

Regulatory Analysis Form		This space for use by IRRC	
(1) Agency Pennsylvania Securities Commission		IRRC Number: <b>2430</b>	
(2) I.D. Number (Governor's Office Use) #50-119			
(3) Short Title Exchange transaction exemptions Investment adviser registration procedure Waiver of exam requirements for certain investment advisers and investment adviser representatives Investment adviser capital requirements Investment adviser required financial reports Investment adviser custody or possession of funds securities			
Regulatory Analysis Form			
(4) PA Code Cite 64 Pa. Code § 203.203 64 Pa. Code § 303.012 64 Pa. Code § 303.032 64 Pa. Code § 304.042 64 Pa. Code § 304.022 64 Pa. Code § 404.013		(5) Agency Contacts & Telephone Numbers Primary Contact: Mary E. Peters 783-4186 Secondary Contact: Paul M. Schwartz 783-4217	

<p>(6) Type of Rulemaking(check one)</p> <p><input checked="" type="checkbox"/> Proposed Rulemaking  <input type="checkbox"/> Final Order Adopting Regulation  <input type="checkbox"/> Final Order, Proposed Rulemaking Omitted</p>	<p>(7) Is a 120 Day Emergency Certification Attached?</p> <p><input checked="" type="checkbox"/> No  <input type="checkbox"/> Yes: By the Attorney General  <input type="checkbox"/> Yes: By the Governor</p>
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(8) Briefly explain the regulation in clear and nontechnical language.

a. Commission Regulation 203.203 would provide a self-executing exemption for certain exchange transactions of debt securities in which certain accredited investors receive registered debt securities of the issuer in exchange for the issuer's debt securities that originally were issued in a private transaction under SEC Rule 144A.

b. Commission Regulation 303.012 would delete use of a management responsibility letter in lieu of an audit report where the investment adviser applicant is a Certified Public Account. This regulation proposal is due to rule changes made by the American Institute of Certified Public Accountants.

c. Commission Regulation 303.032 would require certified public accountants and attorneys to notify the Commission of their eligibility for a waiver of the examination requirement for investment advisers and investment adviser representatives.

d. Commission Regulation 304.042 would apply Pennsylvania's net worth requirements where an investment adviser with a principal place of business in another state seeks registration in Pennsylvania but is not currently registered as an investment adviser in the state where it maintains its principal place of business.

e. Commission Regulation 304.022 would delete use of a management responsibility letter in lieu of an audit report where the investment adviser applicant is a Certified Public Account. This regulation proposal is due to rule changes made by the American Institute of Certified Public Accountants.

f. Commission Regulation 404.013 would permit an investment adviser to send itemized client statements to another person authorized by the client or to reasonably rely on a qualified custodian of the client's funds or securities to send an itemized statement to the client.

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**(9) State the statutory authority for the regulation and any relevant state or federal court decisions.**

- a. 70 P.S. § 1-203(r) and 70 P.S. § 1-609(a)
- b. 70 P.S. § 1-303(a) and 70 P.S. § 1-609(a)
- c. 70 P.S. § 1-303(d) and 70 P.S. § 1-609(a)
- d. 70 P.S. § 1-304(b) and 70 P.S. § 1-609(a)

**(10) Is the regulation mandated by any federal or state law or court order, or federal regulation? If yes, cite the specific law, case or regulation, and any deadlines for action.**

No

### Regulatory Analysis Form

(11) Explain the compelling public interest that justifies the regulation. What is the problem it addresses?

- a. Commission Regulation 203.203 will codify the Exemptive Order issued by the Commission and published in the *Pennsylvania Bulletin* on March 27, 2004 at 34 Pa.B 1734.
- b. Amendment to Commission Regulation 303.012 proposes to reflect changes in the rules set by the American Institute of Public Accountants (AIPA). AIPA no longer permits members to issue management responsibility letters. This proposed regulation would delete use of management responsibility letters in lieu of an audit report where the investment adviser applicant is a certified public accountant or a firm consisting of certified public accountants. This proposed regulation also reflects changes made to section 609 (c) of the Act by Act 109 of 1998.
- c. Amendment to Commission Regulation 303.032 would require certified public accountants and attorneys to notify the Commission of their eligibility for a waiver of the examination requirement for investment advisers and investment advisers representatives. All applicants for registration as an investment adviser or investment adviser representative are processed electronically through the web based Investment Adviser Registration Depository (IARD). IARD only recognizes exam waivers for certain uniform designations which do not include attorneys or CPAs. Therefore, the only way the Commission knows that those applicants are eligible for a waiver of the exam requirement is to impose a notification requirement on the applicant.
- d. Amendment to Regulation 304.042 would provide that Pennsylvania's net worth requirement applies in a situation where an investment advisor is seeking registration in Pennsylvania but has its principal place of business in another state and is not registered in that other state.
- e. Amendment to 304.022 would delete the use of a management responsibility letter in lieu of an audit report where the investment adviser applicant is a certified public accountant or a firm consisting of certified public accountants. Also the amendment would delete the ability of public accountants to render an audit report which is required by changes made to section 609 ( C ) of the Act by Act 109 of 1998 and would delete the definition of principal. Lastly, the amendment would exempt investment advisers with custody of clients' funds or securities from filing an annual audited balance sheet if the investment adviser only inadvertently held the funds or securities and returned them to the client within three business days.
- f. Amendment to Regulation 404.013 would permit an investment adviser to send itemized client statements to another person authorized by the client or to reasonably rely on a qualified custodian of the client's funds or securities to send an itemized statement to the client.

### Regulatory Analysis Form

(12) State the public health, safety, environmental or general welfare risks associated with non-regulation:

The following regulations are being proposed for the following reasons:

Regulation 203.203 would codify the Exemptive Order issued by the Commission and published in the *Pennsylvania Bulletin* on March 27, 2004 at 34 Pa.B. 1734.

Regulation 303.012 would be amended to reflect changes made by the American Institute of Certified Public Accountants and changes made to section 609 ( c ) of the act by Act 109 of 1998.

Regulation 303.032 would be amended to remedy the current situation where the Commission has no way of knowing which attorney's and CPA's are eligible for a waiver of exam requirements by imposing a notification requirement.

Regulation 304.042 would set a net worth requirement that was not previously addressed because of NSMIA.

Regulation 304.022 would be amended to reflect changes made by the American Institute of Certified Public Accountants and changes made to section 609( c ) of the act by Act 109 of 1998.

Regulation 404.013 would clarify who investment advisers can send itemized client statements and when they can reasonably rely on a qualified custodian to do so.

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(13) Describe who will benefit from the regulation. (Quantify the benefits as completely as possible and approximate the number of people who will benefit.)

Issuers offering certain securities in Pennsylvania and investment advisers will be the primary beneficiaries of these regulatory proposals.

(14) Describe who will be adversely affected by the regulation. (Quantify the adverse effects as completely as possible and approximate the number of people who will be adversely affected.)

No one.

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(15) List the persons, groups or entities that will be required to comply with the regulation. (Approximate the number of people who will be required to comply.)

Investment advisers who are required to be registered with the Commission and have custody of clients' funds or securities, which the Commission estimates to be less than ten registrants. Also issuers that engage in a Rule 144A Exchange Transaction with a holder of debt securities located in Pennsylvania. Attorneys and CPA's who waived the exam requirement.

(16) Describe the communications with and input from the public in the development and drafting of the regulation. List the persons and/or groups who were involved, if applicable.

The Commission sought input of the regulated community, primarily by means of the Commission's Attorney Advisory Committee.

(17) Provide a specific estimate of the costs and/or savings to the regulated community associated with compliance, including and legal, accounting or consulting procedures which may be required.

