The Proposed Amendment

Accordingly, pursuant to the authority delegated to me by the Administrator, the Federal Aviation Administration proposes to amend part 39 of the Federal Aviation Regulations (14 CFR part 39) as follows:

PART 39—AIRWORTHINESS DIRECTIVES

1. The authority citation for part 39 continues to read as follows:

Authority: 49 U.S.C. 106(g), 40113, 44701.

§ 39.13 [Amended]

2. Section 39.13 is amended by adding the following new airworthiness directive:

Honeywell International Inc.: Docket No. 2001–NE–11–AD.

Applicability

This airworthiness directive (AD) is applicable to Honeywell International Inc. (formerly AlliedSignal Inc., Garrett Turbine Engine Company and AiResearch Manufacturing Company of Arizona) TPE331–3, −5, −6, −8, −10, and −11 series turboprop and TSE331–3 series turboshaft engines equipped with first stage compressor impeller, part number (P/N) 896223–1, −2, −3, −7, or 3107109–2. These engines are installed on, but not limited to: Ayres S–2R series; Beech 18 and 45 series and Models JRB–6, 3N, 3NM, 3TM, and B100; Cessna Model 441; Construcciones Aeronauticas, S.A. (CASA) C–212 series; De Havilland DH 104 series 7AXC (Dove); Dornier 228 series; Fairchild SA226 and SA227 series (Swearingen Merlin and Metro series); Grumman American G–164 series; Jetstream 3101; Mitsubishi MU–2B series (MU–2 series); Prop-Jets, Inc. Model 400; Rockwell Commander S–2R; Shorts Brothers and Harland, Ltd. SC7 (Skyvan); Pilatus PC–6 series (Fairchild Porter and Peacemaker); and Schweizer G–164 series; and Twin Commander Aircraft Corp. (Jetprop Commander) Models 695 and 695A airplanes; and Sikorsky S–55 series (Helitec Corp. S55T) helicopters.

Note 1: This AD applies to each engine identified in the preceding applicability provision, regardless of whether it has been modified, altered, or repaired in the area subject to the requirements of this AD. For engines that have been modified, altered, or repaired so that the performance of the requirements of this AD is affected, the owner/operator must request approval for an alternative method of compliance in accordance with paragraph (c) of this AD. The request should include an assessment of the effect of the modification, alteration, or repair on the unsafe condition addressed by this AD; and, if the unsafe condition has not been eliminated, the request should include specific proposed actions to address it.

Compliance

Compliance with this AD is required as indicated, unless already done.

To prevent a uncontained engine failure, in-flight shutdown, and secondary damage, do the following:

Removal of Weld Repaired First Stage Compressor Impellers From Service

(a) Remove from service weld repaired first stage compressor impellers, P/N's 896223–1, −2, −3, and −7 and 3107109–2, with SN's listed in Table 1 and Table 2 of the Accomplishment Instructions in 2.A.(1) and 2.A.(2) of Honeywell Alert Service Bulletin TPE331–A72–2083, Revision 1, dated May 17, 2002, in accordance with the following schedule:

(1) Remove impellers with no record of cycles since weld repair, within 3,600 cycles-in-service (CIS) or at the next engine overhaul, or at the next major Continuous Airworthiness Maintenance (CAM) compressor section inspection, after the effective date of this AD, whichever occurs first.

(2) Remove impellers with more than 8,900 cycles since ''weld repair,'' within 3,600 CIS, or at the next engine overhaul, or at the next major CAM compressor section inspection after the effective date of this AD, whichever occurs first.

(3) Remove impellers with 8,900 or less cycles since ''weld repair,'' before reaching 12,500 cycles since weld repair after the effective date of this AD.

(b) For purposes of this AD, weld repaired or weld repair is defined as an impeller repair which involved heat treating and that was performed from 1980 through 1997 at Honeywell Aerospace Services, Aftermarket-Phoenix Repair and Overhaul, 1944 E. Sky Harbor Circle, Phoenix, AZ 85034 (FAA Certificate Number ZN3R030M). Former names and FAA certificate numbers for Honeywell's Repair and Overhaul Facility are listed in Section 2.A. of the Accomplishment Instructions in Honeywell Alert Service Bulletin TPE331–A72–2083, Revision 1, dated May 17, 2002.

