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VIA E-MAIL

To Our Investment Adviser Clients and Other Friends

Re: California Adopts Final Custody Rule

On January 7, 2014, the California Commissioner of Business Oversight (the "**Commissioner**") adopted a new custody rule (the "**Rule**")[1] for investment advisers that are licensed as such in California. The Rule will become effective on April 1, 2014. This letter summarizes key aspects of the Rule for California advisers.

1. Background of Custody Requirements for Private Funds

California-licensed advisers to private funds often avoided being deemed to have custody of client assets by implementing procedures that included, among other things, engaging an independent representative to approve fee payments and other disbursements from the Fund to the adviser and its affiliates (the "**PIMS/Bennett Procedures**"). The PIMS/Bennett Procedures were based on no-action letters that the SEC issued and later revoked, but that the Commissioner continued to recognize informally.

Under the new Rule, however, an adviser cannot avoid having custody by using the PIMS/Bennett Procedures. Rather, advisers that are general partners or managers of pooled investment vehicles ("**Funds**") will now be deemed to have custody of client assets and must comply with the new requirements outlined below.

2. Requirements under the Rule

A California-licensed adviser that holds, directly or indirectly, client assets or has the authority to obtain them must:

(a) Notify the Commissioner that it has custody of client assets in its Form ADV;

(b) Maintain such assets with a "qualified custodian" in a separate account for each client;

[1] California Code of Regulations §260.237.

(c) If advising a Fund:

(i) Send a statement to every Fund investor (an "**Investor**") at least quarterly that shows (1) the total amount of all additions to and withdrawals from the Fund, (2) the opening and closing value of the Fund for the reporting period, (3) a list of all of the Fund's securities positions on the closing date of the reporting period that are required to be disclosed under GAAP for non-registered investment partnerships, and (4) a list of all redemptions and withdrawals by the Investor and the value of the Investor's interest in the Fund; and

(ii) Either (1) cause the Fund's financial statements to be audited annually by a certified public accountant[2] and distribute the audited financials to Investors within 120 days of the Fund's fiscal year end (the "**Annual Audit Exemption**"),[3] or (2) enter into an agreement with an independent third party (the "**Gatekeeper**") who is obligated to act in the Investors' best interest. The agreement must authorize the Gatekeeper to review, verify and approve invoices and receipts for all Funds for fees, expenses and withdrawals; an adviser using the Gatekeeper option that currently relies on the PIMS/Bennett Procedures will need to revise its Gatekeeper agreement to broaden the Gatekeeper's power to review, verify and approve invoices and receipts generally; and

(d) Additionally, an adviser that advises non-Fund clients or that uses the Gatekeeper procedure instead of the Annual Audit Exemption must:

(i) Notify clients of the identity and location of the qualified custodian of the clients' assets;

(ii) Have a reasonable basis after due inquiry for believing the clients receive account statements at least quarterly directly from the qualified custodian that (1) identify the amount of assets in the account at the end of the reporting period, and (2) list all transactions in the account; and

(iii) Retain a certified public accountant to conduct a surprise examination of client assets at least once each calendar year at a time chosen by the accountant. An adviser that has custody only because of its authority to deduct its fees from client accounts is not required to comply with this requirement as long as the adviser has written authorization to deduct its fee, sends invoices for the amount of the fee to its custodian and the client, and notifies the Commissioner that it will rely on this exception to the Rule.

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[2] Under the Rule, the annual audit must be performed by accountants that are registered with and subject to regular inspection by the Public Company Accounting Oversight Board.

[3] Any adviser relying on the Annual Audit Exemption must also, on its liquidation, distribute a final audited financial statement to all Investors and the Commissioner. Later delivery requirements apply to fund of funds.

3. Practical Next Steps for Advisers to Funds

To comply with the Rule when it becomes effective on April 1, 2014, every California-licensed adviser to Funds, even advisers relying on the Annual Audit Exemption, must prepare Investor account statements that contain all required information (as discussed in section 2(c)(i) above), including the securities positions required under GAAP.

An adviser to a Fund that does not rely on the Annual Audit Exemption should also:

(a) Establish a written agreement with a Gatekeeper and determine that the Gatekeeper understands the types of fees and expenses that are allowed under the Fund's governing documents to ensure timely approval of fees and expenses; and

(b) Modify its policies and procedures to ensure that invoices and receipts are collected and sent to the Gatekeeper before any fees or other expenses are deducted from client accounts.

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This letter only generally summarizes the Rule, is not intended as specific or complete advice, and is subject to change as the Commissioner interprets the Rule. For further assistance, including assistance drafting Gatekeeper agreements and updating your policies and procedures, please contact Doug Hammer, John Broadhurst, Geoff Haynes, Chris Rupright, Carolyn Reiser, Neil Koren, Jim Frolik, Christina Hamilton, Joan Grant, Ellyn Roberts, Anthony Caldwell, David Suozzi or Kathryn Miller.

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