The new exemption for Rule 144A Exchange Transactions will eliminate a current requirement that such transactions be registered under Section 205 or 206 of the 1972 Act. The Commission anticipates an annual revenue loss to the General Fund of approximately \$7,5000. The proposed amendments applicable to the few investment adviser registrants who have custody of clients' funds or securities will not impose significant additional record keeping costs beyond those which currently exist.

(18) Provide a specific estimate of the costs and/or savings to local governments associated with compliance, including any legal, accounting or consulting procedures which may be required.

The proposed regulatory actions do not affect local government.

(19) Provide a specific estimate of costs and/or savings to state government associated with the implementation of the regulation, including any legal, accounting, or consulting procedures which may be required.

The new exemption for Rule 144A Exchange Transactions will eliminate a current requirement that such transactions be registered under Section 205 or 206 of the 1972 Act. The Commission anticipates an annual revenue loss to the General Fund of approximately \$7,5000. The proposed amendments applicable to the few investment adviser registrants who have custody of clients' funds or securities will not impose significant additional record keeping costs beyond those which currently exist.

(20) In the table below, provide an estimate of the fiscal savings and costs associated with implementation and compliance for the regulated community, local government, and state government for the current year and five subsequent years.

(in thousands)	Current FY Year	FY+1 Year	FY+2 Year	FY+3 Year	FY+4 Year	FY+5 Year
SAVINGS:	\$	\$	\$	\$	\$	\$

Regulated Community						
Local Government						
State Government						
<b>Total Savings</b>						
<b>COSTS:</b>						
Regulated Community						

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Local Government						
State Government						
<b>Total Costs</b>						
<b>REVENUE LOSSES:</b>						
Regulated Community						
Local Government						
State Government						
<b>Total Revenue Losses</b>						

(20a) Explain how the cost estimates listed above were derived.

The Commission does not have reliable data available to ascertain the amount of legal, accounting and other costs associated with the few investment adviser registrants who have custody of clients' funds or securities.

(20b) Provide the past three year expenditure history for programs affected by the regulation.

<b>PROGRAM</b>	<b>FY-3</b>	<b>FY-2</b>	<b>FY-1</b>	<b>Current FY</b>
PA Securities Commission (Total State Appropriation)				

(21) Using the cost-benefit information provided above, explain how the benefits of the regulation outweigh the adverse effects and costs.

All of the regulatory proposals contained herein are beneficial as they reduce compliance costs on the regulated community without increasing program costs to the Commission.

(22) Describe the nonregulatory alternatives considered and the costs associated with those alternatives. Provide the reasons for their dismissal.

All of the regulatory proposals are derived from specific statutory sections in the Act which authorize the Commission to take action only by rule. Therefore, no non-regulatory alternatives were considered for the Commission Regulations proposed herein.

(23) Describe alternative regulatory schemes considered and the costs associated with those schemes. Provide the reasons for their dismissal.

Due to the response to Item 22, no alternative regulatory schemes were considered.

### Regulatory Analysis Form

(24) Are there any provisions that are more stringent than federal standards? If yes, identify the specific provisions and the compelling Pennsylvania interest that demands stronger regulation.

None of the regulatory proposals are more stringent than comparable federal standards.

(25) How does this regulation compare with those of other states? Will the regulation put Pennsylvania at a competitive disadvantage with other states?

One of the focal points of Act 109 of 1998 and these subsequent regulatory proposals was to create uniformity in treatment of exemptions and registrations with other states as outlined in the Uniform Securities Act, which has been adopted in a majority of states, including Pennsylvania.

(26) Will the regulation affect existing or proposed regulations of the promulgating agency or other state agencies? If yes, explain and provide specific citations.

The proposed regulations affect only the promulgating agency.

(27) Will any public hearings or informational meetings be scheduled? Please provide the dates, times and locations, if applicable.

The Commission has previewed these regulatory proposals with the Commission's Attorney Advisory Committee.

(28) Will the regulation change existing reporting, record keeping, or other paperwork requirements? Describe the changes and attach copies of forms or reports which will be required as a result of implementation, if available.

- a. Commission Regulation 203.203 would create a self-executing, exemption for SEC Rule 144A exchange transactions.
- b. Commission Regulation 303.032 would require attorneys and certified public accountants to report the Commission of his their eligibility for a waiver of the examination requirement.

**Regulatory Analysis Form**

(29) Please list any special provisions which have been developed to meet the particular needs of affected groups or persons including, but not limited to, minorities, elderly, small businesses, and farmers.

(30) What is the anticipated effective date of the regulation; the date by which compliance with the regulation will be required; and the date by which any required permits, licenses or other approvals must be obtained?

It is anticipated that the regulations will become effective upon publication of final rulemaking in the *Pennsylvania Bulletin*.

(31) Provide the schedule for continual review of the regulation.

The Commission Regulations proposed herein will be periodically reviewed by staff and, where changes are warranted, they will be included in the Commission's Regulatory Agenda.



FACE SHEET  
FOR FILING DOCUMENTS  
WITH THE LEGISLATIVE REFERENCE BUREAU

(Pursuant to Commonwealth Documents Law)

# 2430

DO NOT WRITE IN THIS SPACE

<p>Copy below is hereby approved as to form and legality. Attorney General</p> <p><i>[Signature]</i></p> <p>BY: _____ (DEPUTY ATTORNEY GENERAL)</p> <p><u>JUL 15 2004</u> DATE OF APPROVAL</p> <p><input type="checkbox"/> Check if applicable Copy not approved. Objections attached.</p>	<p>Copy below is hereby certified to be a true and correct copy of a document issued, prescribed or promulgated by:</p> <p><u>Pennsylvania Securities Commission</u> (AGENCY)</p> <p>DOCUMENT/FISCAL NOTE NO. <u>50-119</u></p> <p>DATE OF ADOPTION: <u>June 22, 2004</u></p> <p>BY: <i>[Signature]</i></p> <p>TITLE: <u>Secretary</u> (EXECUTIVE OFFICER, CHAIRMAN OR SECRETARY)</p>	<p>Copy below is hereby approved as to form and legality. Executive or Independent Agencies</p> <p><i>[Signature]</i></p> <p><u>June 22, 2004</u> DATE OF APPROVAL</p> <p><del>(Deputy General Counsel)</del> (Chief Counsel, Independent Agency) (Strike inapplicable title)</p> <p><input type="checkbox"/> Check if applicable. No Attorney General approval or objection within 30 days after submission.</p>
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PROPOSED RULEMAKING  
PENNSYLVANIA SECURITIES COMMISSION  
TITLE 64. SECURITIES

Subpart B. Registration of Securities  
Ch. 203. Exempt Transactions

Subpart C. Registration of Broker-Dealers, Agents, Investment Advisers and  
Investment Adviser Representatives and Notice Filings by Federally Covered Advisers  
Ch. 303. Registration Procedure  
Ch. 304. Post Registration Provisions

Subpart D. Fraudulent and Prohibited Practices  
Ch. 404. Prohibited Activities; Investment Advisers and Investment Adviser  
Representatives



**PROPOSED RULEMAKING  
PENNSYLVANIA SECURITIES COMMISSION**

***Statutory Authority***

Notice is hereby given that the Pennsylvania Securities Commission (Commission), pursuant to the authority contained in sections 203(r); 303(a) and (d); and 304(b) of the Pennsylvania Securities Act of 1972, as amended, Act of December 5, 1972 (P.L. 1280, No. 284) (70 P.S. §§1-101 *et seq.*) (Act), proposes to adopt and amend regulations concerning the subject matter of the Act set forth in Annex A and further described under the Summary of Regulations.