Alternative Methods of Compliance

(c) An alternative method of compliance or adjustment of the compliance time that provides an acceptable level of safety may be used if approved by the Manager, Los Angeles Aircraft Certification Office (ACO). Operators must submit their request through an appropriate FAA Principal Maintenance Inspector, who may add comments and then send it to the Manager, Los Angeles ACO.

Note 2: Information concerning the existence of approved alternative methods of compliance with this airworthiness directive, if any, may be obtained from, Los Angeles ACO.

(d) Special flight permits may be issued in accordance with §§ 21.197 and 21.199 of the Federal Aviation Regulations (14 CFR 21.197 and 21.199) to operate the aircraft to a location where the requirements of this AD can be done.

Issued in Burlington, Massachusetts, on July 18, 2002.

Jay J. Pardee,

Manager, Engine and Propeller Directorate, Aircraft Certification Service.

[FR Doc. 02–18816 Filed 7–24–02; 8:45 am]

BILLING CODE 4910–13–P

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 275 and 279

[Release No. IA–2044; File No. S7–28–02]

RIN 3235–AH 26

Custody of Funds or Securities of Clients by Investment Advisers

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

ACTION: Proposed rule.

SUMMARY: The Commission is proposing amendments to the custody rule under the Investment Advisers Act of 1940. The proposed amendments would modernize the rule by, among other things, requiring advisers that have custody of client assets to maintain those assets with broker-dealers, banks, or other qualified custodians. The amendments also would clarify circumstances under which an adviser has custody of client assets. The amendments are designed to conform the rule to modern custodial practices and enhance protections for client assets while reducing burdens on advisers that have custody of client assets.

DATES: Comments must be received on or before September 25, 2002.

ADDRESSES: To help us process and review your comments more efficiently, comments should be sent by one method only.

Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, D.C. 20549–0609. Comments may also be submitted electronically at the following E-mail address: *rule-comments@sec.gov.*

All comment letters should refer to File No. S7–28–02; this file number should be included on the subject line if E-mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW, Washington, D.C. 20549. Electronically submitted comment letters also will be posted on the Commission's Internet web site *(http://www.sec.gov).*[1]

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, D.C. 20549–0506.

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

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Executive Summary

Rule 206(4)–2 under the Advisers Act requires each investment adviser that has custody of client funds or securities to deposit client funds in bank accounts and to segregate and identify client securities and hold them in safekeeping. The rule also requires the adviser to send quarterly account statements to each client whose assets are in the adviser's custody, and to have an independent public accountant conduct an annual surprise examination of the custodied assets.

The Commission is proposing to amend rule 206(4)–2 to reflect modern custodial practices and clarify circumstances under which an adviser has custody of client assets and thus must comply with the rule. The amendments would 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 monthly account statements directly to an adviser's clients, the adviser would be relieved from sending its own account statements and undergoing an annual surprise examination. The proposed amendments would exempt advisers from the custody rule with respect to clients that are registered investment companies or are limited partnerships or other pooled investment vehicles that are subject to annual audit by an independent public accountant. The proposed amendments would also add a definition of ''custody'' to the rule and illustrate circumstances under which an adviser has custody of client assets. Finally, the proposed amendments would remove the requirement in Form ADV that advisers with custody include an audited balance sheet in their disclosure brochure to clients.

I. Background

Rule 206(4)–2 requires advisers to protect the assets that their clients have entrusted to their custody. We adopted the rule in 1962, shortly after Congress amended the Advisers Act to give us rulemaking and inspection authority under the Act's anti-fraud provisions.[3] A key factor prompting us to ask Congress for this authority was concern about the custodial practices of advisers and the safety of client assets.[4]

Rule 206(4)–2 applies to advisers that are registered with the Commission and that have custody of client funds or securities.[5] Under the rule, the adviser must deposit client funds in bank accounts that contain only client funds, and must segregate and identify client securities and hold them in a reasonably safe place.[6] Immediately after accepting custody of a client's funds or securities, the adviser must notify the client of where and how they will be maintained.[7]7 Each quarter, the adviser must send clients account statements, and at least once each year, the adviser must have an independent public accountant conduct a surprise examination of all client funds and securities in the adviser's custody.[8]

We have not amended rule 206(4)–2 substantively since we adopted it over forty years ago.[9] Since then, custodial practices have changed and, as a result, portions of the rule have become outdated or inconsistent with modern custodial practices.[10] Advisers' business practices also have evolved, increasing the likelihood that advisers may obtain custody of client assets in circumstances that we may not have anticipated in 1962.[11] Our staff has attempted to

[1] We do not edit personal or identifying information, such as names or E-mail addresses, from electronic submissions. Submit only information you wish to make publicly available.

