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17 CFR Parts 275 and 279
Custody of Funds or Securities of Clients by Investment Advisers; Final Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 275 and 279

[Release No. IA–2176; File No. S7–28–02]

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Custody of Funds or Securities of Clients by Investment Advisers

AGENCY: Securities and Exchange Commission (the ''Commission'').

ACTION: Final rule.

SUMMARY: The Commission is adopting amendments to the custody rule under the Investment Advisers Act of 1940. The amendments modernize the rule by conforming the rule to modern custodial practices and requiring advisers that have custody of client funds or securities to maintain those assets with broker-dealers, banks, or other qualified custodians. The amended rule also provides a definition of ''custody'' and illustrates circumstances under which an adviser has custody of client funds or securities. The amendments are designed to enhance protections for client assets while reducing burdens on advisers that have custody of client assets.

DATES: *Effective Date:* November 5, 2003. *Compliance Date:* April 1, 2004.

FOR FURTHER INFORMATION CONTACT: Vivien Liu, Senior Counsel, or Jennifer L. Sawin, Assistant Director, at 202–942–0719 or *IArules@sec.gov*, Office of Investment Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0506.

SUPPLEMENTARY INFORMATION: The Commission is adopting amendments to rule 206(4)–2 (17 CFR 275.206(4)–2) [1] under the Investment Advisers Act of 1940 (15 U.S.C. 80b) (the ''Advisers Act'' or ''Act'') and to Part 1A, Item 9 and Part II, Item 14 of Form ADV (17 CFR 279.1).

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Executive Summary

The Commission is amending rule 206(4)–2, the custody rule under the Advisers Act, to reflect modern custodial practices and clarify circumstances under which an adviser has custody of client assets. The amendments require advisers that have custody to maintain client funds and securities with a broker-dealer, bank, or other ''qualified custodian.'' If the qualified custodian sends account statements directly to an adviser's clients, the adviser is relieved from sending its own account statements and from undergoing an annual surprise examination. The amendments also add a definition of ''custody'' to the rule and illustrate circumstances under which an adviser has custody of client funds or securities. Finally, the amendments remove the Form ADV requirement that advisers with custody include an audited balance sheet in their disclosure brochure to clients.

I. Background

Rule 206(4)–2 regulates the custody practices of advisers registered under the Advisers Act. The rule requires advisers that have custody of client securities or funds to implement a set of controls designed to protect those client assets from being lost, misused, misappropriated or subject to the advisers' financial reverses.

Last year we proposed comprehensive amendments to rule 206(4)–2. Our proposal was designed to enhance the protections afforded to advisory clients' assets, harmonize the rule with current custodial practices, and clarify circumstances under which advisers have custody.[2] We received 49 comment letters in response to our proposed rule. Commenters strongly supported the approach of the proposal. One noted that our proposal would replace ''highly detailed compliance requirements with an overall regulatory framework in order to achieve greater accountability and transparency of transactions in client accounts.'' [3] We are adopting the amendments to rule 206(4)–2 with certain changes that respond to commenters' recommendations.

II. Discussion

A. Definition of Custody

We have added to the rule a definition of the term ''custody.'' An adviser has custody of client assets, and therefore must comply with the rule, when it holds, ''directly or indirectly, client funds or securities or [has] any authority to obtain possession of them.''[4] We provide three examples designed to illustrate circumstances under which an adviser has custody of client funds or securities. Commenters agreed that the examples will be helpful to advisers.

The first example clarifies that an adviser has custody when it has possession of client funds or securities, even briefly.[5] An adviser that holds clients' stock certificates or cash, even temporarily, puts those assets at risk of misuse or loss. The amendments, however, expressly exclude inadvertent receipt by the adviser of client funds or securities, so long as the adviser returns them to the sender within three business days of receiving them.[6] The rule does not permit advisers to forward

[1] Unless otherwise noted, when we refer to rule 206(4)–2 or any paragraph of the rule, we are referring to 17 CFR 275.206(4)–2 of the Code of Federal Regulations in which the rule is published.

[2] *Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Release No. 2044 (July 18, 2002) [67 FR 48579 (July 25, 2002)] (''Proposing Release'').

[3] *See Summary of Comments* prepared by our staff, available in our Public Reference Room in File No. S7–28–02, and on our Web site at *http://www.sec.gov/rules/extra/s72802csumm.htm*.

[4] Amended rule 206(4)–2(c)(1). One commenter asked whether an adviser with multiple lines of business within the same corporation or other business entity has ''custody'' if its non-advisory business gives the adviser or its personnel authority to obtain customers' funds or securities. For example, an adviser might provide investment advice and also offer, separately, a bill-paying service through which the adviser's employees gain signatory power over a customer's checking account. If the customer is not an advisory client of the adviser, the adviser does not have custody of ''client funds and securities.'' If, however, the customer is also an advisory client, the adviser has access to a client's assets, and therefore has custody, even though that access arises through a separate line of business.

The same access could also arise through an affiliate of the adviser. An adviser may, for example, have custody if its affiliate holds funds or securities of the adviser's clients under circumstances in which the adviser or its personnel have access to those client assets through the affiliate. Our staff previously has expressed similar views in *Crocker Investment Management Corp.,* SEC Staff Letter (Apr. 14, 1978).

[5] Amended rule 206(4)–2(c)(1)(i). In our proposed rule, our first example of custody referred to ''possession or control'' of client funds or securities, but commenters suggested that the term ''control'' improperly suggested that an adviser that merely has trading authority over a client's securities account has custody for purposes of the rule. *See infra* note. We believe that the definition and other examples make it clear that an adviser has custody when it can control client funds or securities for purposes other than authorized trading, and that the word ''control'' is therefore not needed in the first example.

[6] We had proposed requiring the adviser to return the funds and securities in one day, but commenters suggested that a longer period was needed to reduce inadvertent violations of the rule.

clients' funds and securities without having ''custody,'' although advisers may certainly assist clients in such matters.[7] In addition, the amendments clarify that an adviser's possession of a check drawn by the client and made payable to a third party is not possession of client funds for purposes of the custody definition.[8]

The second example clarifies that an adviser has custody if it has the authority to withdraw funds or securities from a client's account.[9] An adviser with power of attorney to sign checks on a client's behalf, to withdraw funds or securities from a client's account, or to dispose of client funds or securities for any purpose other than authorized trading has access to the client's assets.[10] Similarly, an adviser authorized to deduct advisory fees or other expenses directly from a client's account has access to, and therefore has custody of, the client funds and securities in that account.[11] These advisers might not have possession of client assets, but they have the authority to obtain possession.

Several commenters suggested that we change the definition of ''custody'' to exclude advisers' access to client funds through fee deductions. We are not adopting this suggestion. Removing this form of custody from the definition would mean that clients would not receive the quarterly account statements that are required under the rule, and which are needed so that clients may confirm that the adviser has not improperly withdrawn amounts in excess of its fees.[12] We are, however, amending Form ADV so advisers that have custody only because they deduct fees will not need to amend their registration statements.[13]

The last example clarifies that an adviser has custody if it acts in any capacity that gives the adviser legal ownership of, or access to, the client funds or securities.[14] One common instance is a firm that acts as both general partner and investment adviser to a limited partnership.[15] By virtue of its position as general partner, the adviser generally has authority to dispose of funds and securities in the limited partnership's account and thus has custody of client assets.[16]

B. Use of Qualified Custodians

We are adopting, as proposed, a requirement that advisers with custody of client funds and securities maintain them with qualified custodians.[17] The qualified custodian must hold the funds or securities in an account either under the client's name or under the adviser's name as agent or trustee for its clients.[18]

''Qualified custodians'' under the amended rule include the types of financial institutions that clients and advisers customarily turn to for custodial services. These include banks and savings associations[19] and registered broker-dealers.[20] In order to allow advisers that also offer futures advice to comply with Commodity Futures Trading Commission rules, ''qualified custodians'' also include registered futures commission merchants.[21] Finally, ''qualified custodians'' include foreign financial

[7] We understand that some advisers meet with clients to prepare or compile documents, including stock certificates, for forwarding to a custodian or third party. Nothing in the amended rule suggests that preparing these documents with a client gives the adviser ''custody.''