***Summary and Purpose of Regulations***

- §203.203. The Commission proposes to adopt a regulation that will provide a self-executing exemption for certain exchange transactions of debt securities in which certain Accredited Investors receive registered debt securities of the issuer in exchange for the issuer's debt securities that originally were issued in a private transaction under SEC Rule 144A (Rule 144A Exchange Transactions). This new regulation will codify the Exemptive Order issued by the Commission and published in the *Pennsylvania Bulletin* on March 27, 2004 at 34 Pa.B. 1734.
- §303.012 Since the American Institute of Certified Public Accountants no longer permits its members to issue management responsibility letters, the Commission proposes to amend this regulation to delete use of a management responsibility letter in lieu of an audit report where the investment adviser applicant is a certified public accountant or a firm consisting of certified public accountants. The Commission also proposes to delete the definition of principal which was used to define who could sign a management responsibility letter. Also, the Commission proposes to delete the ability of public accountants to render an audit report which is required by changes made to Section 609(c) of the Act by Act 109 of 1998.
- §303.032. The Commission proposes to amend this regulation to require certified public accountants and attorneys to notify the Commission of their eligibility for a waiver of the examination requirement for investment advisers and investment adviser representatives. All applications for registration as an investment adviser or investment adviser representative are processed electronically through the web based Investment Adviser Registration Depository (IARD). IARD only recognizes exam waivers for certain uniform designations (codified at §303.032(c)(1)(ii)(A)-(E) which do not include attorneys or CPAs. Therefore, the only way the Commission knows that those applicants are eligible for a waiver of the exam requirement is to impose a notification requirement on the applicant.

**PROPOSED RULEMAKING  
PENNSYLVANIA SECURITIES COMMISSION**

§304.042. Staff recently encountered a situation where it had to determine what net worth requirement applied to an investment adviser seeking registration in Pennsylvania which had its principal place of business in another state but was not licensed as an investment adviser in that state. Under the federal National Securities Markets Improvement Act of 1996 (NSMIA), the Commission must defer to the net worth requirements of the state where the investment adviser has its principal place of business if the investment adviser currently is licensed in that state and in compliance with that state's net worth requirements. Since NSMIA did not provide for the case at hand, staff applied PA's net worth requirement. Therefore, the Commission proposes to amend this regulation to state that Pennsylvania's net worth requirements apply where an investment adviser with a principal place of business in another state seeks registration in Pennsylvania but is not currently registered as an investment adviser in the state where it maintains its principal place of business.

The Commission proposes to amend this regulation to make it clear that an investment adviser will not be deemed to have custody of client's funds or securities and thereby be subject to a higher net worth requirement solely due to the investment adviser receiving a fee directly from the assets of the client, serving as a general partner of a pooled investment vehicle or serving as a trustee of a family beneficial trust if the investment adviser meets certain conditions.

§304.022. Since the American Institute of Certified Public Accountants no longer permits its members to issue management responsibility letters, the Commission proposes to amend this regulation to delete use of a management responsibility letter in lieu of an audit report where the investment adviser applicant is a certified public accountant or a firm consisting of certified public accountants. Also, the Commission proposes to delete the ability of public accountants to render an audit report which is required by changes made to Section 609(c) of the Act by Act 109 of 1998. The Commission further proposes to delete the definition of principal which was used to define who could sign a management responsibility letter. Lastly, the Commission proposes to exempt investment advisers with custody of clients' funds or securities from filing an annual audited balance sheet if they only inadvertently held clients' funds or securities and returned them to the client within three business days.

§404.013. The Commission proposes to amend its regulation to permit an investment adviser to send itemized client statements to a another person authorized by the client or to reasonably rely on a qualified custodian of the client's funds or securities to send an itemized statement to the client.

**PROPOSED RULEMAKING  
PENNSYLVANIA SECURITIES COMMISSION**

***Persons Affected by these Regulations***

Investment advisers who are required to be registered with the Commission and have custody of clients' funds or securities, which the Commission estimates to be less than ten registrants, will be affected by these proposed amendments. Also affected will be issuers that engage in a Rule 144A Exchange Transaction with a holder of debt securities located in Pennsylvania.

***Fiscal Impact***

The new exemption for Rule 144A Exchange Transactions will eliminate a current requirement that such transactions be registered under Section 205 or 206 of the 1972 Act. The Commission anticipates an annual revenue loss to the General Fund of approximately \$7,500. The proposed amendments applicable to the few investment adviser registrants who have custody of clients' funds or securities will not impose significant additional record keeping costs beyond those which currently exist.

***Paperwork***

The next exemption for Rule 144A Exchange Transactions will eliminate the filing of Commission Form R. Commission proposes to eliminate Form 203-I. The proposed amendments applicable to the few investment adviser registrants who have custody of clients' funds or securities will require some new record keeping.

***Effective Date***

The proposed amendments and regulations will become effective upon publication in the *Pennsylvania Bulletin* as final-form regulations.

***Regulatory Review***

Under Section 5(a) of the Regulatory Review Act (71 P.S. § 745.5(a)), on \_\_\_\_\_, the Commission submitted a copy of these proposed amendments to the Independent Regulatory Review Commission (IRRC) and the Chairpersons of the House Committee on Commerce and Economic Development and the Senate Committee on Banking and Insurance for comment and review. In addition to submitting the proposed amendments, the Commission has provided IRRC and the Committees with a copy of a detailed Regulatory Analysis form prepared by the Commission in compliance with Executive Order 1996-1, "Regulatory Review and Promulgation." A copy of this material is available upon request.

**PROPOSED RULEMAKING  
PENNSYLVANIA SECURITIES COMMISSION**

If IRRC has objections to any portion of the proposed amendments, it will notify the Commission within 10 days of the close of the committee comment period. The notification shall specify the regulatory review criteria which have not been met. The Regulatory Review Act specifies detailed procedures for review, prior to final publication of the final-form regulations by the Commission, the General Assembly and the Governor of objections raised.

***Availability in Alternative Formats***

This proposed rulemaking may be made available in alternative formats upon request. The Commission also will receive comments on this proposed rulemaking in alternative formats. TDD users should use the AT&T Relay Center (800) 854-5984. To make arrangements for alternative formats, contact Sam Dengel, ADA Coordinator, at (717) 787-6828.

***Contact Person***

Interested persons are invited to send comments concerning the proposed amendments within 30 days of publication of this notice to Paul S. Schwartz, Director, Division of Licensing, Securities Commission, Eastgate Building, 1010 N. Seventh Street, 2nd Floor, Harrisburg, PA 17102-1410, (717) 705-2961. Mr. Schwartz also is the contact person for an explanation of the proposed amendments and regulations.



**BY ORDER OF THE COMMISSION**

  
JEANNE S. PARSONS, SECRETARY

## ANNEX A

### **§203.203. Certain Rule 144A exchange transactions exempt.**

Under section 203(r) of the act (70 P.S. §1-203), the Commission finds that it is neither necessary nor appropriate for the protection of investors to require registration under section 201 of the act (70 P.S. §1-201) for the offer or sale of a security in a transaction if the following requirements are met:

(1) A person who owns outstanding debt securities (and any related guarantees) exchanges those securities for debt securities (and any related guarantees) of the same issuer which are the subject of an effective registration statement filed with the United States Securities and Exchange Commission (SEC) under Section 5 of the Securities Act of 1933 (15 U.S.C. §77(e)) (Exchange Transaction).

(2) The outstanding debt securities (and any related guarantees) are “restricted securities” as that term is defined in SEC Regulation 144(a)(3) (17 CFR 230.144(a)(3)).

(3) No consideration is paid by the owner of the outstanding debt securities (and any related guarantees) in connection with the Exchange Transaction.

(4) There are no material differences in the terms of the outstanding debt securities (and any related guarantees) and the debt securities (and any related guarantees) which are the subject of the Exchange Transaction.