[2] 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.

[3] Amendments to the Advisers Act (Pub. L. 86–750, 86th Cong., 2nd Sess., 74 Stat. 885, 1960) (amending sections 206(4) and 204 of the Advisers Act); *Adoption of Rule 206(4)–2 under the Investment Advisers Act of 1940,* Investment Advisers Act Release No. 123 (Feb. 27, 1962) [27 FR 2149 (Mar. 6, 1962)].

[4] *See Securities Act Amendments, 1959: Hearings Before House Committee on Interstate and Foreign Commerce,* 86th Cong., 107 (1959) (statement of Edward Gadsby, Chairman of the Securities and Exchange Commission). *See also* Securities and Exchange Commission, *Protection of Clients' Securities and Funds in Custody of Investment Advisers: Report on Embezzlement of Clients' Securities and Recommendations for Amending the Investment Advisers Act of 1940 (1945)* (describing various frauds involving advisers' embezzlement of client assets and recommending the Commission be given authority to regulate advisers' custodial practices); Investment Advisers Act Release No. 39 (Jan. 31, 1945).

[5] As of June 2002, 867 advisers (approximately 11% of the 7,583 investment advisers registered with the Commission) reported on their Form ADV that they had custody of client funds or securities.

[6] Rule 206(4)–2(a)(1) and (2).

[7] Rule 206(4)–2(a)(3).

[8] Rule 206(4)–2(a)(4) and (5).

[9] Rule 206(4)–2 has been amended twice. In 1989, we amended the rule to require accountants conducting surprise examinations to include Form ADV–E [17 CFR 279.8] as a cover page when filing examination certificates with us. *See Forms for Filing by Accountants,* Investment Advisers Act Release No. 1181 (July 26, 1989) [54 FR 32048 (Aug. 4, 1989)]. In 1997, as part of implementing Title III of the National Securities Markets Improvement Act of 1996 (Pub. L. 104–290, 110 Stat. 3428), we amended the rule so that it applies only to advisers registered (or required to be registered) with us. *See Rules Implementing Amendments to the Investment Advisers Act of 1940,* Investment Advisers Act Release No. 1633 (May 15, 1997) [62 FR 28112 (May 22, 1997)].

[10] For example, the rule requires an adviser to segregate, identify and safe-keep client securities. *See* rule 206(4)–2(a)(1). This requirement assumes that securities are held in physical certificates. Most securities are now, however, held through book-entry in custodians' accounts with securities depositories. *See Custody of Investment Company Assets with a Securities Depository,* Investment Company Act Release No. 25266 (Nov. 15, 2001) [66 FR 58412 (Nov. 21, 2001)] at n.7 and accompanying text. *See also* James Rogers, *Policy Perspectives on Revised UCC Article 8,* 43 UCLA L. Rev. 1431 (1996).

[11] For example, many firms today have (as general partners) formed limited partnerships through which they provide advisory services (as investment advisers). Form ADVs submitted by advisers registered with us show that as of May 16, 2002, 2560 advisers act (or have related persons that act) as general partners to limited partnerships or as managing members to limited liability companies. Advisers that serve as both general partner and adviser generally have custody over the assets of the limited partnerships. *See infra* Section II. A of this Release.

accommodate these evolving business practices, and to reduce unnecessary compliance burdens on advisers, by issuing numerous no-action and interpretive letters and releases that helped to clarify the operation of the rule.[12] Many underlying issues remain, however, that can be resolved only through amendments to the rule. In addition, the accumulated guidance in these no-action and interpretive letters, while helpful to advisers, has diminished the transparency of the rule's requirements because an adviser seeking to understand the rule must review a large body of letters in addition to the rule itself.

