for the account of the trust to which the assets relate;

ii. the named grantors or to the named beneficiaries of the trust;

iii. a third party independent of the investment adviser in payment of the fees or charges of the third party including, but not limited to, attorney, accountant's, or qualified custodian's fees for the trust, and taxes, interest, maintenance, or other expenses, if there is property other than securities or cash owned by the trust;

iv. third parties independent of the investment adviser for any other purpose legitimately associated with the management of the trust; or

v. a broker-dealer in the normal course of portfolio purchases and sales, provided that the transfer is made on payment against delivery basis or payment against trust receipt; and

(4) not be required to meet the financial requirements for custodial investment advisers in part 2876.4112 and 2876.4113, subpart 1, or the bonding requirement in part 2876.4115 if the investment adviser has custody solely because it meets the definition of custody as defined in subpart 3, item A, subitem (1), unit (c), and complies with the safekeeping requirements in items A to E and this item.

Subp. 2. **Exceptions.**

A. With respect to shares of an open-end company as defined in Section 5(a)(1) of the Investment Company Act of 1940 ("mutual fund"), the investment adviser may use the mutual fund's transfer agent in lieu of a qualified custodian for purposes of complying with subpart 1.

B. Certain privately offered securities.

(1) The investment adviser is not required to comply with subpart 1 with respect to securities that are:

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

(b) uncertificated and ownership thereof is recorded only on books of the issuer or its transfer agent in the name of the client; and

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

(2) Notwithstanding subitem (1), the provisions of this item are 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, the audited financial statements are distributed, as described in item C and the investment adviser notifies the administrator in writing on Form ADV that the investment adviser intends to provide audited financial statements, as described in this subitem.

C. An investment adviser is not required to comply with subpart 1, item D, with respect to the account of a limited partnership (or limited liability company, or another type of pooled investment vehicle) that is subject to an 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. The investment adviser must also notify the administrator in

writing on Form ADV that the investment adviser intends to employ the use of the audit safeguards described in this item.

D. The investment adviser is not required to comply with this part 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 safekeeping requirements of Minnesota Statutes, section 80A.66, subsection (f), or the net worth and bonding requirements of parts 2876.4112, 2876.4113, subpart 1, and 2876.4115, if the investment adviser has custody solely because the investment adviser or employee, director, or owner of the investment adviser is a 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 trustee. These relationships shall include "step" relationships.

(2) For each account under subitem (1), the investment adviser complies with 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 subpart 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 in unit (a); and

(c) the investment adviser maintains a copy of both documents described in units (a) and (b) until the account is closed or the investment adviser is no longer trustee.

F. Any investment adviser who intends to have custody of client funds or securities but is not able to utilize a qualified custodian as defined in subpart 3, item C, must first obtain approval from the administrator and must comply with all of the applicable safekeeping provisions under subpart 1, including taking responsibility for those provisions that are designated to be performed by a qualified custodian.

Subp. 3. **Definitions.** For purposes of this part, the following terms have the meanings given them.

A. "Custody" means holding directly or indirectly, client funds or securities, or having any authority to obtain possession of them, or having 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 its 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.

B. "Independent representative" means a person who:

(1) acts as agent for an advisory client, including in the case of a pooled investment vehicle, for limited partners of a limited partnership, 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, members, or other beneficial owners;

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

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

C. "Qualified custodian" means the following independent institutions or entities that are not affiliated with the investment adviser by any direct or indirect common control and have not had a material business relationship with the investment adviser in the previous two years:

(1) a bank or savings association that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act;

(2) a registered broker-dealer holding the client assets in customer accounts;

(3) a registered 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

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

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