### **§ 303.012. Investment adviser registration procedure.**

\* \* \*

(b) Except as set forth in subsection (f), the following statements of financial condition shall accompany an application for initial registration as an investment adviser:

(1) An applicant that has custody of client funds or securities or an applicant that requires payment of advisory fees 6 months or more in advance and in excess of \$1,200 per client shall file an audited balance sheet of the applicant prepared in accordance with generally accepted accounting principles and accompanied by a standard audit report containing an unqualified opinion of an independent certified public accountant [or an independent public accountant]. The accountant shall submit, as a supplementary opinion, comments based upon the audit as to material inadequacies found to exist in the accounting system, the internal accounting controls and the procedures for safeguarding securities and funds and shall indicate corrective action taken or proposed. The balance sheet required by this paragraph shall be as of the end of the

applicant's most recent fiscal year. If that balance sheet is as of a date more than 45 days prior to the date of filing the application, the applicant also shall file a subsequent balance sheet prepared in accordance with generally accepted accounting principles as of a date within 45 days of the date of filing. This balance sheet may be unaudited and may be prepared by management of the applicant. **[If the applicant is a certified public accountant or a public accountant or whose principals include one or more certified public accountants or public accountants, the applicant, in lieu of filing an audit report, may file a report modeled after the management responsibility letter contained in paragraph 9600.22 of the American Institute of Certified Public Accountant's Technical Information Service and signed by a certified public accountant or public accountant who either is the applicant or one of the principals of the applicant.]**

\* \* \*

(e) For purposes of this section, the following terms have the following meanings:

***[Principal – The chair, president, chief executive officer, general manager, chief operating officer, chief financial officer, vice president or other officer in charge of a principal business function (including sales, administration, finance, marketing, research and credit), secretary, treasurer, controller and any other natural person who performs similar functions.]***

*Principal place of business* – The meaning set forth in 17 CFR 275-203A-3(c) (relating to definitions) promulgated under the Investment Advisers Act of 1940 (15 U.S.C.A. §§80b-1 – 80b-21).

**§303.032. Examination requirements for investment advisers and investment adviser representatives.**

\* \* \*

(c) *Waivers of exam requirements.* Compliance with subsection (a) is waived if:

\* \* \*

(2) The individual is licensed as a certified public accountant, is currently in good standing and has no disciplinary history that requires an affirmative response to Items [23A-E] **14A-E** or Item [23H] **14H** of Form U-4 or successor items thereto, **and has notified the Commission that the individual is eligible for a waiver of the examination requirement imposed by subsection (a).**



(3) The individual is licensed as an attorney, is currently in good standing and has no disciplinary history that requires an affirmative response to Items [23A-E] 14A-E or Item [23H] 14H of Form U-4 or successor items thereto, **and has notified the Commission that the individual is eligible for a waiver of the examination requirement imposed by subsection (a).**

(4) The individual has received an order from the Commission waiving compliance with subsection (a).

**§303.042. Investment adviser capital requirements.**

(a) Every investment adviser registered [or required to be registered] under section 301 of the act (70 P.S. §1-301) shall maintain at all times the following net worth requirements:

(1) **[An] The following shall apply where an investment adviser [that] has its principal place of business in a state other than this Commonwealth [shall maintain the net worth required by the state where the investment adviser maintains its principal place of business if the investment adviser currently is licensed in that state and is in compliance with that state's net worth requirements].**

**(i) If the investment adviser currently is licensed as an investment adviser in the state in which it maintains its principal place of business and is in compliance with that state's net worth requirements, the net worth required by this section shall be the same as the net worth requirement imposed by that state.**

**(ii) If the investment adviser currently is not licensed as an investment adviser in the state in which it maintains its principal place of business, the net worth required by this section shall be the same as if the investment adviser had its principal place of business in this Commonwealth.**

\* \* \*

(3) An investment adviser that has its principal place of business in this Commonwealth and has custody of client funds or securities shall maintain at all times a minimum net worth of \$35,000 [except] **unless the investment adviser meets any of the following:**

**(i) The investment adviser has custody solely as a result of receiving fees directly deducted from clients' funds or securities if the investment adviser:**

**(A) Possesses written authorization from the client to deduct advisory fees from an account held by a qualified custodian.**

**(B) Sends the qualified custodian written notice of the amount of the fee to be deducted from the client's account.**

**(C) Sends the client a written invoice itemizing the fee, including any formulae used to calculate the fee, the time period covered by the fee and the amount of assets under management on which the fee was based.**

**(ii) The investment adviser has custody solely as a result of serving as a general partner, manager of a limited liability company or a person occupying a similar status or performing a similar function which gives the investment adviser or its supervised person legal ownership or access to client funds or securities if:**

**(A) The pooled investment vehicle is subject to audit at least annually and distributes its audited financial statements which have been prepared by an independent certified public accountant in accordance with generally accepted accounting principles to all limited partners, members or beneficial owners within 120 days of the end of its fiscal year.**

**(B) The investment adviser:**

**(I) Hires an independent party to review all fees, expenses and capital withdrawals from the accounts included in the pooled investment vehicle prior to forwarding them to the qualified custodian with the independent party's approval for payment.**

**(II) Sends written invoices or receipts to the independent party which describe the amount of the fees (including any formulae used to calculate the fees, the time period covered by the fees and the amount of assets under management on which the fees were based), expenses or capital withdrawals for the independent party to verify that payment of the fees, expenses or capital withdrawals is in accordance with the documents governing the operation of the pooled investment vehicle and any statutory requirements applicable thereto.**

**(iii) The investment adviser has custody solely as a result of acting as trustee for a beneficial trust in which the beneficial owners of the trust are a parent or step-parent; grandparent or step-grandparent; spouse, brother or step-brother, sister or step-sister, or grandchild or step-grandchild of the investment adviser.**

\* \* \*

(c) For the purpose of this section, the following terms have the following meanings:

*Custody* — A person is deemed to have custody of client funds or securities if the person directly

or indirectly holds clients funds or securities, has any authority to obtain possession of them or has the ability to appropriate them.

**Independent party – A person who meets all of the following requirements:**

**(1) Is engaged by an investment adviser with respect to payment of fees, expenses or capital withdrawals from a pooled investment vehicle in which the investment adviser has custody solely as a result of serving as a general partner, manager of a limited liability company or a person occupying a similar status or performing a similar function which gives the investment adviser or its supervised person legal ownership or access to client funds or securities.**

**(2) Does not control, is not controlled by, and is not under common control with the investment adviser.**

**(3) Within the preceding consecutive 12 month period, did not derive 5% or more of its gross revenues from the investment adviser who hired the person to be an independent party, including the amount to be received from the investment adviser under the terms of the independent party engagement.**

*Net capital* – The meaning set forth in 17 CFR 240.15c3-1 (relating to net capital requirements for brokers or dealers), promulgated under the Securities Exchange Act of 1934 (15 U.S.C.A. § 78a—78kk).

*Net worth*—The excess of assets over liabilities as determined by generally accepted accounting principles reduced by the following:

(i) Prepaid expenses except items properly classified as current assets under generally accepted accounting principles.

(ii) Deferred charges.

(iii) Goodwill, franchises, organizational expenses, patents, copyrights, marketing rights, unamortized debt discount and expense and all other assets of an intangible nature.

(iv) Home furnishings, automobiles and any other personal items not readily marketable in the case of an individual.

(v) Advances or loans to stockholders and officers in the case of a corporation; members and managers in the case of a limited liability company; and advances or loans to partners in the case of a partnership.