[8] Checks payable to an adviser for payment of advisory or similar fees due to the adviser also do not represent ''client funds'' within the meaning of the custody rule and therefore advisers would not have custody as a result of receiving those checks. An adviser would, however, have custody of client funds if it holds a check drawn by the client and made payable to the adviser with instructions to pass the funds through to a custodian or to a third party.

[9] Amended rule 206(4)–2(c)(1)(ii).

[10] An adviser's authority to issue instructions to a broker-dealer or a custodian to effect or to settle trades does not constitute ''custody.'' Clients' custodians are generally under instructions to transfer funds (or securities) out of a client's account only upon corresponding transfer of securities (or funds) into the account. This ''delivery versus payment'' arrangement minimizes the risk that an adviser could withdraw or misappropriate the funds or securities in its client's custodial account.

[11] Some commenters asked whether they could, instead of complying with the amended rule, continue following procedures established under certain no-action letters, *e.g., Investment Counsel Association of America, Inc.,* SEC Staff Letter (June 9, 1982); *John B. Kennedy,* SEC Staff Letter (June 5, 1996); and *Securities America Advisers Inc.,* SEC Staff Letter (Apr. 4, 1997). The staff is withdrawing those letters. Advisers, including those firms that have relied on these letters in the past, must comply with the amended rule.

[12] *See* Section II.C. of this Release. We note, however, that rule 206(4)–2 defines ''custody'' broadly in order to serve the remedial purposes of the rule, and to ensure that advisory clients receive timely reports on transactions in their assets and thus can take action to protect themselves in the event of an adviser's misuse of their funds. Consequently, an adviser that has ''custody'' for purposes of rule 206(4)–2 may not necessarily have custody for other purposes.

[13] *See* Section II.E of this Release.

[14] Amended rule 206(4)–2(c)(1)(iii).

[15] This example applies equally to an adviser that acts as both managing member and investment adviser of a limited liability company or another type of investment vehicle, or as both trustee and investment adviser of a trust. A firm may also have custody when a supervised person fills one of these roles, such as when a portfolio manager serves as trustee of a client trust. *E.g., In the Matter of Gofen and Glossberg, Inc.,* Investment Advisers Act Release No. 1400 (Jan. 11, 1994). We understand that supervised persons may, on occasion, engage the advisory firm to advise an estate, conservatorship or personal trust for which the supervised person serves as executor, conservator or trustee. We would not view the adviser to have custody of the funds or securities of the estate, conservatorship, or trust solely because the supervised person has been appointed in these capacities as a result of family or personal relationship with the decedent, beneficiary or grantor (and not a result of employment with the adviser).

The amended rule contains a limited exception from the rule for client accounts that are limited partnerships subject to an annual audit. *See infra* Section II.D.2 of this Release. Some commenters asked whether they could, instead of complying with the amended rule, continue following procedures established under certain no-action letters, *e.g., Bennett Management Co.,* SEC Staff Letter (Feb. 26, 1990); *PIMS, Inc.,* SEC Staff Letter (Oct. 21, 1991); *Canyon Management Co.,* SEC Staff Letter (Oct. 15, 1991); *Pacific Management, Ltd.,* SEC Staff Letter (Oct. 29, 1991); *Lee Capital Management,* SEC Staff Letter (Oct. 29, 1991); *Eichler Magnin, Inc.,* SEC Staff Letter (Nov. 4, 1991); *GBU, Inc.,* SEC Staff Letter (Apr. 22, 1993). The staff is withdrawing those letters. Advisers, including those firms that have relied on these letters in the past, must comply with the amended rule.

[16] Investment advisers that also act as general partners for real estate partnerships in which their advisory clients are limited partners requested clarification about the rule's application to such partnerships. In such circumstances, the rule does not apply to the assets of the real estate partnership unless the partnership is an advisory client of the investment adviser.

[17] Amended rule 206(4)–2(a)(1). The amended rule does not prohibit an adviser from using more than one qualified custodian to hold funds and securities of a client.

[18] Under the amendments, client funds and securities must be held on behalf of the client by the qualified custodian so that the qualified custodian can provide account information to the clients. Keeping stock certificates in the adviser's bank safe deposit box, for example, would not satisfy the requirements of the rule.

[19] Amended rule 206(4)–2(c)(3)(i). A ''bank'' under section 202(a)(2) of the Advisers Act (15 U.S.C. 80b–202(a)(2)) includes national banks, members of the Federal Reserve System, and other banks and trust companies having similar authority to national banks and supervised by State or Federal banking agencies. A ''savings association'' is a financial institution as defined in section 3(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(b)(1)) and insured and supervised by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act (12 U.S.C. 1811).

[20] Amended rule 206(4)–2(c)(3)(ii). ''Qualified custodian'' includes any broker-dealer that is registered with and regulated by us under the Securities Exchange Act of 1934 (the ''Exchange Act''), holding the client assets in customer accounts.

[21] Amended rule 206(4)–2(c)(3)(iii). Futures commission merchants are registered with the Commodity Futures Trading Commission (''CFTC'') under section 4f(a) of the Commodity Exchange Act (7 U.S.C. 6f(a)) and regulated by the CFTC. ''Qualified custodian'' includes a registered futures commission merchant holding the client assets in customer accounts. Registered investment advisers that also provide clients with advice about futures, including ''security futures,'' may also be subject to CFTC rules; CFTC rules require that ''customer funds'' be custodied with a futures commission merchant. *See* rule 4.30 (17 CFR 4.30) under the Commodity Exchange Act. *See also* Commodity Futures Modernization Act (Pub. L. 106–554, 114 Stat. 2763 (2000)) (security futures are both securities and futures). The rule also allows advisers to maintain client securities with a futures commission merchant to the extent the securities are incidental to client futures transactions.

institutions that customarily hold financial assets for their customers, provided that the foreign financial institution keeps advisory clients' assets in customer accounts segregated from its proprietary assets.[22]

Many advisers registered with us are themselves qualified custodians under the amended rule.[23] These advisers may maintain their own clients' funds and securities, subject to the account statement requirements described below and the custody rules imposed by the regulators of the advisers' custodial functions. Advisers may also maintain client assets with affiliates that are qualified custodians.

