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COMMISSIONER



BRIAN C. McNEIL  
EXECUTIVE SECRETARY

MARK SENDROW  
DIRECTOR

SECURITIES DIVISION  
1300 West Washington, Third Floor  
Phoenix, AZ 85007-2996  
TELEPHONE: (602) 542-4242  
FAX: (602) 594-7470  
E-MAIL: accsec@ccsd.cc.state.az.us

ARIZONA CORPORATION COMMISSION

August 30, 2002

Thomas F. Basso, CEO  
Trendstat Capital Management, Inc.  
4300 N. Miller Rd., Ste. 141  
Scottsdale AZ 85251-3621

44-3159

RE: Trendstat Capital Management, Inc.  
A.R.S. § 44-3159, A.A.C. R14-6-206, and A.A.C. R14-6-212

Dear Mr. Basso:

The Securities Division has reviewed Trendstat Capital Management Inc.'s no-action request dated August 2, 2002. On the basis of the information set forth in that letter, the Securities Division declines to issue a no-action letter.

The Securities Division cannot agree with the position that, since Trendstat Capital Management, Inc. complies with the standards identified in the no-action letter issued by the Securities and Exchange Commission ("SEC") in PIMS, Inc., it does not have custody of client funds or securities. The investment adviser in PIMS, Inc. had custody of client assets. The SEC essentially stated in that opinion that the investment adviser did not have to comply with rules 206(4)-2 and 204-1(b)(2) if other specified procedures were put into place. The Securities Division does not have the authority to create new licensing standards through the no-action process under A.R.S. § 44-1826. Additionally, you urge the Securities Division to follow the proposed amendments to SEC rule 206(4)-1 because A.A.C. R14-6-206 is patterned after that rule. To adopt the SEC's proposed amendments, the Securities Division must amend A.A.C. R14-6-206. Therefore, we are unable to provide the relief that you seek based upon your compliance with the PIMS, Inc. no-action position or based upon the proposed amendments to SEC rule 206(4)-2. Because Trendstat Capital Management, Inc. has custody of client funds or securities, it must comply with the financial statement and audit requirements in A.R.S. § 44-3159, A.A.C. R14-6-206, and A.A.C. R14-6-212 to become licensed in Arizona as an investment adviser.

As this position is premised upon the facts set forth in your letter, it should not be relied on for any other set of facts or by any other person. We have attached a photocopy of your letter containing the facts upon which this position is based.

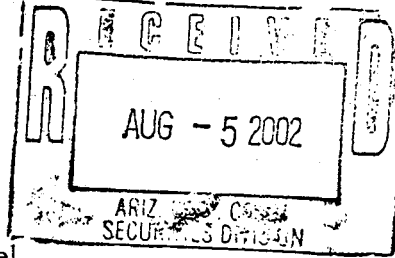
Very truly yours,

MARK SENDROW  
Director of Securities

MS:sd  
Attachment

CERTIFIED MAIL 7001 1940 0006 0194 8996

August 2, 2002



Associate General Counsel  
Securities Division, Arizona Corporation Commission  
1300 West Washington Street, Third Floor  
Phoenix, AZ 85007

Re: Request for No Action or Interpretation; Constructive Custody

This is a request for no action or an interpretive opinion that, based on the facts and safeguards set forth below, Trendstat Capital Management, Inc. ("Trendstat") shall not be deemed to have constructive custody of client assets in the case of Trendstat's management of Market Math Ltd. ("Market Math"), a California limited partnership and since Trendstat does not have actual custody, will not be required to comply with the rules or laws applicable to investment advisers who have custody of client funds including A.R.S. §44-3159 (A) (2) and of the Arizona Corporation Commission Securities Division's (the "Commission") rules R14-6-212 (2) and R14-6-206 (6).