**Pooled investment vehicle – A limited partnership, limited liability company or an entity with a similar legal status and performing similar functions. A pooled investment vehicle does not include an investment company that has filed a registration statement under the Investment Company Act of 1940 (54 Stat. 789, 15 U.S.C. §80a-1 et seq.)**

**Principal place of business** — The meaning set forth in 17 CFR 275.203A-3(c)(relating to definitions) promulgated under the Investment Advisers Act of 1940 (15 U.S.C.A § § 80b-1—80b-21).

**Qualified custodian** – The following shall be considered qualified custodians for purposes of this section:

**(i) A bank as that term is defined in section 102(d) of the act (70 P.S. §1-102(d)).**

**(ii) A federally covered adviser as that term is defined in section 102(f.1) of the act (70 P.S. §1-102(f.1)).**

**(iii) A broker dealer registered with the Commission under section 301 of the act (70 P.S. §1-301).**

**Supervised person** – A person who meets the definition in section 202(a)(25) of the Investment Advisers Act of 1940 (15 U.S.C. §80b-2(a)(25)).

#### **§304.022. Investment adviser required financial reports.**

(a) Except as provided in [subsection (b)] **subsections (b) and (c)**, the following investment advisers registered under section 301 of the act (70 P.S. §1-301) shall file the following reports of financial condition with the Commission within 120 days of the investment adviser's fiscal year end:

(1) An investment adviser that has custody of client funds or securities or requires prepayment of advisory fees 6 months or more in advance and in excess of \$1,200 per client shall file with the Commission an audited balance sheet as of the end of its fiscal year. The balance sheet shall be prepared in accordance with generally accepted accounting principles and contain an unqualified opinion of an independent certified public accountant **[or independent public accountant]**. The accountant shall submit, as a supplementary opinion, comments based on the audit as to material inadequacies found to exist in the accounting system, the internal accounting controls and procedures for safeguarding securities and funds, and shall indicate corrective action taken or proposed. **[If the investment adviser is a certified public accountant or a public accountant or whose principals include one or more certified public accountants or public accountants, the investment adviser, in lieu of filing an audit report, may file a report modeled after the management responsibility letter contained in paragraph 9600.22 of the**

American Institute of Certified Public Accountant's Technical Information Service signed by a certified public accountant or public accountant or one of the principals of the investment adviser.]

\* \* \*

(c) [For purposes of this section, the following terms have the following meanings:

*Principal* – The chair, president, chief executive officer, general manager, chief operating officer, chief financial officer, vice president or other officer in charge of a principal business function (including sales, administration, finance, marketing, research and credit), secretary, treasurer, controller and any other natural person who performs similar functions.

*Principal place of business* – The meaning set forth in 17 CFR 275-203A-3(c) (relating to definitions) promulgated under the Investment Advisers Act of 1940 (15 U.S.C.A. §§80b-1 – 80b-21).] Where an investment adviser registered under section 301 of the act inadvertently held or obtained a client's securities or funds and returned them to the client within three business days or has forwarded third party checks within 24 hours, the investment adviser shall not be deemed to have custody and subject to the requirements of subsection (a) if the investment adviser maintains records which contains the following information about the securities or funds returned to the client:

(1) If a security:

(i) The name of the issuer.

(ii) Type of security.

(iii) Date of issuance.

(iv) Certificate number or other identifying information.

(v) Denomination, interest rate and maturity date applicable to a debt security.

(vi) Name in which the securities are registered.

(2) If funds:

(i) The name of the payee or beneficial owner.

(ii) Check number, transmittal number, payor name and address and any

**other identifying information.**

**(3) Date on which the funds or securities were received by the investment adviser.**

**(4) Date on which the funds or securities were sent by the investment adviser to the client.**

**(5) Form of delivery used by the investment adviser to transmit the funds or securities to the client and a copy of written confirmation of receipt of the funds or securities by the client.**

**(d) For purposes of this section, the following terms have the following meanings:**

**Principal place of business – The meaning set forth in 17 CFR 275-203A-3(c) (relating to definitions) promulgated under the Investment Advisers Act of 1940 (15 U.S.C.A. §§80b-1 – 80b-21).**

**§403.013. Investment adviser custody or possession of funds or securities.**

(a) Failure of an investment adviser not registered as a broker dealer that has custody or possession of funds or securities in which any client has a beneficial interest to comply with the requirements of this section shall constitute a fraudulent, deceptive or manipulative act, practice or course of business, within the meaning of section 404 of the act (70 P.S. §1-404).

(b) An investment adviser registered under Section 301 of the act (70 P.S. §1-301) that has custody or possession of any funds or securities in which any client has any beneficial interest shall:

(1) Notify the Commission in writing that the investment adviser has or may have custody. Such notification shall be given on Form ADV.

(2) Segregate the securities of each client marked to identify the particular client having the beneficial interest therein and held in safekeeping in some place reasonably free from risk of destruction or other loss.

(3) Deposit all client funds in one or more bank accounts containing only client's funds.

(4) Maintain the accounts described in paragraph (3) in the name of the investment adviser as agent or trustee for such clients.

(5) Maintain a separate record for each such account described in paragraph (3) showing the name and address of the bank where the account is maintained, the dates and amounts of

deposits in and withdrawals from the account, and the exact amount of each client's beneficial interest in the account.

(6) Immediately after accepting custody or possession of funds or securities from any client, notify the client in writing of the place where and the manner in which the funds and securities will be maintained and subsequently, if and when there is a change in the place where or the manner in which the funds or securities are maintained, the investment adviser gives written notice thereof to the client.

(7) At least once every three months, send each client **or the client's authorized representative as defined in this section** an itemized statement showing the funds and securities in the investment adviser's custody at the end of each such period and all debits, credits and transactions in the client's account during such period **or have a reasonable basis for believing that a qualified custodian will send an itemized statement to each client or the client's authorized representative during the same time interval containing substantially the same information.**

(8) At least once every calendar year, engage an independent certified public accountant [or independent public accountant] to verify all client funds and securities by actual examination at a time chosen by the accountant without prior notice to the investment adviser. A report stating that an accountant has made an examination of the client funds and securities, and describing the nature and extent of the examination, shall be filed with the Commission within 30 days after each examination.

**(c) Where an independent certified public accountant makes an examination described in subsection (b)(8) and, upon examination, finds material discrepancies, the accountant shall notify the Commission within one business day of the finding by means of facsimile transmission or electronic mail, followed by first class mail, directed to the Commission's Division of Licensing.**

[(c)] **(d)** For purposes of this section, a person will be deemed to have custody if [said ] **the** person directly or indirectly holds client funds or securities, has any authority to obtain possession of them, or has the ability to appropriate them.

**(e) For the purpose of this section, the following terms have the following meanings:**

**Authorized representative – The person specified in a written authorization which the client has signed and filed with the investment adviser or qualified custodian authorizing the investment adviser or qualified custodian to deliver the client's account statements to that person.**

**Qualified custodian – The following shall be considered qualified custodians for purposes of**

**this section:**

**(i) A bank as that term is defined in section 102(d) of the act (70 P.S. §1-102(d)).**

**(ii) A federally covered adviser as that term is defined in section 102(f.1) of the act (70 P.S. §1-102(f.1)).**

**(iii) A broker dealer registered with the Commission under section 301 of the act (70 P.S. §1-301).**



## PROPOSED RULEMAKING

**Annex A**  
**TITLE 58. RECREATION**  
**PART III. GAME COMMISSION**  
**CHAPTER 147. SPECIAL PERMITS**  
**Subchapter R. DEER CONTROL**  
**DEER MANAGEMENT ASSISTANCE**  
**PROGRAM PERMITS**

**§ 147.674. Issuance of DMAP harvest permits.**

\* \* \* \* \*

(e) Permits will not be issued to persons who failed to complete and submit harvest report and survey information from the prior season.

[Pa.B. Doc. No. 04-1722. Filed for public inspection September 17, 2004, 9:00 a.m.]