The amended rule contains special provisions for two types of securities: mutual fund shares and private issues. Commenters noted that, at times, a client or adviser may purchase shares of a mutual fund directly from the fund's transfer agent rather than through another intermediary such as a broker-dealer. In these cases, the mutual fund's transfer agent maintains the securities for the client on the mutual fund's books. The adviser, however, may also have custody because, for example, the adviser has check-writing or fee-deduction authority over the assets.[24] The amended rule allows an adviser to use the mutual fund transfer agent in lieu of a qualified custodian with respect to those shares.[25]

Commenters also pointed out that, on occasion, a client may purchase privately-offered securities and that maintaining certain of these assets in accounts with qualified custodians poses difficulties because the client's ownership of the security is recorded only on the books of the issuer. The client may receive copies of subscription or partnership agreements that are not maintained with a custodian.[26] The amendments except advisers from the rule with respect to privately-offered uncertificated securities in their clients' accounts, if ownership of the securities is recorded only on the books of the issuer or its transfer agent, in the name of the client, and transfer of ownership is subject to prior consent of the issuer or holders of the issuer's outstanding securities.[27] These impediments to transferability provide some external safeguards against the kinds of abuse the rule seeks to prevent. These safeguards, however, may be ineffective in the case of limited partnerships (or other pooled investment vehicles). Because the private securities are held in the name of the limited partnership and the adviser acts for the partnership, the adviser has apparent authority to arrange transfers that would be recognized by the issuer of the securities. Accordingly, an adviser may use the exception for private securities with respect to the account of a limited partnership only if the limited partnership is audited annually, and the audited financial statements are distributed, as described in amended rule 206(4)–2(b)(3).[28]

C. Delivery of Account Statements to Clients

Rule 206(4)-2, as amended, requires that advisers with custody of clients' funds or securities have a reasonable belief that the qualified custodian holding the assets provides periodic account statements to those clients.[29] A number of commenters asserted that some custodial accounts are on quarterly rather than monthly reporting cycles and that moving to a monthly cycle would increase expenses substantially. In response to these comments, the amended rule requires quarterly account statements rather than the monthly statements we proposed. This provision, which requires qualified custodians to deliver account statements directly to advisory clients (and not through the adviser), is designed to assure the integrity of those account statements and permit clients to identify any erroneous or unauthorized transactions or withdrawals by an adviser.[30]

As we discussed in the Proposing Release, we recognize that there may be circumstances in which an adviser would need to continue using the approach of the current rule.[31] Accordingly, if a client does not receive account statements directly from the qualified custodian, the adviser must continue sending quarterly account statements to that client and to undergo an annual surprise examination by an independent public accountant [32] to verify the funds and securities of that client.[33] The amendments require the

[22] Amended rule 206(4)–2(c)(3)(iv). We proposed to include foreign financial institutions only for securities whose primary trading market was in the country where the custodian was located. Some commenters urged that we permit foreign custodians to be used more broadly, arguing that some advisers, and some clients, especially those residing overseas, may at times have reason to use a foreign firm as a custodian or may have existing relationships with foreign institutions. We are modifying the rule from the proposal to avoid disrupting these existing practices. Where an adviser selects a foreign financial institution to hold clients' assets, we believe the adviser's fiduciary obligations require it either to have a reasonable basis for believing that the foreign institution will provide a level of safety for client assets similar to that which would be provided by a ''qualified custodian'' in the United States or to fully disclose to clients any material risks attendant to maintaining the assets with the foreign custodian.

[23] For example, Form ADVs submitted by SEC-registered advisers indicate that as of May 16, 2002, 647 advisers were broker-dealers registered with us under section 15 of the Exchange Act (15 U.S.C. 78o) and 77 advisers were banks (or separately identifiable departments or divisions of banks).

[24] Commenters were concerned that without an exception, an advisory client or adviser would have to use a qualified custodian in addition to the mutual fund transfer agent.

[25] *See* amended rule 206(4)-2(b)(1). The fund transfer agent must fulfill all aspects of the role of a qualified custodian under the rule, including sending statements directly to the client, or the adviser will be subject to annual surprise examinations. *See* discussions in Section II.C. of this Release.

[26] Commenters specifically mentioned clients' investments in limited partnerships, where clients receive only a copy of the partnership agreement as evidence of their investment. Commenters also mentioned assignment agreements for debt or equity interests in a private company, or other types of customized agreements. *See* our staff's summary of comments posted on our web site at www.sec.gov/rules/extra/s72802csumm.htm.

[27] For example, in many privately-offered limited partnerships transfer of a limited partnership interest must be approved by a majority or some other percentage of the other limited partners. The rule does not require a specific number or percentage of the other security holders that must approve the transfer; applicable partnership law or the limited partnership agreement would set that standard.

[28] *See* Section II.D.2 of this Release. Otherwise, an adviser to a limited partnership (or other types of pooled investment vehicles) will still be required to maintain custody of privately-offered securities in accordance with the requirements of the rule.

Some privately-offered securities may be difficult to value. Account statements that must be delivered to a client under the rule must report the amount of the client's securities, but the rule does not require those statements to include a valuation of the securities.

[29] Amended rule 206(4)-2(a)(3)(i). An adviser could form this reasonable belief if, for example, the qualified custodian provides the adviser with a copy of the account statement that was delivered to the client.

Account statements may be delivered electronically as well as on paper. Electronic delivery must comply with the Commission's interpretive guidelines on delivering documents electronically. *See Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information; Additional Examples under the Securities Act of 1933, Securities Exchange Act of 1934, and Investment Company Act of 1940,* Release No. 33–7288 (May 9, 1996) [61 FR 24644 (May 15, 1996)]. The guidelines are available at www.sec.gov/rules/concept/33–7288.txt. *See also* New York Stock Exchange's June 13, 1997 Information Memo (No. 97–32) entitled *''Electronic Delivery of Information to Customers by Members and Member Organizations.''*

[30] We understand qualified custodians sometimes use service providers to deliver account statements. The amended rule does not prohibit a qualified custodian from doing so, as long as the statements are not routed through the adviser.

[31] *See* Section II.C. of the Proposing Release.

[32] Article 2 of Regulation S-X sets forth Commission standards for the independence of accountants. 17 CFR 210.2–01.

[33] Amended rule 206(4)-2(a)(3)(ii). If qualified custodians deliver account statements directly to

accountant to notify our Office of Compliance Inspections and Examinations within one business day of finding any material discrepancies during an examination.[34]

We understand that some clients may not wish to receive custodial reports. Under rule 206(4)–2, as amended, clients can choose to have an independent representative receive account statements on their behalf.[35] An ''independent representative'' is a person that (i) acts as agent for an advisory client and by law or contract is obligated to act in the best interest of the advisory client; (ii) does not control, is not controlled by, and is not under common control with the adviser; and (iii) does not have, and has not had within the past two years a material business relationship with the adviser.[36]

The rule requires that account statements be delivered to clients. Advisers that take legal title to the client assets they manage, such as advisers that also serve as general partner to investment pools, have asked how they should apply this provision. Because this arises most often in connection with pooled investment vehicles, rule 206(4)–2, as amended, contains a special provision clarifying that account statements (whether delivered by the qualified custodian or the adviser) must be sent directly to the investors in the pool if the adviser to the pool also acts as its general partner, managing member, or in a similar capacity and has custody of client funds or securities.[37] Delivery of account statements to the adviser but not to the limited partners would not deter the adviser's misuse of client assets.[38]

D. Exemptions

1. Registered Investment Companies

Advisers need not comply with the rule with respect to clients that are registered investment companies.[39] Registered investment companies and their advisers must comply with the strict requirements of section 17(f) of the Investment Company Act of 1940 and the custody rules we have adopted under that section.[40]

2. Pooled Investment Vehicles

Advisers need not comply with the reporting requirements of the rule with respect to pooled investment vehicles, such as limited partnerships or limited liability companies, if the pooled investment vehicle (i) is audited at least annually; and (ii) distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or members or other beneficial owners) within 120 days of the end of its fiscal year.[41] We had proposed a complete exemption for audited pools, but have decided to exempt them only from the reporting requirement and to retain application of the other provisions of the rule, including the requirement that funds and securities be held with a qualified custodian; these requirements provide meaningful protections to investors in these pools for which an annual audit provides an insufficient substitute.

3. Registered Broker-Dealers

The amendments eliminate the exemption from the rule for advisers that are also registered broker-dealers, which are qualified custodians under the rule and for which the exemption is unnecessary.

