FINANCIAL REPORTING REQUIREMENTS FOR REGISTERED INVESTMENT ADVISERS WITH CUSTODY OF CLIENT FUNDS AND SECURITIES

Advisory Interpretation

March 19, 2025

Background

General Rule

Section 36b-5(c) of Chapter 672a of the Connecticut Uniform Securities Act (the "Act") prohibits any investment adviser that is registered or required to be registered in Connecticut from taking or having custody of client funds or securities if the Commissioner by regulation prohibits custody or, in the absence of a regulation, the investment adviser fails to notify the Commissioner that it may have custody.

The Commissioner promulgated a regulation under Section 36b-5 of the Act.

Specifically, Section 36b-31-5b of the Regulations under the Act makes it a fraudulent, deceptive or misleading act, practice or course of business for an investment adviser having custody or possession of client funds or securities to take any action regarding those funds or securities unless certain conditions are met.

These conditions involve 1) the segregation and safekeeping of custodied funds or securities in earmarked accounts; 2) notice to the client regarding the place and manner in which the custodied funds or securities will be maintained; 3) the sending or quarterly itemized statements to the client; and 4) an annual "surprise" verification of the custodied funds and securities by an independent public accountant.

Section 36b-31-5b of the Regulations was patterned after Securities and Exchange Commission ("SEC") Rule 206(4)-2, 17 C.F.R. § 275.206(4)-2, promulgated under the Investment Advisers Act of 1940.

2005 Refinements

On February 4, 2005, the Banking Commissioner, responding to the SEC's amendments to Rule 206(4)-2, issued an Order Updating Custody Requirements For State-Registered Investment Advisers (the "Custody Order") that reflected modern custodial practices.

In essence, the Custody Order exempted advisers with custody from the ***surprise verification*** requirement in Section 36b-31-5b of the Regulations if certain safeguards were met.

These conditions included the adviser using a "qualified custodian" - typically a bank or securities broker-dealer – notice to the Commissioner and notice to the affected clients.

The Financial Reporting Requirement

The financial reporting requirement is separate and apart from provisions governing custody.

If an adviser is not relying on the Custody Order but is observing the requirement in Section 36b-31-5b of the Regulations that custodied funds and securities be subject to a "surprise" verification by an independent public accountant, the financial reporting requirement would continue to apply. In particular, the filed financial statements would have to be audited

Section 36b-14(b)(1) of the Act provides that: "Every registered investment adviser shall file such financial reports as the commissioner by regulation prescribes." Section 36b-31-14d(a) of the Regulations states, in part, that: "Each registered investment adviser shall, within 90 days following the end of its fiscal or calendar year, file with the commissioner a report of its financial condition as of the end of its fiscal year. Such report shall be examined in accordance with generally accepted auditing standards and reported upon with an opinion expressed by an independent certified public accountant or independent public accountant *if the investment adviser (1) has custody or possession of clients' funds or securities* . . . ." (Emphasis added)

Several Connecticut-registered investment advisers have questioned whether the audited financial statement requirement in Section 36b-31-14d(a) of the Regulations applies to every scenario described in the Custody Order.

The Division is issuing this advisory interpretation pursuant to Section 36b-31(f) of the Act and Sections 36b-31-31c and 36b-31-31e of the Regulations to clarify that financial statements filed annually by certain investment advisers need not be audited.

Financial statements filed with the Commissioner under Section 36b-31-14d(a) of the Regulations need not be audited in the following situations:

1. **Connecticut-Registered Investment Advisers Using a Third Party Custodian**

The Custody Order exempts registered investment adviser complying with its terms from the "surprise audit" and other requirements in Section 36b-31-5b of the Regulations. To qualify, client funds and securities must be maintained by a "Qualified Custodian" who is responsible for sending account statements to clients; and notice must be provided to the affected clients and to the Commissioner. If the investment adviser does not use a Qualified Custodian or if the investment adviser (versus a Qualified Custodian) takes charge of sending out account statements, the Section 36b-31-14d(a) financial statements would have to be audited.

2. Direct Fee Deduction

Investment advisers having the authority to make withdrawals from client accounts to pay their advisory fees (i.e., direct fee deduction) are deemed to have custody. However, where a Connecticut-registered investment adviser has custody **solely** by virtue of direct fee deduction, its filed financial statements would not have to be audited provided that: 1) the investment adviser obtains 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 concurrently sends the qualified custodian notice of the amount of the fee to be deducted, and sends the client an invoice itemizing the fee, including the formula used to calculate the fee, the amount of assets under management upon which the fee is based and the time period covered by the fee; and 3) the investment adviser discloses the direct fee deduction arrangement on Form ADV.

3. Standing Letters of Authorization (SLOAs)

Connecticut-registered investment advisers having custody solely by virtue of using a SLOA arrangement would not be required to have their filed financial statements audited for purposes of Section 36b-31-14d of the Regulations. (*See related SLOA Policy Statement issued November 2022,* https://portal.ct.gov/dob/securities-licensing/advisers-state/standing-letters-of-authorization).

4. Advisers to Pooled Investment Vehicles Using an "Independent Party" to Evaluate Disbursements

Some Connecticut-registered investment advisers have custody solely because they hold a position with a pooled investment vehicle that gives them (or their investment adviser agents) legal ownership of, or access to, client funds or securities. For example, the adviser or its investment adviser agent may be the general partner of a limited partnership, managing member of a limited liability company, trustee of a trust or comparable position for another kind of pooled investment vehicle. Here, where the investment adviser complies with the Custody Order's requirement that it hire an independent party to review all fees, expenses and capital withdrawals from the pooled accounts and to act as a "gatekeeper" for related disbursements made by the qualified custodian, the department would not require that the adviser's financial statements filed under Section 36b-31-14d of the Regulations be audited.

An adviser that is exempt from the *account statement* requirement in the Custody Order because it advises the accounts of a limited partnership, limited liability company or other type of pooled investment vehicle need not file an audited financial statement with the department if the advised entity is subject to audit at least annually and distributes 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 or, in the case of a fund of funds, within 180 days of the end of its fiscal year. Such advisers should plan to maintain copies of those audited financials as well as a list of those parties receiving them.

5. Registered Investment Advisers that the Custody Order Exempts from Section 36b-31-5b of the Regulations and the Requirements of the Custody Order

The Custody Order exempts certain arrangements from its terms and from Section 36b-31-5b of the Regulations. These involve:

a. Securities acquired from the issuer in a private placement and subject to restrictions on transferability. Where the security holder client is a pooled investment vehicle, this exemption is only available where the pooled investment vehicle is audited and the audited financial statements are distributed to its beneficial owners

b. Clients who are investment companies registered under the Investment Company Act of 1940, 15 U.S.C. 80a-1 to 80a-64, inclusive.

c. Trusts where the investment adviser is trustee and the beneficiaries have a familial relationship to the investment adviser as described in the Custody Order