## SECURITIES COMMISSION

**[64 PA. CODE CHS. 203, 303, 304 AND 404]**

**Investment Advisors; Exchange Transactions**

The Securities Commission (Commission), under sections 203(r), 303(a) and (d) and 304(b) of the Pennsylvania Securities Act of 1972 (act) (70 P. S. §§ 1-203(r), 1-303(a) and (d) and 1-304(b)), proposes to amend regulations concerning the subject matter of the act to read as set forth in Annex A.

### *Summary and Purpose of the Proposed Rulemaking*

The Commission proposes to add § 203.203 (relating to certain Rule 144A exchange transactions exempt) to provide a self-executing exemption for certain exchange transactions of debt securities in which certain accredited investors receive registered debt securities of the issuer in exchange for the issuer's debt securities that originally were issued in a private transaction under SEC Rule 144A (Rule 144A Exchange Transactions).

Since the American Institute of Certified Public Accountants no longer permits its members to issue management responsibility letters, the Commission proposes to amend § 303.012 (relating to investment advisor registration procedure) to delete use of a management responsibility letter instead of an audit report where the investment advisor applicant is a certified public accountant (CPA) or a firm consisting of CPAs. The Commission also proposes to delete the definition of "principal" which was used to define who could sign a management responsibility letter. Also, the Commission proposes to delete the ability of public accountants to render an audit report which is required by changes made to section 609(c) of the act (70 P. S. § 1-609(c)) by the act of November 24, 1998 (P. L. 829, No. 109) (Act 109).

The Commission proposes to amend § 303.032 (relating to examination requirements for investment advisors and investment advisor representatives) to require CPAs and attorneys to notify the Commission of eligibility for a waiver of the examination requirement for investment advisors and investment advisor representatives. Applications for registration as an investment adviser or investment adviser representative are processed electronically through the web-based Investment Adviser Registration Depository (IARD). The IARD only recognizes exam waivers for certain uniform designations which do not include attorneys or CPAs. Therefore, the only way the Commis-

sion knows that the applicants are eligible for a waiver of the exam requirement is to impose a notification requirement on the applicant.

The Commission proposes to amend § 303.042 (relating to investment advisor capital requirements) to make it clear that an investment adviser will not be deemed to have custody of a client's funds or securities and thereby be subject to a higher net worth requirement solely due to the investment adviser receiving a fee directly from the assets of the client, serving as a general partner of a pooled investment vehicle or serving as a trustee of a family beneficial trust if the investment adviser meets certain conditions.

Since the American Institute of Certified Public Accountants no longer permits its members to issue management responsibility letters, the Commission proposes to amend § 304.022 (relating to investment advisor required financial reports) to delete use of a management responsibility letter instead of an audit report where the investment adviser applicant is a CPA or a firm consisting of CPAs. Also, the Commission proposes to delete the ability of public accountants to render an audit report which is required by changes made to section 609(c) of the act by Act 109. The Commission further proposes to delete the definition of "principal" which was used to define who could sign a management responsibility letter. Lastly, the Commission proposes to exempt investment advisers with custody of clients' funds or securities from filing an annual audited balance sheet if they only inadvertently held clients' funds or securities and returned them to the client within 3 business days.

The Commission proposes to amend § 404.013 (relating to investment advisor custody or possession of funds or securities of clients) to permit an investment adviser to send itemized client statements to another person authorized by the client or to reasonably rely on a qualified custodian of the client's funds or securities to send an itemized statement to the client.

### *Persons Affected by the Proposed Rulemaking*

Investment advisers who are required to be registered with the Commission and have custody of clients' funds or securities, which the Commission estimates to be less than ten registrants, will be affected by the proposed rulemaking. Also affected will be issuers that engage in a Rule 144A Exchange Transaction with a holder of debt securities in this Commonwealth.

### *Fiscal Impact*

The new exemption for Rule 144A Exchange Transactions will eliminate a current requirement that transactions be registered under section 205 or section 206 of the act (70 P. S. §§ 1-205 and 1-206). The Commission anticipates an annual revenue loss to the General Fund of approximately \$7,500. The proposed amendments applicable to the few investment adviser registrants who have custody of clients' funds or securities will not impose significant additional recordkeeping costs beyond those which currently exist.

### *Paperwork*

The next exemption for Rule 144A Exchange Transactions will eliminate the filing of Commission Form R. The Commission proposes to eliminate Form 203-I. The proposed amendments applicable to the few investment adviser registrants who have custody of clients' funds or securities will require some new recordkeeping.



*Effective Date*

The proposed rulemaking will become effective upon final-form publication in the *Pennsylvania Bulletin*.

*Regulatory Review*

Under section 5(a) of the Regulatory Review Act (71 P.S. § 745.5(a)), on September 1, 2004, the Commission submitted a copy of this proposed rulemaking and a copy of a Regulatory Analysis Form to the Independent Regulatory Review Commission (IRRC) and to the Chairpersons of the House Committee on Commerce and Economic Development and the Senate Committee on Banking and Insurance. A copy of this material is available to the public upon request.

Under section 5(g) of the Regulatory Review Act, IRRC may convey any comments, recommendations or objections to the proposed rulemaking within 30 days of the close of the public comment period. The comments, recommendations or objections must specify the regulatory review criteria which have not been met. The Regulatory Review Act specifies detailed procedures for review, prior to final publication of the rulemaking, by the Commission, the General Assembly and the Governor of comments, recommendations or objections raised.

*Availability in Alternative Formats*

This proposed rulemaking is available in alternative formats upon request. The Commission also will receive comments on this proposed rulemaking in alternative formats. TDD users should use the AT&T Relay Center, (800) 854-5984. To make arrangements for alternative formats, contact Sam Dengel, ADA Coordinator, (717) 787-6828.

*Contact Person*

Interested persons should send comments concerning the proposed rulemaking within 30 days of publication to Mary E. Peters, Deputy Chief Counsel, Securities Commission, Eastgate Building, 1010 N. Seventh Street, 2nd Floor, Harrisburg, PA 17102-1410, (717) 783-4186. Mary E. Peters also is the contact person for an explanation of the proposed rulemaking.

JEANNE S. PARSONS,  
*Secretary*

**Fiscal Note:** 50-119. (1) General Fund; (2) Implementing Year 2003-04 is \$7,500; (3) 1st Succeeding Year 2004-05 is \$7,500; 2nd Succeeding Year 2005-06 is \$7,500; 3rd Succeeding Year 2006-07 is \$7,500; 4th Succeeding Year 2007-08 is \$7,500; 5th Succeeding Year 2008-09 is \$7,500; (4) 2002-03 Program—\$7,500; 2001-02 Program—\$7,500; 2000-01 Program—\$7,500; (8) recommends adoption. This proposed rulemaking will codify the Exemptive Order issued by the Commission and published on March 4, 2004. The exemption of certain transactions from registration will cause the revenue loss previously outlined.

**Annex A**

**TITLE 64. SECURITIES**

**PART I. SECURITIES COMMISSION**

**Subpart B. REGISTRATION OF SECURITIES**

**CHAPTER 203. EXEMPT TRANSACTIONS**

**§ 203.203. Certain Rule 144A exchange transactions exempt.**

Under section 203(r) of the act (70 P.S. § 1-203), the Commission finds that it is neither necessary nor appropriate for the protection of investors to require registra-

tion under section 201 of the act (70 P.S. § 1-201) for the offer or sale of a security in a transaction if the following requirements are met:

(1) A person who owns outstanding debt securities (and any related guarantees) exchanges those securities for debt securities (and any related guarantees) of the same issuer which are the subject of an effective registration statement filed with the United States Securities and Exchange Commission (SEC) under section 5 of the Securities Act of 1933 (15 U.S.C.A. §§ 77(e)) (exchange transaction).