E. Amendments to Form ADV

We are revising an instruction to Item 9 of Part 1A of Form ADV, which asks whether the adviser has custody of client funds or securities. A large number of advisers registered with us deduct their fees directly from client accounts and therefore have custody, but currently answer ''no'' to Item 9 in

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some, but not all, of an adviser's clients (or with respect to some, but not all, of a client's funds and securities), the adviser's quarterly statements and the scope of the surprise examination could cover only the client funds and securities for which custodial statements are not delivered directly. The accountant must ensure, however, that all client funds and securities either are covered by statements sent directly from the qualified custodian or are covered by the surprise examination.

The accountant should perform the examination in accordance with U.S. Generally Accepted Auditing or Attestation Standards, except that the accountant must verify or substantiate all client funds and securities covered by the examination. The examination should include confirmation of all cash and securities held by custodians, including a physical examination of securities if applicable, and reconciliation of all such cash and securities to the books and records of client accounts maintained by the adviser, as well as confirmation of such information with the adviser's clients. *See American Institute of Certified Public Accountants, Audit and Accounting Guide: Audits of Investment Companies § 11.12 (2002); Statement of the Commission Describing Nature of Examination Required to be Made of All Funds and Securities Held by an Investment Adviser and the Content of Related Accountant's Certificate,* Investment Advisers Act Release No. 201 (May 26, 1966) (31 FR 7821). The examination must be performed at a time chosen by the accountant without prior notice or announcement to the adviser, and the timing of the examination must be irregular from year to year, so that the adviser will be unaware of the date on which it will take place.

The accountant must file a certificate on Form ADV–E with the Commission within 30 days after the completion of the examination. We would expect that, ordinarily, an accountant should be able to complete its examination and file Form ADV–E within 90 to 120 days of commencing the examination.

[34] Amended rule 206(4)-2(a)(3)(ii)(C). The independent accountant may first take reasonable steps to establish the basis for believing a material discrepancy exists. The obligation to notify the Commission arises once the accountant has a basis for believing there is a material discrepancy. Ordinarily, an accountant should be able to determine promptly whether it has a basis for believing there is a material discrepancy.

[35] Our proposed amendments permitted the use of independent representatives only for investors in pooled investment vehicles. In response to the suggestions of several commenters, we have decided to permit all advisory clients to designate independent representatives under the rule.

[36] Amended rule 206(4)–2(c)(2).

[37] Amended rule 206(4)–2(a)(3)(iii). These account statements may be sent to the investors' independent representative(s) under amended rule 206(4)–2(a)(4). However, as discussed below in more detail, the amendments provide an exemption from amended rule 206(4)–2(a)(3) for advisers with respect to pooled investment vehicles that are audited annually. *See* discussions in Section II.D.2 of this Release.

[38] Registered advisers that provide their advisory services through trusts must also ensure that account statements are delivered to their clients. Where an adviser acts as trustee for its client's trust, the investment advisory agreement often takes the form of a trust instrument. These advisers are acting in a capacity that gives them legal ownership of the client assets and thus have custody. In many cases, the advisory client is also the trust grantor and beneficiary. In other circumstances, the adviser may need to have quarterly statements delivered to an independent representative who may be a co-trustee, lead beneficiary, trust attorney, executor, or, in the case of court-supervised trusts, the court.

[39] Rule 206(4)–2(b)(4).

[40] 15 U.S.C. 80a–17(f) and rules 17f–1 through 17f–7 under the Investment Company Act of 1940 (17 CFR 270.17f–1 through 17 CFR 270.17f–7)

[41] Amended rule 206(4)–2(b)(3). We are aware that a small percentage of advisers subject to the rule advise foreign pooled investment vehicles that prepare their financial statements in accordance with International Accounting Standards or some comprehensive body of accounting standards other than U.S. Generally Accepted Accounting Principles (''U.S. GAAP''). An adviser may use such financial statements to qualify for this exception with respect to pools that have a place of organization outside the U.S. or a general partner or other manager with a principal place of business outside the U.S., if such financial statements contain information that is substantially similar to financial statements prepared in accordance with U.S. GAAP and contain a footnote reconciling any material variations between such comprehensive body of accounting standards and U.S. GAAP. To ensure such material variations are adequately described, the financial statements should discuss and quantify them in the manner described in Item 17 of Form 20–F (17 CFR 249.220f) (except that the financial statements need not provide reconciliation to Regulation S–X as required of issuers under Form 20–F). For both U.S. and foreign pooled investment vehicles, the rule provides that ''audit'' has the meaning under section 2(d) of Article 1 of Regulation S–X (17 CFR 210.1–02(d)), and pooled investment vehicles' financial statements must be audited in accordance with U.S. Generally Accepted Auditing Standards.

We proposed to require distribution of the audited financial statements within 90 days, but have extended that period to 120 days so that funds of funds will have enough time to complete their financial statements. Funds of funds, as pointed out by commenters, usually wait for the completion of the financial statements of the underlying investment funds before confirming their own data and finalizing their own financial statements.

reliance on no-action letters issued by our staff.[42] Commenters requested that we modify Item 9 to avoid requiring these advisers to amend their Form ADVs in this respect. The new instruction specifies that advisers that have custody only because they deduct fees may answer ''no'' to Item 9.[43] It will be some number of months before the NASD, which operates the IARD for us, completes reprogramming the IARD to implement this change to Item 9. In the interim, advisers registered with the Commission that have custody only because they deduct fees should answer ''no'' to Item 9 of current Form ADV.

Finally, we are eliminating the requirement that advisers with custody of client assets include an audited balance sheet in their disclosure statements (''brochures'') sent to clients.[44] Commenters agreed that the requirement is no longer necessary due to the adoption of rule 206(4)–4, which requires every adviser to disclose to its clients any financial condition that is reasonably likely to impair the adviser's ability to meet its contractual commitments to its clients.[45]

III. Effective Date

The effective date of the amendments is November 5, 2003. Advisers must comply with the amended rule by April 1, 2004. By this compliance date, an adviser with custody of clients' funds and securities must ensure that those assets are kept in accounts with qualified custodians. Also by this date, the adviser must have established its reasonable belief that the qualified custodians send quarterly account statements directly to the clients or to their independent representatives, or as an alternative, follow the requirements of sending quarterly statements and undergoing an annual surprise examination.[46] In addition, by this date, advisers to limited partnerships that are not currently subject to annual audits must ensure that those partnerships have become obligated to undergo annual audits if the adviser intends to rely on the exception in paragraph (b)(3) of the amended rule.[47]

IV. Consideration of Promotion of Efficiency, Competition, and Capital Formation

Section 202(c) of the Advisers Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[48]

The amendments eliminate unnecessary burdens and thus may permit advisers to operate more efficiently. Because they apply equally to all advisers registered with us, we do not anticipate that they create any competitive disadvantages. We do not expect them to have an effect on capital formation or the capital markets.

V. Cost-benefit Analysis

A. Background

The Commission is sensitive to the costs and benefits resulting from its rules. The amendments we adopt today are designed to harmonize the custody rule with current custodial practices, enhance the protections afforded to advisory clients' assets, and reduce advisers' compliance burden. The amended rule requires advisers with custody of client funds and securities to maintain those funds and securities with broker-dealers, banks, or other ''qualified custodians.'' The amended rule relieves advisers from sending clients quarterly account statements and undergoing an annual surprise examination if qualified custodians send account statements directly to the clients at least quarterly. The amended rule also defines ''custody,'' incorporating a definition already used in Form ADV, and illustrates common circumstances under which an adviser has custody. Finally, the amendments make two custody-related changes to Form ADV.