Reason for asking for the Interpretation and/or No-Action decision: Trendstat has been registered as an investment adviser with the Securities and Exchange Commission ("SEC") since 1984. Since Trendstat no longer qualifies to remain registered with the SEC pursuant to paragraph (a)(1)(A) of Section 203A of the Investment Advisers Act of 1940 (the "IAA"), Trendstat has applied for registration as an investment adviser in the state of Arizona, the state in which Trendstat has its principal office and place of business. In the process of applying for registration with the state of Arizona, staff has raised the issue as to whether Trendstat should be treated as having constructive custody of client assets and accordingly would be required to have its corporate accounting records audited immediately (prior to approval of Trendstat's state registration as an investment adviser). In addition, Trendstat has been advised that if it were deemed to have custody, it also will be required to have a surprise audit performed on Market Math, Trendstat's client, and to file annually a certified balance sheet for Trendstat. The state reviewer indicated that the cost of these audits should be minimal, but in obtaining estimates on the price of the additional audit and certified balance sheets, Trendstat found additional costs to be \$15,000 in the first year for the audit of Trendstat and \$15,000 per year for the surprise audit and certified balance sheet (i.e. \$30,000 per annum). This is in addition to the year end audit already required by the Commodity Futures Trading Commission ("CFTC") and the National Futures Association ("NFA"), the futures industry's self regulatory organization, that costs Market Math approximately \$20,000. These prices do not include all the time and salary of those involved in assisting the auditors by providing the auditors information to allow them to complete their work. This also does not include the cost to Market Math, which currently is more than \$110,000 per year, of having a separate and independent administrator as well as an independent certified public accountant ("CPA") accounting firm, separate and independent of the CPA accounting firm that performs Market Math's annual audit, which reviews every invoice and

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computation for withdrawals from the client's bank account related to Trendstat, its officer, directors, employees or affiliates. In addition, this does not take into account the fact that limited partners of Market Math, in accordance with applicable CFTC regulations, receive monthly statements of account providing the details of their respective capital account. Further, Trendstat complies with all the substantive requirements of the Arizona statutes and rules relating to custody other than the certified balance sheet and surprise audit. However, Trendstat has additional procedural and regulatory safeguards by virtue of having adopted the SEC-endorsed procedures so as not to be deemed to have custody of its client's assets, of being regulated by the CFTC including monthly independent reporting and annual audited and certified annual reports and the additional requirements applicable to Market Math, which is a pooled investment vehicle. These additional safeguards provide greater protection of client assets than if Trendstat were to minimally comply with the audited balance sheet/surprise audit requirements of the Arizona statute and rules.

Background: Trendstat became the investment manager and co-general partner of a limited partnership called Market Math Ltd., in January 1997. At that time, Trendstat was registered with the CFTC as both a Commodities Trading Advisor ("CTA") and a Commodity Pool Operator ("CPO"), and with Arizona as a registered investment adviser ("RIA") until December 1997, when Trendstat withdrew its Arizona state registration and became registered with the Securities and Exchange Commission as an RIA. Because the majority of investments for Market Math are futures and other derivative instruments rather than securities investments, Market Math is primarily engaged in commodities trading and is a pooled investment vehicle or commodity pool, subject to the jurisdiction of the CFTC. Consistent with CFTC regulations, a Futures Commission Merchant ("FCM") registered with the CFTC is required to have custody of Market Math's funds and futures interests. The operator of such a pooled investment vehicle is required to register as a CPO, must maintain the futures assets in segregated accounts in the name of the pool (in this case, Market Math, the client of Trendstat) and is not allowed to commingle those assets with any other assets or with assets of the CPO. The CPO of Market Math is required to provide monthly account statements to each limited partner reflecting not only the net asset value of the pool, but also the net asset value of the capital account of the limited partner, all of which is prepared in accordance with GAAP and pursuant to CFTC regulations which requires independent valuation of assets of the pool with the possible exception of illiquid assets, none of which Trendstat trades. The CPO also must obtain a certified and audited financial statement at the end of each fiscal year end which is filed with the CFTC along with a certification of a principal of Trendstat attesting to the material accuracy of the statements. With the advice of counsel, in 1997, Trendstat structured procedures for the operation of Market Math to comply with the differing compliance requirements of its RIA, CTA and CPO registrations which ensured that Trendstat would not, and could not, have actual custody of its clients' funds and that Trendstat would not be deemed to have constructive custody of its client's funds. In the interim, Trendstat has been audited as an investment adviser by the SEC twice and twice as a commodity trading advisor by the NFA (i.e. four times in five years). In addition to complying with the procedures outlined in the series of SEC no action letters regarding constructive custody including the PIMMS letter in 1991 ("PIMMS"), Trendstat hired an independent firm to be the administrator of Market Math and to perform CPO functions on behalf of Market Math.