Today, as part of our ongoing effort to review and modernize federal securities law, we are proposing comprehensive amendments to rule 206(4)–2 under the Advisers Act. The amendments, which we describe in more detail below, are 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 of client assets.

II. Discussion

A. Definition of Custody

Currently, we define ''custody'' in our instructions to Form ADV.[13] We propose to incorporate that definition into rule 206(4)–2, provide examples that illustrate the application of the definition, and include, within the rule, a limited exception for advisers that inadvertently receive client assets.

The proposed definition would provide that an adviser has custody of client assets when it holds, ''directly or indirectly, client funds or securities or [has] any authority to obtain possession of them.'' [14] Accordingly, an adviser must comply with the rule when it has access to client funds and securities as well as when the adviser holds those assets. In either circumstance, clients are at risk that their assets may be lost, misused, misappropriated, or subject to the adviser's financial reverses.[15]

We propose to include, in the definition, three examples designed to illustrate circumstances under which an adviser has custody of client assets.[16] The first example clarifies that an adviser has custody when it has *any* possession or control of client funds or securities.[17] An adviser that holds clients' stock certificates or cash, even temporarily, puts those assets at risk of misuse or loss. We recognize, however, that an adviser may inadvertently receive client assets when a third party sends funds or securities to a client via the adviser, or when a client attempts to route funds or securities to his custodian through the adviser's office. To avoid causing an adviser to violate the rule inadvertently as a result of actions by other persons, the rule would expressly exclude inadvertent receipt by the adviser of client funds or securities, so long as the adviser returns them to the sender within one business day of receiving them.[18] We also propose to clarify that an adviser's possession of a check drawn by the client and made payable to a third party will not be considered possession of client funds for purposes of the custody definition.[19] The client's relationship with the drawee bank should provide the client with protections comparable to the protections the proposed rule would provide.[20]

The second example clarifies that an adviser has custody if it has the authority to withdraw funds or securities from a client's account.[21] 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 assets for any purpose other than authorized trading has access to the client's assets.[22] 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.[23] These advisers might not have possession of client assets, but they have the authority to obtain possession.

The last example clarifies that an adviser has custody if it is the legal owner of the client assets or has access to those assets.[24] One common instance is a firm that acts as both general partner and investment adviser to a limited partnership.[25] By virtue of its position

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[12] Our Division of Investment Management has issued approximately 90 no-action and interpretive letters, and one interpretive release, under the rule. *See Investment Advisers; Uniform Registration, Disclosure, and Reporting Requirements; Staff Interpretation,* Investment Advisers Act Release No. 1000 (Dec. 3, 1985) [50 FR 49835 (Dec. 5, 1985)].

[13] Advisers use Form ADV to register with us. We amended instructions to Form ADV in 1985 to, among other things, explain that an adviser has custody if it directly or indirectly holds client funds or securities, has any authority to obtain possession of them, or has the ability to appropriate them. *See* Glossary of Terms, Form ADV; *Uniform Investment Adviser Registration Application Form,* Investment Advisers Act Release No. 991 (Oct. 15, 1985) [50 FR 42903 (Oct. 23, 1985)].

[14] Proposed rule 206(4)–2(c)(1).

[15] *See Proposal to Adopt Rule 206(4)–2 under the Investment Advisers Act of 1940,* Investment Advisers Act Release No. 122 (Nov. 6, 1961) [26 FR 10607 (Nov. 10, 1961) (the custody rule was designed to require investment advisers to maintain client funds and securities ''in such a way that they will be insulated from and not be jeopardized by any unlawful activities or financial reverses, including insolvency, of the investment adviser.''). *See also supra* note 3.

[16] While these examples represent some of the most common circumstances, there are other circumstances in which an adviser may have custody of client assets. An adviser may, for example, have custody if its affiliate holds assets of the adviser's clients and the adviser either controls the affiliate's operations or has access to the client assets through the affiliate. *See* section 208(d) of the Advisers Act [15 U.S.C. 80b–8(d)] (adviser may not, indirectly or through or by any other person, do any act or thing that would be unlawful for the adviser to do directly). Our staff previously has expressed similar views. *See Crocker Investment Management Corp.,* SEC Staff Letter (Apr. 14, 1978); *Ryder Stilwell Investment Advisers,* SEC Staff Letter (Nov. 22, 1988); *Baker, Jongewaard & Levenson Financial Planning Group, Inc.,* SEC Staff Letter (Feb. 24, 1989); *Penn Davis McFarland, Inc.,* SEC Staff Letter (Apr. 2, 1990).