In our Proposing Release, we carefully analyzed the costs and benefits of our proposed amendments and requested comment regarding the costs and benefits to individual advisers and to the industry as a whole. We estimated based on advisers' filings with us that 867 advisers registered with us (approximately 11 percent) have custody of clients' assets, that 156 of these firms were broker-dealers (123) or banks (33), that would keep custody of their own clients' assets and, in their capacity as qualified custodians, send account statements to those clients,[49] and that in 95 percent of the remaining advisers with custody [50] qualified custodians would send account statements to 99 percent of clients and the adviser would prepare account statements for the remaining 1 percent of clients.[51] We estimated that the remaining 36 advisory firms [52] would prepare their own statements for all clients.[53] Commenters strongly favored the amendments and agreed that they would ease the regulatory burden on advisers and increase investor protections.[54] We did not, however, receive specific comments on our cost benefit analyses.

We are adopting the amendments substantially as proposed, with some revisions in response to comments. We believe our original analyses regarding the benefits and costs of the amendments remain accurate. Most of the benefits and costs under the amended rule, however, are not quantifiable.

B. Benefits

Improved protection for advisory clients. The amended rule requires advisers to maintain clients' securities, as well as clients' funds, with qualified custodians. Although most advisers

[42] We are, as indicated earlier, withdrawing those staff letters. *See supra* note 11.

[43] The revised instruction applies only with respect to an adviser's registration with us, and does not affect advisers registered or registering with the states. We note, also, that advisers registering with one or more states must respond separately to Part 1B of Form ADV, which specifically asks whether the adviser deducts fees from its clients' accounts.

[44] Part II, Item 14 of Form ADV.

[45] 17 CFR 275.206(4)–4. *See also* Section II.E. of the Proposing Release.

[46] Until the compliance date, advisers may rely on SEC staff letters for exemption from the surprise examination. *See* SEC staff letters listed in supra notes 11 & 15.

[47] Amended rule 206(4)–2(b)(3). Advisers to limited partnerships that are currently subject to annual audits may rely on this exception immediately upon the rule's effective date. The rule requires that the limited partnership be subject to an annual audit, but does not specify the means by which that binding commitment must be made. In most cases, we expect that the limited partnership agreement itself will require that the partnership be audited annually. In other cases, the adviser may evidence the commitment through an ongoing letter of engagement with an independent public accountant, or may use its disclosure statement to commit to the investors that the audit will be performed annually.

[48] 15 U.S.C. 80b–2(c). We are adopting amendments to Form ADV under sections 203(c)(1) and 204 of the Advisers Act. These sections authorize the Commission to prescribe rules as necessary or appropriate in the public interest or for the protection of investors.

[49] Registered broker-dealers or banks are ''qualified custodians'' under the amended rule and may custody their own clients' funds and securities.

[50] 867–156 = 711 advisers. 95 percent of 711 advisers = 675 advisers.

[51] We based this estimate on our experience examining investment advisers. We estimated that SEC-registered investment advisers have a mean of 670 clients each. Thus, this group of advisers would be preparing their own statements for an aggregate group of 4,725 clients (670 mean clients per adviser $\times$ 1% = 7 clients per adviser $\times$ 675 advisers = 4,725 clients).

[52] $867 - 156 - 675 = 36$.

[53] We estimated that these 36 advisers would have 24,120 clients in the aggregate ($36 \times 670 = 24{,}120$).

[54] *See Summary of Comments* prepared by our staff, available in our Public Reference Room in File No. S7–28–02, and on our Web site at *www.sec.gov/rules/extra/s72802csumm.htm*.

with custody already maintain their clients' securities with banks or broker-dealers as a matter of practice, the rule has not previously required it. Including this requirement in the rule will ensure that all advisers with custody provide this protection to their clients.

Under the amended rule, when qualified custodians send quarterly account statements directly to advisory clients, the adviser is no longer required to send its own quarterly statements and to undergo an annual surprise examination.[55] Receiving quarterly account statements directly from the qualified custodians will enable advisory clients to identify questionable transactions early and allow them to move more swiftly than relying on an annual surprise examination. Many commenters commended this new approach.

For the small group of advisers that cannot use the new approach and therefore must continue to undergo an annual surprise examination,[56] the amended rule requires the independent public accountant conducting the examination to advise the Commission of any material discrepancies it discovers in the examination. The Commission will therefore be able to act promptly to prevent further losses resulting from the adviser's malfeasance.

Remove unnecessary regulatory requirements. Commenters generally agreed that the new compliance requirements would reduce their compliance burden. The compliance requirements under the amended rule focus on investment advisers ascertaining whether qualified custodians are sending quarterly account statements to each of the advisers' clients. This sets forth a much simpler and less expensive compliance procedure for the adviser than sending its own quarterly account statements and undergoing an annual surprise examination.[57] As discussed above, we expect most advisers will have qualified custodians send clients' account statements directly. The amendments also eliminate the costs of complying with staff no-action letters that set out alternative procedures to the annual surprise examination; advisers previously relying on these letters must now comply with the revised rule. We did not receive comments on our estimates or on quantifying these cost reductions.[58]

The amendments eliminate the requirement set forth in Form ADV that advisers with custody must include, in their disclosure brochures sent to clients, a balance sheet prepared and audited by an independent public accountant.[59] Eliminating the balance sheet requirement will reduce advisers' compliance burden.[60] The amendments also revise the instruction to Item 9 of Part 1A of Form ADV, so that SEC-registered advisers that have custody solely because they deduct their advisory fees from clients' assets need not report custody for purposes of Part 1A. These advisers currently rely on our staff's no-action letters to report that they do not have custody; they commented that requiring them to change their response to Item 9 would confuse their clients.[61] This revision avoids requiring these advisers to amend their registration statements.[62]

Improved clarity and transparency of the rule. The amendments will improve the clarity and transparency of the rule by adding a definition of ''custody'' to the rule and by providing examples of the custodial situations most likely to be encountered by an adviser in today's securities markets. Advisers will benefit from this transparency because they (or their counsel) will no longer need to refer to other materials such as staff no-action letters for these examples. Commenters generally responded favorably to the insertion of the definition and examples.

C. Costs

The amendments require that all client funds or securities be maintained with qualified custodians. This requirement may impose costs on the advisers that currently have physical possession of client assets. We estimated in the Proposing Release that the additional cost of this requirement, if any, would be minimal because most advisers already maintain client assets with banks or broker-dealers.[63] Many commenters confirmed that their custody arose through their access to their clients' funds or securities, not through any physical possession of them, and this requirement would not impose additional costs on them.

In addition, the amendments exempt advisers with custody from the costs of undergoing annual surprise examinations and sending account statements only when qualified custodians send account statements directly to the advisers' clients at least quarterly. This condition may impose costs on a small number of advisers that do not already have qualified custodians deliver account statements directly to the advisers' clients.[64] These advisers

[55] We proposed that qualified custodians send account statements to clients monthly. A number of commenters asserted that some custodial accounts are on quarterly rather than monthly reporting cycles and that moving to a monthly cycle would increase expenses substantially. In response to these comments, the amended rule requires quarterly account statements rather than the monthly statements we proposed.

[56] As we discussed on our Proposing Release, based on information collected from Form ADVs, 867 advisers registered with the Commission—approximately 11%—report having custody. Of these, 156 are ''qualified custodians'' that may custody their own clients' assets; we expect these 156 firms will all send quarterly custodial account statements to their clients and thus will be exempt from annual surprise examinations. Of the remaining 711 SEC-registered advisers with custody, we expect 675 (95%) will have qualified custodians deliver account statements directly to 99% of their clients, and will need to send statements and undergo annual surprise examinations only with respect to the remaining 1%. We expect the remaining 36 advisers will continue to be subject to the annual surprise examination requirement with respect to all of their clients.