ATA Research, Inc. (ATA), a CFTC/NFA registered CPO, which at the time of contracting was one of the largest CPOs measured by assets under management, contracted to provide the administrator function and to perform certain CPO functions for Market Math. ATA hired a second firm, Lamp Technologies, as Market Math's bookkeeper and to provide a separate, independent calculation of

Market Math's net asset value, to provide limited partners of Market Math with the year-end tax form K-1's and verify all the cash transactions, both in and out of the Market Math. Trendstat does not handle any cash, nor does it create any monthly statements or K-1's to limited partners. Trendstat does manage all of Market Math's investments, provides limited partners of Market Math with a monthly newsletter and a daily estimate of performance to those who have requested to receive that information.

Attachment A is a flow chart of all the organizations involved in the current custody/administration structure. All subscription funds, additions, withdrawals or expense payments to or from limited partners or to service providers are sent directly to and from the Market Math bank account at Wells Fargo Bank. No payment or wire of cash is made out of the Market Math bank account for the benefit of Trendstat, any of its affiliates and any of their officers, employees, principals, family members or beneficiaries without the prior verification and written approval of an independent CPA accounting firm, (separate and independent of the CPA auditing firm that performs the annual certified audit and each of which is independent of either ATA, the Administrator or Lamp, the bookkeeping firm), the Administrator and Trendstat. Despite being the largest investor of Market Math, I can not even liquidate a portion of my own investment account in Market Math, notwithstanding that I am the CEO of Trendstat, without a redemption letter and approximately 3 weeks delay while it proceeds through the verification and approval process for the three signatories. The bank sends each of Market Math, the Administrator and the verifying independent CPA accounting firm copies of Market Math's bank statements monthly which detail all transactions, charges, expenses, additions and withdrawals in and out of Market Math's account.

In addition to these PIMMS-sanctioned procedures, Market Math's bookkeeper produces monthly account statements for Market Math and also for each partner, which are prepared in accordance with GAAP and with CFTC regulations. Since all of Market Math's assets are held in the custody of either independent banks (funds and foreign exchange currencies), a futures commission merchant registered under the CFTC (futures positions) or a prime broker which also is registered as a broker dealer under the federal securities laws (security investments), the assets of investors in Market Math are protected and subject to more safeguards than are currently required under this Arizona statute and rules.

#### Interpretative Authority of the Commission and Efficacy of Custodial Safeguards

The issue of whether Trendstat will be deemed to have custody of Market Math's assets arises in the context of the Commission's rules regarding Trendstat's application for licensure as an investment adviser with the state of Arizona (R14-6-212 (2)<sup>1</sup>; requirement for an audited balance sheet) but also in the Arizona statute regarding Trendstat's continuing regulatory requirements (A.R.S. §44-3159 (A) (2); if a *licensed* investment adviser has custody, an audited balance sheet must be filed as of the end of the investment adviser's fiscal year end) and in the Commission's rule R14-6-206 which requires an annual surprise audit.

In each case, the determination must be made the investment adviser has "custody" of client assets. As Trendstat was unable to locate a separate definition of "custody" in the Arizona statutes applicable to these rules and statute, it would appear that pursuant to A.R.S. §44-3102, the Commission has the discretion to interpret the meaning of this word and in doing so, may refer to the identical terms used in

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<sup>1</sup> The statute relating to investment adviser applications has no specific requirement (paragraph C.3. requires merely "financial reports as required by the commission") for a certified balance sheet. A.R.S. §44-3153 (C)(3).

the investment advisers act of 1940, including its regulations and interpretative releases. In this regard, we note not only the line of SEC no action letters, including the PIMMS letter, but also the SEC's recent Investment Advisers Act Release No. 2044 (the "Release") published July 18, 2002. We encourage the Commission to accept the SEC's views regarding circumstances under which an investment adviser who is also a general partner would not be deemed to have custody, especially with regard to a pooled investment vehicle or, at a minimum, under the circumstances presented by Trendstat, which not only complies with the SEC requirements but also has the additional safeguards of an independent administrator and applicable CFTC rules including the requirement for annual audited financial statements certified by Trendstat and monthly reporting to limited partners. In the Release, the SEC summarizes and reconfirms staff logic in their series of no action letters by which an investment adviser such as Trendstat would not be deemed to have custody of client assets. The SEC notes the requirements of its Rule 206(4)-2 adopted in 1962 (which R14-6-2-6 parallels) are outmoded and has proposed amendments to the Rule. Most notably, the SEC proposes elimination of the application of the rule as to pooled investment vehicles such as Market Math if such pooled investment vehicle has its transactions and assets audited annually and distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners within 90 days of its fiscal year, both requirements with which Market Math currently complies. The SEC noted the benefits of certified balance sheets and surprise audits do not outweigh the significant costs of these requirements<sup>2</sup>, especially in light of the greater efficacy and customer protection benefits of periodic reporting and distribution of annual certified and audited financial statements.