[17] Proposed rule 206(4)–2(c)(1)(i).

[18] Our staff has issued no-action letters agreeing not to recommend enforcement action to the Commission if an adviser failed to comply with rule 206(4)–2 in such circumstances. *See Hayes Financial Services, Inc.,* SEC Staff Letter (Apr. 2, 1991).

[19] Checks payable to an adviser for payment of advisory fees 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.

[20] The client's relationship with the drawee bank provides the client with periodic statements and other sources of information regarding the disposition of the check.

[21] Proposed rule 206(4)–2(c)(1)(ii).

[22] *See* Glossary of Terms, Form ADV (entry for Custody states that an advisory ''firm has custody, for example, if it has a general power of attorney over a client's account or signatory power over a client's checking account''). The Commission staff also has interpreted the rule in this manner in several letters. *See, e.g., Eugene Kaufman Inc.,* SEC Staff Letter (Jan. 7, 1982); *Howard J. Gordon Investments,* SEC Staff Letter (Dec. 1, 1982); *Baldwin Brothers Inc.,* SEC Staff Letter (Sept. 1, 1989); and *Baker, Jongewaard & Levenson Financial Planning Group Inc.,* SEC Staff Letter (Feb. 24, 1989).

[23] We understand many advisers rely on a series of staff no-action letters to avoid application of the rule when they have authority to withdraw their advisory fees from client assets (and, in the case of general partners, withdraw capital from the partnerships) that are otherwise held by an independent custodian. *See, 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 Advisors Inc.,* SEC Staff Letter (Apr. 4, 1997). The no-action assurances in these letters are conditioned on the advisers' use of alternative procedures to protect client assets, including an independent custodian's periodic delivery, to the clients, of information about the withdrawals. We have designed the proposed rule so that these advisers would be able to comply with the rule without facing the burdens they previously sought to avoid. *See infra* Sections II. B and II. C of this Release.

[24] Proposed rule 206(4)–2(c)(1)(iii).

[25] This example applies equally to an adviser that acts as both managing member and investment

Continued

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.[26]

Our proposed definition of ''custody'' is based on our longstanding interpretation of the term currently used in the rule.

- Should we revise the definition in any way?
- The proposed rule would continue to interpret ''custody'' broadly to include advisers' access to client funds and securities. Does that definition continue to work well to protect client assets?
- Advisers that withdraw their fees from clients' accounts and rely on staff letters to avoid application of the custody rule send clients invoices detailing how those fees were calculated. Should our rules require advisers that deduct fees from clients' accounts to send such invoices to those clients?
- Will the examples be helpful? Are there additional examples we should add?

B. Use of Qualified Custodians

Rule 206(4)–2 currently requires advisers to maintain client funds with a bank, but does not require that client securities be held in a brokerage account or with any other type of financial institution.[27] Almost all advisers that have custody of client securities maintain them in accounts with a broker or a bank, but on occasion our examiners discover an adviser keeping certificates in office files or in a safety deposit box. Such practices do not provide adequate protection for client securities, because these certificates may too easily be lost, stolen, or destroyed.[28] We are therefore proposing to amend the rule to require that advisers maintain both client funds and securities with a qualified custodian in an account either under the client's name or under the adviser's name as agent or trustee for its clients.[29]

''Qualified custodians'' under the proposed rule would include the types of financial institutions that customarily provide custodial services and are regulated and examined by their regulators with respect to those services.[30] These would include banks,[31] savings associations,[32] registered broker-dealers,[33] and registered futures commission merchants.[34] We recognize that advisory clients often invest in securities traded on foreign exchanges and their advisers must, as a practical matter, maintain securities with financial institutions in foreign countries where the securities are traded.[35] With respect to securities for which the primary market is in a country other than the United States, and to cash and cash equivalents reasonably necessary to effect transactions in those securities, we would treat financial institutions that customarily hold financial assets in that country and that hold the client assets in customer accounts segregated from their proprietary assets as qualified custodians.