[57] In the Proposing Release, we estimated that approximately 744 advisers (those that report having custody but are not registered broker-dealers) were required to undergo annual surprise examinations under the current rule, and that on average, an adviser spends approximately 335 hours (0.5 hours per client for an average of 670 clients) and pays $8,000 annually in fees to an independent public accountant in connection with undergoing the examination. We also estimated that under the amended rule, only 36 advisers will continue to incur these full costs of an annual surprise examination with respect to all their clients; we estimated that another 675 advisers will incur these costs only with respect to one percent of their clients, spending approximately 3.5 hours and paying $1,000 annually in fees in connection with the annual surprise examination.

[58] The Commission does not collect information on the number of advisers that currently do not comply with the custody rule in reliance on SEC staff no-action letters, but that will be subject to the revised rule.

[59] This change will not, however, impair client protections. A balance sheet may give an imperfect picture of the financial health of an advisory firm, because many advisers, including very profitable firms, have few financial assets. Moreover, rule 206(4)–4, which did not exist when the balance sheet requirement was adopted, requires every adviser to disclose any financial condition that is likely to impair its ability to meet its contractual commitments to its clients; this disclosure is more useful to clients than a balance sheet.

[60] The Commission staff has estimated, in connection with Paperwork Reduction Act analyses, that an adviser not otherwise required to prepare audited financial statements presently spends approximately $15,000 annually to comply with this requirement, and that approximately 580 advisers with custody are currently incurring these costs. *See infra* note and accompanying text.

[61] Because those staff no-action letters are being withdrawn, these advisers must now comply with the amended custody rule.

[62] We have been advised by groups representing advisers registered with us that perhaps as many as 90% of SEC-registered advisers deduct fees from their clients' accounts.

[63] In our Proposing Release, we estimated that no more than 1 percent of advisers with custody keep any clients' securities in places other than accounts with qualified custodians, and even these advisers maintain almost all of their clients' assets with qualified custodians.

[64] In the Proposing Release, we have estimated that most qualified custodians are delivering account statements to advisers' clients and that less than 1% of advisory clients (excluding investors in

Continued

will have to arrange for qualified custodians to deliver account statements directly to their advisory clients, and the qualified custodians may pass any new costs on to the advisers. These costs are necessary for the protection of advisory clients and we estimated in the Proposing Release that they should be no greater, at an aggregate level, than the costs incurred under the current account statement delivery requirement. We received no specific comments on these assumption and estimates, and we believe they remain accurate.

VI. Paperwork Reduction Act

As set forth in the Proposing Release, the amendments contain several ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995.[65] The titles for the collections of information are ''Rule 206(4)–2, Custody of Funds or Securities of Clients by Investment Advisers'' and ''Form ADV, Financial Information'' under the Advisers Act. The Commission submitted the amendments to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The collection of information for the rule and the form has been approved by OMB under control numbers 3235–0241 and 3235–0049, respectively (both expire on September 30, 2005). An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

The collections of information under rule 206(4)–2 are necessary to ensure that clients' funds and securities in the custody of advisers are safeguarded, and information contained in the collections is used by staff of the Commission in its enforcement, regulatory, and examination programs. The respondents are investment advisers registered with us that have custody of clients' funds or securities. The collections of information under Form ADV are necessary for use by staff of the Commission in its examination and oversight program. The respondents are investment advisers seeking to register with the Commission or to update their registration. Responses provided to the Commission are not kept confidential.

A. Rule 206(4)–2

We are adopting the amendments substantially as proposed. The amendments require advisers with client funds and securities to maintain those funds and securities in custodial accounts with banks, broker-dealers, or other ''qualified custodians.'' The amendments exempt advisers with custody of client assets from the current requirements of sending their clients quarterly account statements and undergoing an annual surprise examination if qualified custodians send account statements directly to the advisory clients at least quarterly.[66] The amendments exempt advisers from the rule with respect to accounts of registered investment companies, and exempt advisers from the reporting requirement with respect to pooled investment vehicles that are audited annually and have the audit results distributed to their investors.[67] We received no comments on the collection of information burden of the amendments.

We estimated in our Proposing Release that the amendments would generally reduce the paperwork burden for advisers. We estimated the aggregate burden under the current rule at 1,246,200 hours, and the aggregate cost under the current rule at $5,952,000, assuming that an adviser would pay an independent public accountant $8,000 to conduct an annual surprise examination.

For purposes of calculating the burden hours under the amendments, we estimated in the Proposing Release that (i) of the 867 advisers reporting that they had custody of clients' assets, 156 would be fully exempted from the requirements of sending quarterly advisory account statements and undergoing an annual surprise examination,[68] (ii) 95 percent (675 advisers) of the remaining 711 advisers would be eligible for the exemption from these two requirements with respect to 99 percent of their clients, and (iii) 5 percent (36 advisers) of the remaining 711 advisers would continue to be subject to both requirements with respect to all of their clients. Assuming an average of 670 clients per adviser registered with us, we estimated that the aggregate annual burden that advisers would face under the amended rule would be 72,113 hours rather than the estimated 1,246,200 hours under the current rule.[69]

We further estimated in the Proposing Release that (i) the aggregate cost for accounting fees for the annual surprise examination would be $288,000 for the 36 advisers who would be subject to the collection of information for all of their clients;[70] and (ii) the accounting fees for the 675 advisers who would be subject to the collection of information for 1 percent of their clients would decrease to $1,000 per adviser, for an aggregate of $675,000. The aggregate cost for information collection burden under the amended rule would therefore be $963,000 rather than the estimated $5,952,000 under the current rule.[71] We received no comments on these estimates and assumptions.

As stated above, we are adopting the amendments substantially as proposed. Accordingly, our estimate of the annual aggregate burden of collection for the amended rule remains 72,113 hours and our estimate of the aggregate cost remains $963,000. This collection of information is mandatory, and responses are not kept confidential.

B. Form ADV

The amended rule eliminates the requirement set forth in Part II, Item 14 of Form ADV that an adviser with custody must include in its brochure a balance sheet audited by an independent public accountant.[72] This will reduce paperwork burden for

pooled investment vehicles) do not receive account statements directly from custodians. Many commenters indicated that their custodians do deliver account statements to their clients directly.

[65] 44 U.S.C. 3501 to 3520.

[66] We proposed that qualified custodians send account statements to clients monthly. A number of commenters noted that some custodial accounts are on quarterly rather than monthly reporting cycles and that moving to a monthly cycle would increase expenses. In response to these comments, the amended rule requires only quarterly account statements. This revision will not affect our original estimate of information collection burden, which was based on an assumption that the amendments would not result in any change in qualified custodians' reporting cycles.

[67] We had proposed a complete exemption for advisers to audited pooled investment vehicles, but are adopting an exemption from the account statement delivery requirements only. Exempting audited investment pools from the account statement delivery requirement will eliminate both the adviser's burden of sending account statements and its burden in undergoing an annual surprise examination. This modification does not affect estimate of the information collection burden.

[68] Advisers that are registered broker-dealers (123 firms) or banks (33 firms) will be ''qualified custodians'' under the amended rule and may keep custody of their own (and other advisers') clients' assets. We understand that broker-dealers and banks generally send account statements at least quarterly. These advisers will therefore be in compliance with the amended rule without incurring any additional burden under the rule.

[69] The 675 advisers facing this burden with respect to 1% of their clients will spend 2.5 hours per client for 7 clients annually. 675 advisers × 7 clients × 2.5 hours = 11,812.5 hours. The 36 advisers facing this burden with respect to all of their clients will spend 2.5 hours per client for 670 clients annually. 36 advisers × 670 clients × 2.5 hours = 60,300 hours. 11,812.5 hours + 60,300 hours = a total hour burden of 72,112.5 (rounded to 72,113) hours annually for all advisers in the aggregate.