While Trendstat effectively has unlimited discretionary authority to make trading decisions on behalf of Market Math and although Trendstat is the general partner of the partnership, that is to be distinguished from having custody of its clients' assets. In Trendstat's view, in light of Trendstat's contractual commitments, operating procedures and the additional safeguards provided by CFTC regulations including the annual certified and audited financial statements and monthly reporting, Trendstat neither has actual custody nor constructive custody of its clients' assets. If Trendstat were not deemed to have custody of its clients' assets, the Commission rules and surprise audit requirement would not apply. Finally, we would note that Trendstat has additional, far more effective safeguards; not only its compliance with the procedures outlined in multiple no action letters granted by the SEC, but due to Market Math Ltd.'s annual certified and audited financial statements and the provision of monthly reports to each limited partner in compliance with CFTC regulations and with GAAP, all of which in the aggregate go well beyond and provide greater safeguards continuously throughout the year than those of surprise audits or certified balance sheets which provide customer protection only one random month out of each year.

Compliance with all other requirements of Arizona's Statutes and Rules:

While Trendstat does not believe it should be deemed to have custody of its client's assets, Trendstat nonetheless complies with all requirements of A.R.S. § 44-3153, A.R.S. §44-3159 and Commission rules R14-6-206 and R14-6-212 (requirements for investment advisers with custody) other than the certified balance sheet and surprise audit requirements. Specifically, Trendstat notes the following:

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<sup>2</sup> In the Release, the SEC noted (regarding Rule 206(4)) that "experience has shown the current rule has limited deterrent effect. Advisers that intend to misuse client assets can fabricate client account statements and, because the surprise examination is performed only annually, many months may pass before the accountant has an opportunity to detect a fraud."

A.R.S. §44-3159

A.R.S. §44-3159, in summary, requires an investment adviser with custody to:

1. notify the Commission in writing (which may be made on its Form ADV) that the investment adviser has or may have custody of client funds or securities,
2. Segregate and keep in safekeeping all securities of the client,
3. Deposit all funds in a bank account with only the client's funds denoted as for such client and maintenance of a record showing the details of all deposits and withdrawals into and out of the account,
4. Notify the client in writing after acceptance of client funds or securities from the client where and the manner in which the funds and securities will be maintained and if such location or the manner in which they are held is changed, provide written notification to the client within 10 business days,
5. Send a detailed statement of all transactions to the client at least quarterly, and
6. File an audited balance sheet.

Trendstat's ADV Part II and also the private placement memorandum (the "PPM") of Market Math, which must be provided to all prospective limited partners of the partnership prior to or contemporaneous with their solicitation under CFTC regulations, explains in detail the location and manner in which client funds and securities as well as the funds of each of Trendstat's client's partners (each limited partner) are held. In addition, under CFTC regulations, the PPM must be supplemented and the supplement distributed to all limited partners within 10 days of any material change and must be updated in its entirety every 9 months. Further, Trendstat would be required to disclose in the PPM, any material financial or other condition that would hinder or make it unable to comply with either its investment adviser or general partner obligations to the partnership.

CFTC rules require that all Market Math's futures interests and the funds in support of such positions be in the custody of a registered Futures Commission Merchant, segregated and held in Market Math's name. Under CFTC regulations, Trendstat is not legally allowed to maintain client accounts in the name of Trendstat, either as trustee or agent or to have custody of client funds. Rather, all accounts must be in the client's name. All of Market Math's futures positions, securities and cash in support of those positions are held in Market Math's name at ABN AMRO Incorporated, a registered FCM and registered broker dealer who is Market Math's FCM, prime broker and securities broker. Market Math maintains a bank account with Wells Fargo for idle cash sent for subscription to Market Math (at which time the funds will be sent on to ABN for investing) or withdrawn from ABN and sent to Wells Fargo to pay fees or redemptions. ABN cannot wire money to any other place than Market Math's Wells Fargo account. Both Trendstat and the Administrator, ATA Research, receive copies daily of all positions and equity on all Market Math accounts to provide crosschecks on the other firm. Checks from Wells Fargo need to be cosigned by authorized individuals from both Trendstat and the Administrator. None of Trendstat, its affiliates, officers, employees or their families are permitted to receive checks drawn on the Wells Fargo account, whether for fees or for capital redemptions and Wells Fargo is instructed not to honor checks to these payees. Trendstat and its affiliates, officers, employees or their families are permitted to receive payments and redemption proceeds only by wire and only if the independent CPA, has verified the accuracy and legitimacy of the computation for the payment or distribution and approved it.