Many advisers registered with us also would be qualified custodians under the proposed rule.[36] These advisers could maintain their own clients' assets, subject to the account statement requirements described below and the custody rules imposed by the regulators of the advisers' custodial functions. Advisers could also maintain client assets with affiliates that are qualified custodians.

We request comment on our proposal to require client funds and securities to be maintained by a qualified custodian.

- Should we require that all client funds and securities be maintained with qualified custodians?
- Are there other financial institutions that should be included as qualified custodians?
- Is our proposal with respect to foreign qualified custodians too broad—

adviser of a limited liability company or another type of investment vehicle, or as both trustee and investment adviser of a trust.

26 Advisers that also act as general partners have, in the past, avoided application of rule 206(4)–2 to their activities by relying on staff no-action and interpretive letters. *See, e.g., Bennett Management Co.,* SEC Staff Letter (Feb. 26, 1990); *Canyon Management Company,* SEC Staff Letter (Oct. 15, 1991); *PIMS Inc.,* SEC Staff Letter (Oct. 21, 1991). The no-action assurances in these letters are conditioned on, among other things, an independent representative reviewing and authorizing the adviser's withdrawals of funds from the partnership accounts and on custodians sending quarterly account statements to the independent representative. Under the proposed rule, an adviser would not be subject to an annual surprise examination if the qualified custodian sends monthly account statements directly to the limited partners or to their independent representative—a requirement similar to the procedures that these advisers already follow under the staff letters. *See infra* Section II. C of this Release. Moreover, under our proposal, the custody rule would not apply to advisers with respect to limited partnerships that are audited annually. *See infra* Section II. D. 2 of this Release.

27 Instead, the rule currently requires that client securities be held in a reasonably safe place. *See* rule 206(4)–2(a)(1) and (2).

28 For discussions of risks in keeping securities certificates, *see* Uniform Commercial Code, Revised Article 8, Prefatory Note at I.C.; Randall D. Guynn, Modernizing Securities Ownership, Transfer and Pledging Laws 21 (Capital Markets Forum, International Bar Association 1996).

29 Proposed rule 206(4)–2(a)(1). Under the proposed rule, client funds and securities would have to be maintained in a custodial account so that the qualified custodian can provide account information to the clients. Keeping securities certificates in a bank safety deposit box, for example, would not satisfy the requirements of the proposed rule.

30 Regulatory agencies or self-regulatory organizations require (either by rule or by supervisory policy) these financial institutions to carry fidelity bonds to cover possible losses caused by their employees' fraudulent activities. *See, e.g.*, New York Stock Exchange (''NYSE'') rule 319, 2 New York Stock Exchange Guide (CCH) ¶ 2319; National Association of Securities Dealers (''NASD'') rule 3020, NASD Manual (CCH) 4836; 12 CFR 7.2013 (national banks); 12 CFR 563.190 (savings associations); 12 U.S.C. 1828(e) and *Federal Deposit Insurance Corporation Manual of Examination Policies,* Section 4.4 (insured state nonmember banks); *3–1555 Federal Reserve Regulatory Service* (Feb. 28, 1962) and *Federal Reserve Board Commercial Bank Examination Manual,* Section 4040.1 (insured state member banks).

We are not proposing to require advisers to look beyond the ''primary'' custodian to determine whether the client assets are maintained with a qualified custodian. As a result, our proposed definition of ''qualified custodian'' does not include clearing agencies or securities depositories because they usually hold or process funds and securities transmitted from primary custodians. *Compare* section 17(f)(2) of the Investment Company Act of 1940 (''Investment Company Act'') [15 U.S.C. 80a–17(f)(2)] and rules 17f–4 and 17f–7 [17 CFR 270.17f–4 and 17f–7] under the Investment Company Act.

31 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.

32 ''Qualified custodian'' would include any ''savings association'' 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].

33 ''Qualified custodian'' would include 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.