[70] These 36 advisers would be subject to a surprise examination. Based on our experience examining investment advisers, we estimated that each surprise examination would cost $8,000. 36 advisers × $8,000 = $288,000.

[71] $288,000 + $675,000 = $963,000.

[72] *See supra* Section II.E. of this Release.

advisers that have custody of client assets.

In the Proposing Release, we estimated the current aggregate annual cost of this requirement at $11,460,000.[73] For purposes of calculating this cost under the amendments, we estimated the 580 advisers that are paying accountants' fees to comply with the balance sheet requirement under the current rule would no longer incur these costs. Therefore, we estimated in the Proposing Release that the number of advisers subject to this requirement would be reduced to 184, and the aggregate annual cost of this requirement would be reduced to $2,760,000, for an average annual cost for each adviser registered with us of $364.[74]

Commenters generally supported the elimination of the balance sheet requirement, but made no specific comment on our estimated numbers. We are adopting this amendment as proposed. These estimated numbers therefore remain the same.

We are also adding an instruction to Item 9 of Part 1A of Form ADV, which asks whether the adviser has custody of clients' funds or securities. Many advisers registered with us deduct fees from clients' accounts but currently answer ''no'' to Item 9 in reliance on no-action letters issued by our staff. The new instruction would permit advisers that have custody solely because they deduct fees to continue answering ''no'' to Item 9. Consequently, the new instruction does not affect the collection of information burden of Form ADV.

This collection of information is mandatory, and responses are not kept confidential.

[73] We estimated that each adviser that needed an audited balance sheet in order to comply with the requirement paid approximately $15,000 on average in accounting fees. According to our records, 184 advisers registered with us require prepayment of fees, and 887 advisers registered with us provide an audited balance sheet to their clients under Part II, Item 14 of Form ADV. (Because advisers are not presently required to file Part II of ADV with the Commission, the 887 figure is from data collected before January 1, 2001.) Since 867 advisers report having custody of their clients' assets, and this number of advisers combined with those who require prepayment of fees exceeds the 887 providing balance sheets by 164, we have estimated that 164 of the advisers with custody also require prepayment of fees. Of the 703 advisers providing balance sheets because of the custody provision (867 advisers with custody − 164 also requiring prepayment of fees = 703), 123 are also broker-dealers that are required to maintain audited financial statements under other rules, and only the remaining 580 advisers incur accountants' fees to comply with the balance sheet requirement under the custody provision. $15,000 in fees × (184 advisers with advance fees + 580 additional advisers with custody) = $11,460,000.

[74] (184 × $15,000) / 7,583 = $364.

VII. Final Regulatory Flexibility Analysis

The Commission proposed amendments to rule 206(4)–2, the custody rule under the Advisers Act, in a release issued on July 18, 2002 (''Proposing Release'').[75] An initial Regulatory Flexibility Analysis (''IRFA'') was published in the Proposing Release. No comments were received on the IRFA. The Commission has prepared the following Final Regulatory Flexibility Analysis (''FRFA'') regarding amendments to rule 206(4)–2 and Form ADV, in accordance with 5 U.S.C. 604.

A. Need for the Amendments

We are adopting the amendments substantially as proposed. The amendments are necessary to harmonize the advisers' custody rule with current custodial practices, enhance the protections afforded to client assets, and clarify circumstances under which advisers have custody of client assets. The amendments require advisers to maintain client funds and securities with broker-dealers, banks, or other ''qualified custodians.'' If the qualified custodian sends account statements directly to an adviser's clients at least quarterly, the adviser will be relieved from sending its own account statements and from undergoing an annual surprise examination of those clients' accounts. The amendments exempt advisers from the rule with respect to clients that are registered investment companies and exempt advisers to limited partnerships (or other types of pooled investment vehicles) from the account statement delivery requirement if the limited partnerships are subject to annual audit and distribute the audit results to their limited partners.

The amendments add a definition of ''custody'' to the rule and illustrate the circumstances under which an adviser has custody of client assets. Advisers will benefit from this transparency because they (and their counsel) will no longer need to refer to external materials such as staff no-action letters for these examples. Finally, the amendments eliminate the requirement in Form ADV that advisers with custody include an audited balance sheet in their disclosure brochures to clients; other disclosures now provide clients with information that is likely to be more helpful to them in this regard.

[75] *Custody of Funds or Securities of Clients by Investment Advisers,* Investment Advisers Release No. 2044 (July 18, 2002) [67 FR 48579 (July 25, 2002)].

B. Significant Issues Raised by Public Comment

The Commission received 49 letters from commenters in response to the Proposing Release.[76] Commenters strongly supported the proposal. As discussed in Section II of this Release, above, the Commission is adopting the amendments substantially as proposed with some changes to respond to commenters' suggestions. The Commission specifically requested comment with respect to the IRFA, but did not receive any comments concerning the IRFA.

C. Small Entities Subject to Rule

In developing the amendments, we have considered their potential effect on small entities. Under Commission rules, for the purposes of the Advisers Act and the Regulatory Flexibility Act, an investment adviser generally is a small entity if it: (i) Has assets under management having a total value of less than $25 million; (ii) did not have total assets of $5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had $5 million or more on the last day of its most recent fiscal year.[77] The Commission estimates that approximately 28 SEC-registered investment advisers that have custody of client assets are small entities.[78]

D. Projected Reporting, Record-keeping, and Other Compliance Requirements

The amended rule imposes no new reporting and record-keeping requirements. In addition, we believe that most advisers that maintain custody of client assets, including advisers that are small entities, already maintain these assets with qualified custodians. Therefore, the amendments will not materially increase the effort necessary on the advisers' behalf to comply with the Commission's rules. To the contrary, the amendments provide advisers with the opportunity to eliminate costs they incur complying with the present rule's requirements to send account statements to clients and undergo an

[76] *See Summary of Comments* prepared by our staff, available in our Public Reference Room in File No. S7–28–02, and on our Web site at *http://www.sec.gov/rules/extra/s72802csumm.htm.*

[77] 17 CFR 275.0–7(a).

[78] This estimate is based on the information provided submitted by SEC-registered advisers in Form ADV, Part 1A [17 CFR 279.1] as of May 2002.

annual surprise examination.[79] In addition, we are amending Form ADV to eliminate the requirement that an adviser with custody of client assets provide its clients with a copy of its audited balance sheet, thereby further reducing the advisers' compliance costs. We are also amending Form ADV to add an instruction to Item 9 of Part 1A; this instruction permits SEC-registered advisers that have custody only because they deduct their fees from their clients' assets to continue responding ''no'' to Item 9.[80]

E. Agency Action To Minimize Effect on Small Entities

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the amended rule, the Commission considered the following alternatives: (a) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for such small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the rule, or any part thereof, for such small entities.

The overall impact of the amendments is to decrease regulatory burdens on advisers. Small advisers, as well as large ones, will benefit from the amended rule. Moreover, the amendments achieve the rule's objectives through alternatives that are already consistent in large part with advisers' current custodial practices. Therefore, the potential impact of the amendments on small entities should not be significant. For these reasons, alternatives to the amendments, such as differing compliance or reporting requirements, simplification of compliance and reporting requirements, or the use of performance rather than design standards, are unlikely to minimize any impact that the amended rule may have on small entities. Regarding exemption from coverage of the rule amendments, or any part thereof, for small entities, such an exemption would deprive small entities of the burden relief provided by the amendments. Moreover, since the protections of the Advisers Act are intended to apply equally to clients of both large and small advisory firms, it would be inconsistent with the purposes of the Act to specify different requirements for small entities or to establish different compliance or reporting requirements for small entities with regard to this requirement.

