

Office of Financial Regulation

Securities Division

Bureau of Enforcement

Investment Adviser Compliance Alert: Common Deficiencies **Relating to Direct Fee Deductions from Client Accounts Held at Custodians**

The Office of Financial Regulation (“OFR”), Securities Division, Bureau of Enforcement (“Bureau”), is informing Florida registered investment advisers about common examination deficiencies relating to direct fee deductions from client accounts.

Common Deficiencies Identified During Examinations

Under Florida’s investment adviser regulations, custody includes any arrangement under which the investment adviser is authorized or permitted to withdraw client funds maintained with a custodian upon the investment adviser’s instruction to the custodian.¹ As a result, investment advisers have custody when their clients have authorized them to instruct custodians to withdraw funds, including the amount thereof, from client accounts to pay their advisory fees. Based on its examinations, the Bureau has concluded that some investment advisers are unaware that these direct fee deduction arrangements constitute custody in Florida.

Investment advisers are required to notify OFR when they have custody by way of their Form ADV.² Specifically, investment advisers must check yes to Form ADV, Part 1A, Items 9A(1)(a) and 9B(1)(a) and complete Items 9A(2) and 9B(2) when they have custody. This requirement applies even when custody is solely due to direct fee deductions from clients’ custodian accounts. During its examinations, the Bureau has observed that certain investment advisers’ Form ADV filings incorrectly state that they do not have custody when in fact they do have custody based on direct fee deduction arrangements with their clients.

Under Florida’s investment adviser custody regulation, investment advisers must send clients itemized invoices when they are authorized to instruct custodians to withdraw funds from clients’ accounts to pay their advisory fees.³ The invoices must be sent concurrently with the fee deduction and include the formula used to calculate the fee, the amount of assets under management that the fee calculation is based on, and the time period covered by the fee. The fee invoices must be sent irrespective of whether the clients receive monthly statements from custodians. Based on its examinations, the Bureau has observed that some investment advisers are not sending the required fee invoices even though they have custody based on direct fee deductions or they are sending the fee invoices but they do not contain the required information.

Differences Between Florida and Federal Custody Requirements

The U.S. Securities and Exchange Commission’s (“SEC”) custody requirements are different than Florida’s. Although SEC registered investment advisers have custody due to direct fee deductions, they are not required to check yes to Items 9A(1)(a) or 9B(1)(a) in their Form ADVs when they have custody

¹ F.A.C. 69W-600.0132(1)(a)1.a.

² F.A.C. 69W-600.132(2)(a)

³ F.A.C. 69W-600.132(2)(i)

solely based on clients authorizing them to withdraw funds from their accounts to pay advisory fees.⁴ As a result, Item 9 of the Form ADV includes the following instruction:

If you are registering or registered with the SEC, answer “No” to Item 9.A.(1)(a) and (b) if you have custody solely because (i) you deduct your advisory fees directly from your clients’ accounts....

It is important for state registered investment advisers to understand that the above instruction is not applicable to them and, as discussed above, custody solely due to direct fee deduction must be disclosed in Form ADVs to comply with Florida requirements.

Another key difference between SEC and Florida custody requirements is that SEC investment advisers do not need to send itemized invoices to their clients when they engage in direct fee deductions. Instead, SEC investment advisers are solely required to have a reasonable basis, after due inquiry, for believing that the 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.⁵ As noted above, Florida registered investment advisers who engage in direct fee deductions must send clients itemized invoices irrespective of whether the custodian sends account statements.

Conclusion

Florida registered investment advisers should ensure that they are complying with state law custody requirements which differ from custody requirements applicable to SEC registered investment advisers. Investment advisers who have the authority from their clients to instruct custodians to disburse funds upon their instruction to pay their advisory fees should review their Form ADV and confirm that it is accurate regarding custody. They should also verify that they are sending invoices concurrent with the direct fee deductions from their client accounts and that they contain the information described above required under Florida’s investment adviser custody regulation.

⁴ 17 C.F.R. 275.206(4)-2

⁵ 17 C.F.R. 275.206(4)-2(a)(3)