(2) The outstanding debt securities (and any related guarantees) are "restricted securities" as that term is defined in 17 CFR 230.144(a)(3) (relating to persons deemed not to be engaged in a distribution and therefore not underwriters).

(3) No consideration is paid by the owner of the outstanding debt securities (and any related guarantees) in connection with the exchange transaction.

(4) There are no material differences in the terms of the outstanding debt securities (and any related guarantees) and the debt securities (and any related guarantees) which are the subject of the exchange transaction.

**Subpart C. REGISTRATION OF  
BROKER-DEALERS, AGENTS, INVESTMENT  
ADVISERS AND INVESTMENT ADVISER  
REPRESENTATIVES AND NOTICE FILINGS BY  
FEDERALLY-COVERED ADVISERS**

**CHAPTER 303. REGISTRATION PROCEDURE**

**§ 303.012. Investment adviser registration procedure.**

\* \* \* \* \*

(b) Except as set forth in subsection (f), the following statements of financial condition shall accompany an application for initial registration as an investment adviser:

(1) An applicant that has custody of client funds or securities or an applicant that requires payment of advisory fees 6 months or more in advance and in excess of \$1,200 per client shall file an audited balance sheet of the applicant prepared in accordance with generally accepted accounting principles and accompanied by a standard audit report containing an unqualified opinion of an independent certified public accountant [ or an independent public accountant ]. The accountant shall submit, as a supplementary opinion, comments based upon the audit as to material inadequacies found to exist in the accounting system, the internal accounting controls and the procedures for safeguarding securities and funds and shall indicate corrective action taken or proposed. The balance sheet required by this paragraph shall be as of the end of the applicant's most recent fiscal year. If that balance sheet is as of a date more than 45 days prior to the date of filing the application, the applicant also shall file a subsequent balance sheet prepared in accordance with generally accepted accounting principles as of a date within 45 days of the date of filing. This balance sheet may be unaudited and may be prepared by management of the applicant. [ If the applicant is a certified public accountant or a public accountant or whose principals include one or more certified public accountants or public accountants, the applicant, in lieu of filing an audit report, may file a report modeled after the management responsibility letter contained in paragraph 9600.22



of the American Institute of Certified Public Accountant's Technical Information Service and signed by a certified public accountant or public accountant who either is the applicant or one of the principals of the applicant. ]

\* \* \* \* \*

(e) For purposes of this section, the following terms [ shall ] have the following meanings:

[ *Principal*—The chairperson, president, chief executive officer, general manager, chief operating officer, chief financial officer, vice president or other officer in charge of a principal business function (including sales, administration, finance, marketing, research and credit), secretary, treasurer, controller and any other natural person who performs similar functions. ]

\* \* \* \* \*

§ 303.032. Examination requirements for investment advisers and investment adviser representatives.

\* \* \* \* \*

(c) *Waivers of exam requirements.* Compliance with subsection (a) is waived if:

\* \* \* \* \*

(2) The individual is licensed as a certified public accountant, is currently in good standing and has no disciplinary history that requires an affirmative response to Items [ 23A-E ] 14A-E or Item [ 23H ] 14H of Form U-4 or successor items thereto, and has notified the Commission that the individual is eligible for a waiver of the examination requirement imposed by subsection (a).

(3) The individual is licensed as an attorney, is currently in good standing and has no disciplinary history that requires an affirmative response to Items [ 23A-E ] 14A-E or Item [ 23H ] 14H of Form U-4 or successor items thereto, and has notified the Commission that the individual is eligible for a waiver of the examination requirement imposed by subsection (a).

\* \* \* \* \*

§ 303.042. Investment adviser capital requirements.

(a) Every investment adviser registered [ or required to be registered ] under section 301 of the act (70 P. S. § 1-301) shall maintain at all times the following net worth requirements:

(1) [ An ] The following applies when an investment adviser [ that ] has its principal place of business in a state other than this Commonwealth [ shall maintain the net worth required by the state where the investment adviser maintains its principal place of business if the investment adviser currently is licensed in that state and is in compliance with that state's net worth requirements ].

(i) If the investment adviser currently is licensed as an investment adviser in the state in which it maintains its principal place of business and is in compliance with that state's net worth requirements, the net worth required by this section shall be the same as the net worth requirement imposed by that state.

(ii) If the investment adviser currently is not licensed as an investment adviser in the state in which it maintains its principal place of business, the net worth required by this section shall be the same as if the investment adviser had its principal place of business in this Commonwealth.

\* \* \* \* \*

(3) An investment adviser that has its principal place of business in this Commonwealth and has custody of client funds or securities shall maintain at all times a minimum net worth of \$35,000[ . ] unless the investment adviser meets any of the following:

(i) The investment adviser has custody solely as a result of receiving fees directly deducted from clients' funds or securities if the investment adviser:

(A) Possesses written authorization from the client to deduct advisory fees from an account held by a qualified custodian.

(B) Sends the qualified custodian written notice of the amount of the fee to be deducted from the client's account.

(C) Sends the client a written invoice itemizing the fee, including any formulae used to calculate the fee, the time period covered by the fee and the amount of assets under management on which the fee was based.

(ii) The investment adviser has custody solely as a result of serving as a general partner, manager of a limited liability company or a person occupying a similar status or performing a similar function which gives the investment adviser or its supervised person legal ownership or access to client funds or securities if:

(A) The pooled investment vehicle is subject to audit at least annually and distributes its audited financial statements which have been prepared by an independent certified public accountant in accordance with generally accepted accounting principles to all limited partners, members or beneficial owners within 120 days of the end of its fiscal year.

(B) The investment adviser:

(I) Hires an independent party to review all fees, expenses and capital withdrawals from the accounts included in the pooled investment vehicle prior to forwarding them to the qualified custodian with the independent party's approval for payment.

(II) Sends written invoices or receipts to the independent party which describe the amount of the fees (including any formulae used to calculate the fees, the time period covered by the fees and the amount of assets under management on which the fees were based), expenses or capital withdrawals for the independent party to verify that payment of the fees, expenses or capital withdrawals is in accordance with the documents governing the operation of the pooled investment vehicle and any statutory requirements applicable thereto.

(iii) The investment adviser has custody solely as a result of acting as trustee for a beneficial trust in which the beneficial owners of the trust are a parent or step-parent; grandparent or step-grandparent; spouse, brother or step-brother, sister or step-sister; or grandchild or step-grandchild of the investment adviser.



\* \* \* \* \*

(c) For the purpose of this section, the following terms have the following meanings:

\* \* \* \* \*

**Independent party**—A person who meets all of the following requirements:

(i) Is engaged by an investment adviser with respect to payment of fees, expenses or capital withdrawals from a pooled investment vehicle in which the investment adviser has custody solely as a result of serving as a general partner, manager of a limited liability company or a person occupying a similar status or performing a similar function which gives the investment adviser or its supervised person legal ownership or access to client funds or securities.

(ii) Does not control, is not controlled by and is not under common control with the investment adviser.

(iii) Within the preceding consecutive 12 month period, did not derive 5% or more of its gross revenues from the investment adviser who hired the person to be an independent party, including the amount to be received from the investment adviser under the terms of the independent party engagement.

\* \* \* \* \*

**Pooled investment vehicle**—

(i) A limited partnership, limited liability company or an entity with a similar legal status and performing similar functions.

(ii) The term does not include an investment company that has filed a registration statement under the Investment Company Act of 1940 (15 U.S.C.A. §§ 80a-1—80a-64).

\* \* \* \* \*

**Qualified custodian**—The following shall be considered qualified custodians for purposes of this section:

(i) A bank as that term is defined in section 102(d) of the act (70 P. S. § 1-102(d)).