VIII. Statutory Authority

We are adopting amendments to rule 206(4)–2 pursuant to our authority set forth in sections 206(4) and 211(a) of the Advisers Act [15 U.S.C. 80b–6(4) and 80b–11(a)].

We are adopting amendments to Form ADV pursuant to the authority set forth in sections 203(c)(1), 204, and 211(a) of the Advisers Act [15 U.S.C. 80b–3(c)(1), 80b–4 and 80b–11(a)].

List of Subjects in 17 CFR Parts 275 and 279

Reporting and recordkeeping requirements, Securities.

Text of Rule

■ For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

■ 1. The authority citation for Part 275 continues to read in part as follows:

Authority: 15 U.S.C. 80b–2(a)(11)(F), 80b–2(a)(17), 80b–3, 80b–4, 80b–6(4), 80b–6a, 80b–11, unless otherwise noted.

* * * * *

■ 2. Section 275.206(4)–2 is revised to read as follows:

§ 275.206(4)–2 Custody of funds or securities of clients by investment advisers.

(a) *Safekeeping required.* If you are an investment adviser registered or required to be registered under section 203 of the Act (15 U.S.C. 80b–3), it is a fraudulent, deceptive, or manipulative act, practice or course of business within the meaning of section 206(4) of the Act (15 U.S.C. 80b–6(4)) for you to have custody of client funds or securities unless:

(1) *Qualified custodian.* A qualified custodian maintains those funds and securities:

(i) In a separate account for each client under that client's name; or

(ii) In accounts that contain only your clients' funds and securities, under your name as agent or trustee for the clients.

(2) *Notice to clients.* If you open an account with a qualified custodian on your client's behalf, either under the client's name or under your name as agent, you notify the client in writing of the qualified custodian's name, address, and the manner in which the funds or securities are maintained, promptly when the account is opened and following any changes to this information.

(3) *Account statements to clients.*—(i) *By qualified custodian.* You have a reasonable basis for believing that the qualified custodian sends an account statement, at least quarterly, to each of your clients 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; or

(ii) *By adviser.* (A) You send a quarterly account statement to each of your clients for whom you have custody of funds or securities, identifying the amount of funds and of each security of which you have custody at the end of the period and setting forth all transactions during that period;

(B) An independent public accountant verifies all of those funds and securities by actual examination at least once during each calendar year at a time that is chosen by the accountant without prior notice or announcement to you and that is irregular from year to year, and files a certificate on Form ADV-E (17 CFR 279.8) with the Commission within 30 days after the completion of the examination, stating that it has examined the funds and securities and describing the nature and extent of the examination; and

(C) The independent public accountant, upon finding any material discrepancies during the course of the examination, notifies the Commission within one business day of the finding, by means of a facsimile transmission or electronic mail, followed by first class mail, directed to the attention of the Director of the Office of Compliance Inspections and Examinations; and

(iii) *Special rule for limited partnerships and limited liability companies.* If you are a general partner of a limited partnership (or managing member of a limited liability company, or hold a comparable position for another type of pooled investment vehicle), the account statements required under paragraphs (a)(3)(i) or (a)(3)(ii) of this section must be sent to each limited partner (or member or other beneficial owner).

(4) *Independent representatives.* A client may designate an independent representative to receive, on his behalf,

[79] Under the amended rule, an adviser will not be required to send quarterly account statements or undergo a surprise examination with respect to accounts for which a qualified custodian sends account statements directly to clients at least quarterly.

[80] These advisers, in reliance on no-action letters issued by the Commission's staff, have responded ''no'' to Item 9 and have not been required to comply with the custody rule. The letters are being withdrawn and these advisers must now comply with the revised rule.

notices and account statements as required under paragraphs (a)(2) and (a)(3) of this section.

(a) *Exceptions.*—(1) *Shares of mutual funds.* With respect to shares of an open-end company as defined in section 5(a)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a–5(a)(1)) (''mutual fund''), you may use the mutual fund's transfer agent in lieu of a qualified custodian for purposes of complying with paragraph (a) of this section;

(2) *Certain privately offered securities.* (i) You are not required to comply with this section with respect to securities that are:

(A) Acquired from the issuer in a transaction or chain of transactions not involving any public offering;

(B) Uncertificated, and ownership thereof is recorded only on books of the issuer or its transfer agent in the name of the client; and

(C) Transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.

(ii) Notwithstanding paragraph (b)(2)(i) of this section, the provisions of this paragraph (b)(2) are available with respect to securities held for the account of a limited partnership (or limited liability company, or other type of pooled investment vehicle) only if the limited partnership is audited, and the audited financial statements are distributed, as described in paragraph (b)(3) of this section.

(3) *Limited partnerships subject to annual audit.* You are not required to comply with paragraph (a)(3) of this section with respect to the account of a limited partnership (or limited liability company, or another type of pooled investment vehicle) that is subject to audit (as defined in section 2(d) of Article 1 of Regulation S–X (17 CFR 210.1–02(d)) at least annually and distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or members or other beneficial owners) within 120 days of the end of its fiscal year; and

(4) *Registered investment companies.* You are not required to comply with this section (17 CFR 275.206(4)–2) with respect to the account of an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 to 80a–64).

(c) *Definitions.* For the purposes of this section:

(1) *Custody* means holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. Custody includes:

(i) Possession of client funds or securities, (but not of checks drawn by clients and made payable to third parties,) unless you receive them inadvertently and you return them to the sender promptly but in any case within three business days of receiving them;

(ii) Any arrangement (including a general power of attorney) under which you are authorized or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian; and

(iii) Any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives you or your supervised person legal ownership of or access to client funds or securities.

(2) *Independent representative* means a person that:

(i) Acts as agent for an advisory client, including in the case of a pooled investment vehicle, for limited partners of a limited partnership (or members of a limited liability company, or other beneficial owners of another type of pooled investment vehicle) and by law or contract is obliged to act in the best interest of the advisory client or the limited partners (or members, or other beneficial owners);

(ii) Does not control, is not controlled by, and is not under common control with you; and

(iii) Does not have, and has not had within the past two years, a material business relationship with you.

(3) *Qualified custodian means:*

(i) A bank as defined in section 202(a)(2) of the Advisers Act (15 U.S.C. 80b–2(a)(2)) or a savings association as defined in section 3(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(b)(1)) that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act (12 U.S.C. 1811);

(ii) A broker-dealer registered under section 15(b)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(b)(1)), holding the client assets in customer accounts;

(iii) A futures commission merchant registered under section 4f(a) of the Commodity Exchange Act (7 U.S.C. 6f(a)), holding the client assets in customer accounts, but only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; and

(iv) A foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets.

PART 279—FORMS PRESCRIBED UNDER THE INVESTMENT ADVISERS ACT OF 1940

■ 3. The authority citation for Part 279 continues to read as follows:

Authority: The Investment Advisers Act of 1940, 15 U.S.C. 80b–1, *et seq.*

■ 4. Form ADV (referenced in § 279.1) is amended by:

■ a. In Part 1A, Item 9, revising the introductory text to add, after the first sentence, ''If you are registering or registered with the SEC and you deduct your advisory fees directly from your *clients'* accounts but you do not otherwise have *custody* of your *clients'* funds or securities, you may answer ''no'' to Item 9A.(1) and 9A.(2).''; and

■ b. In Part II, Item 14, adding ''(unless applicant is registered or registering only with the Securities and Exchange Commission),'' after the words ''client funds or securities''.

Note: The text of Form ADV does not and this amendment will not appear in the Code of Federal Regulations.

Dated: September 25, 2003.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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