ATA, as Administrator, maintains an accounting record of all financial records of Market Math, including, but not limited to, dates and amounts of deposits and withdrawals and the exact amount of each limited partner's beneficial interest in Market Math.

Trendstat never receives any client funds. All subscriptions are sent to the Administrator, ATA, and all subscription proceeds are payable in the name of Market Math Ltd. and the funds deposited into Wells Fargo in Market Math's account. The next monthly statement for that limited partner includes all the information on the date and amount of the addition and capital accounts for that limited partner reflect the subscription. The use of the proceeds and the names, addresses and manner in which all assets of Market Math are held are stated in Market Math's PPM (Attachment B). Additionally, in Market Math's partnership agreement (Attachment C), Trendstat may not "maintain physical custody or possession of funds or securities of the Partnership."

Market Math's Administrator publishes an account statement separately for Market Math and for each limited partner monthly, rather than quarterly. The Administrator uses valuation sources independent of Trendstat and its affiliates to calculate the net asset value of Market Math and the capital accounts of the limited partners and to price out all the assets held by Market Math at month-end. In addition, Trendstat provides performance estimates daily to those limited partners that request such information.

Market Math is audited each year-end pursuant to CFTC rules. The partnership has been audited for about 16 years now, if you look at the history of the partnership and the previous manager in California. Art Bell and Associates, responsible for auditing over 50% of the futures industry, according to their estimates, currently provides Market Math the independent CPA partnership accounting audit required by the CFTC. The audit is scheduled when they can perform the services, not when the adviser wants to hold the audit. Trendstat is not consulted in setting the audit date, since Trendstat has no client assets and provides very little in the way of information to complete the audit. All the accounting records used in audits and reviews by regulators are located in Dallas, TX, in the offices of Market Math's Administrator. If a separate "surprise" audit were required to comply with the Commission's rules in addition to the year end audit which is held in two different cities, Dallas and Scottsdale, the cost of these surprise audits would be an additional and unnecessary cost to the client and a time burden on employees of Trendstat and Market Math's Administrator. Performing a surprise audit of Trendstat does little to add to client security, since no client assets are held at Trendstat.

The goal of the Arizona statute and rules is for the clients' assets to be protected and accounted for independently. This goal is achieved under the procedural and regulatory safeguards applicable to Market Math. Trendstat believes that an alternative custody/administration procedure including the surprise audit and balance sheet requirements under the State's regulations actually provides less safety of client assets than currently exists with Trendstat and Market Math's present custody/administration procedures and regulatory requirements and would minimize the burdensome cost in time and money of additional, surprise audits of Market Math. In addition, there are many possible detriments to Trendstat's change in its established procedures and the contractual arrangements upon which limited partners have relied over the years. Limited partners like the protection mechanisms Trendstat has put in place and might be disappointed to see them be removed.

There is no additional client protection or added value in performing surprise audits to Trendstat's existing custody arrangement or auditing Trendstat. If Trendstat, or its employees had the ability to easily get to client assets or by any other scheme designed to defraud investors, then there would be no cross check on that activity until the surprise auditor discovers the scheme, which may come too late to prevent such actions.

Certifications:

I certify to the best of my knowledge on behalf of Trendstat, on whose behalf this request is being made, that this exemption request is not directly or indirectly the subject of any pending or final judicial, SRO or administrative proceeding.

I certify on behalf of Trendstat that Trendstat will attempt to maintain a registration with the SEC until the status of the No-Action request is determined.

Each of Trendstat and Thomas F. Basso, its CEO and principal, acknowledges that this request, together with any documents or information submitted and any response from the division, is public information that may be released for publication, except as otherwise provided by law.

Agreed to by:



Thomas F. Basso  
CEO  
Trendstat Capital Management, Inc.

8/2/02  
Date



**Attachment A – Flow Chart of Current Custody/Administration Structure**

No custody of client assets

Custody of client assets