(ii) A Federally covered adviser as that term is defined in section 102(f.1) of the act.

(iii) A broker dealer registered with the Commission under section 301 of the act (70 P. S. § 1-301).

**Supervised person**—A person who meets the definition in section 202(a)(25) of the Investment Advisers Act of 1940 (15 U.S.C.A. § 80b-2(a)(25)).

**CHAPTER 304. POSTREGISTRATION PROVISIONS**  
**§ 304.022. Investment adviser required financial reports.**

(a) Except as provided in [ subsection ] subsections (b) and (c), the following investment advisers registered under section 301 of the act (70 P. S. § 1-301) shall file the following reports of financial condition with the Commission within 120 days of the investment adviser's fiscal year end:

(1) An investment adviser that has custody of client funds or securities or requires prepayment of advisory fees 6 months or more in advance and in excess of \$1,200 per client shall file with the Commission an audited

balance sheet as of the end of its fiscal year. The balance sheet shall be prepared in accordance with generally accepted accounting principles and contain an unqualified opinion of an independent certified public accountant [ or independent public accountant ]. The accountant shall submit, as a supplementary opinion, comments based on the audit as to material inadequacies found to exist in the accounting system, the internal accounting controls and procedures for safeguarding securities and funds, and shall indicate corrective action taken or proposed. [ If the investment adviser is a certified public accountant or a public accountant or whose principals include one or more certified public accountants or public accountants, the investment adviser, in lieu of filing an audit report, may file a report modeled after the management responsibility letter contained in paragraph 9600.22 of the American Institute of Certified Public Accountants' Technical Information Service signed by a certified public accountant or public accountant or one of the principals of the investment adviser. ]

\* \* \* \* \*

(c) [ For purposes of this section, the following terms have the following meanings:

**Principal**—The chair, president, chief executive officer, general manager, chief operating officer, chief financial officer, vice president or other officer in charge of a principal business function (including sales, administration, finance, marketing, research and credit), secretary, treasurer, controller and any other natural person who performs similar functions.

**Principal place of business**—The meaning set forth in 17 CFR 275-203A-3(c) (relating to definitions) promulgated under the Investment Advisers Act of 1940 (15 U.S.C.A. §§ 80b-1—80b-21). ] When an investment adviser registered under section 301 of the act inadvertently held or obtained a client's securities or funds and returned them to the client within 3 business days or has forwarded third party checks within 24 hours, the investment adviser will not be deemed to have custody and subject to the requirements of subsection (a) if the investment adviser maintains records which contains the following information about the securities or funds returned to the client:

- (i) If a security:
  - (A) The name of the issuer.
  - (B) The type of security.
  - (C) The date of issuance.
  - (D) A certificate number or other identifying information.
  - (E) The denomination, interest rate and maturity date applicable to a debt security.
  - (F) The name in which the securities are registered.
- (ii) If funds:
  - (A) The name of the payee or beneficial owner.
  - (B) The check number, transmittal number, payor name and address and any other identifying information.





(iii) The date on which the funds or securities were received by the investment adviser.

(iv) The date on which the funds or securities were sent by the investment adviser to the client.

(v) The form of delivery used by the investment adviser to transmit the funds or securities to the client and a copy of written confirmation of receipt of the funds or securities by the client.

(d) For purposes of this section, the following term has the following meaning:

*Principal place of business*—The meaning set forth in 17 CFR 275-203A-3(c) (relating to definitions) promulgated under the Investment Advisers Act of 1940 (15 U.S.C.A. §§ 80b-1—80b-21).

**Subpart D. FRAUDULENT AND PROHIBITED PRACTICES**

**CHAPTER 404. PROHIBITED ACTIVITIES; INVESTMENT ADVISERS AND INVESTMENT ADVISER REPRESENTATIVES**

**§ 404.013. Investment adviser custody or possession of funds or securities of clients.**

\* \* \* \* \*

(b) An investment adviser registered under section 301 of the act (70 P. S. § 1-301) that has custody or possession of any funds or securities in which any client has any beneficial interest shall:

\* \* \* \* \*

(7) At least once every 3 months, send each client or the client's authorized representative as defined in this section an itemized statement showing the funds and securities in the investment adviser's custody at the end of each period and all debits, credits and transactions in the client's account during that period or have a reasonable basis for believing that a qualified custodian will send an itemized statement to each client or the client's authorized representative during the same time interval containing substantially the same information.

(8) At least once every calendar year, engage an independent certified public accountant [or independent

public accountant] to verify all client funds and securities by actual examination at a time chosen by the accountant without prior notice to the investment adviser. A report stating that an accountant has made an examination of the client funds and securities, and describing the nature and extent of the examination, [ shall ] must be filed with the Commission within 30 days after each examination.

(c) When an independent certified public accountant makes an examination described in subsection (b)(8) and, upon examination, finds material discrepancies, the accountant shall notify the Commission within 1 business day of the finding by means of facsimile transmission or electronic mail, followed by first class mail, directed to the Commission's Division of Licensing.

(d) For purposes of this section, a person will be deemed to have custody if the person directly or indirectly holds client funds or securities, has any authority to obtain possession of them, or has the ability to appropriate them.

(e) For the purpose of this section, the following terms have the following meanings:

*Authorized representative*—The person specified in a written authorization which the client has signed and filed with the investment adviser or qualified custodian authorizing the investment adviser or qualified custodian to deliver the client's account statements to that person.

*Qualified custodian*—The following will be considered qualified custodians for purposes of this section:

(i) A bank as that term is defined in section 102(d) of the act (70 P. S. § 1-102(d)).

(ii) A Federally covered adviser as that term is defined in section 102(f.1) of the act.

(iii) A broker dealer registered with the Commission under section 301 of the act.

[Pa.B. Doc. No. 04-1723. Filed for public inspection September 17, 2004, 9:00 a.m.]



**COMMONWEALTH OF PENNSYLVANIA  
PENNSYLVANIA SECURITIES COMMISSION  
January 31, 2005**

**TO:** IRRC

**FROM:** Mary E. Peters *M.E.P.*  
Deputy Chief Counsel

**RE:** Final Regulation; 50-119

Attached you will find a copy of the Commission's Final Regulations. For your information, the Commission has made no changes from the Proposed Regulations and the Commission received no comment letters on the Proposed Regulations. If you should have any questions or need any additional information, please feel free to contact me at 783-4186.



TRANSMITTAL SHEET FOR REGULATIONS SUBJECT TO THE  
REGULATORY REVIEW ACT

I.D. NUMBER: 50-119

SUBJECT: Exchange transaction exemptions, investor adviser registration,  
exam requirement waivers, capital requirements, financial reports,  
AGENCY: Custody.

PA Securities Commission

TYPE OF REGULATION

- Proposed Regulation
- Final Regulation *Isabel Ulysses*
- Final Regulation with Notice of Proposed Rulemaking Omitted
- 120-day Emergency Certification of the Attorney General
- 120-day Emergency Certification of the Governor
- Delivery of Tolloed Regulation
  - a.  With Revisions
  - b.  Without Revisions

FILING OF REGULATION

DATE	SIGNATURE	DESIGNATION
<i>2/1/05</i>	<i>Brenda Zablotky</i>	HOUSE COMMITTEE ON
<i>2-1-05</i>	<i>Sharon M. Dermott B+S</i>	SENATE COMMITTEE ON
<i>2-1-5</i>	<i>Cheryl Schill</i>	
<i>2/1/05</i>	<i>Dr. Helmut</i>	INDEPENDENT REGULATORY REVIEW COMMISSION
		ATTORNEY GENERAL
		LEGISLATIVE REFERENCE BUREAU