34 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'' would include 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 be required by CFTC rules to maintain custody of those clients' funds and security futures with a futures commission merchant. *See* rule 4.30 [17 CFR 4.30] under the Commodity Exchange Act. *See also* the Commodity Futures Modernization Act (Pub. L. 106–554, 114 Stat. 2763 (2000)) (security futures are both securities and futures).

35 *See Exemption for Custody of Investment Company Assets Outside the United States,* Investment Company Act Release No. 14132 (Sept. 7, 1984) [49 FR 36080 (Sept. 14, 1984)] (prohibiting foreign financial institutions from acting as qualified custodians for securities purchased on a foreign stock exchange would cause ''inconvenience and expense associated with moving the securities away [from] their primary market'').

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

should we limit them to entities regulated by a foreign financial regulatory authority? Alternatively, is the proposal too narrow—how many advisory clients would need to have a foreign custodian hold funds or securities other than those permitted under the proposed amendments?

• Should the rule permit advisers that are qualified custodians to maintain their clients' funds and securities themselves? With affiliated qualified custodians?

C. Delivery of Account Statements to Clients

Rule 206(4)–2 seeks to deter misuse of client assets by requiring an adviser with custody to send each client quarterly account statements,[37] and to engage an independent public accountant to conduct an annual surprise examination of client assets in custody.[38] Advisers have complained about the cost of annual surprise examinations and have sought to avoid them.[39] Moreover, experience has shown that the current rule has limited deterrent effect. Advisers that intend to misuse client assets can fabricate client account statements [40] and, because the surprise examination is performed only annually, many months may pass before the accountant has an opportunity to detect a fraud.

After reviewing the operation of the current rule and evaluating its benefits and costs, we are proposing an entirely different approach to protect advisory clients—an approach that would rely on periodic disclosure of account information by a qualified custodian rather than rely on a surprise examination. We propose to exempt advisers from the requirements to send quarterly account statements and to undergo annual surprise examinations if the qualified custodian sends monthly account statements directly to each advisory client.[41] Qualified custodians' delivery of account statements to clients directly should provide clients with confidence that any erroneous or unauthorized transactions or withdrawals by an adviser have been reflected.

We recognize that our new approach may not work in all custodial arrangements. Some advisers do not disclose the identity of their clients to their custodians to prevent a potential competitor from having access to their clients. Others may wish to protect the privacy of certain well-known clients. To accommodate this business practice, the proposed rule would require an adviser to continue sending quarterly account statements to each client that does not receive account statements directly from the qualified custodian and to undergo an annual surprise examination to verify the funds and securities of those clients.[42] To enhance our ability to protect advisory clients' assets by intervening as early as possible, the proposed amendments would require notice of any material discrepancies found during the examination. The rule would require the accountant finding such discrepancies during an examination to notify our Office of Compliance Inspections and Examinations.[43]

The proposed amendments contain a special provision requiring account statements (whether delivered by the qualified custodian or the adviser) to be sent directly to the limited partners of a limited partnership (or to their independent representative) if the adviser to the limited partnership also acts as its general partner and has custody of client assets.[44] As general partner, the adviser generally has custody of these client assets.[45] This special provision would avoid the adviser's being the sole recipient of account statements in its capacity as general partner of the limited partnership.[46] Delivery of account statements to the adviser but not to the limited partners would not, of course, deter the adviser's misuse of client assets.

• We request comments on our proposal to rely on account statements delivered to clients by qualified custodians instead of relying on investment advisers sending account statements and undergoing annual surprise examinations. Would the proposal afford equivalent protection to clients? Should the rule expressly require advisers to review the custodian's statement and identify any discrepancies?

• Should advisers that are acting as their clients' qualified custodians or that are using affiliated qualified custodians continue to be subject to annual surprise examinations?

• We understand that many, perhaps most, qualified custodians already send account statements directly to customers as a matter of practice, and therefore the effect of our proposal would be to eliminate the cost of annual surprise examinations for many advisers without imposing additional burdens.

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[37] Rule 206(4)–2(a)(4). This requirement is applicable to advisers with respect to each client whose assets are in the advisers' custody.

[38] Rule 206(4)–2(a)(5).

[39] *See Baldwin Brothers, Inc.,* SEC Staff Letter (Apr. 22, 1985). *See also* staff letters listed in notes 23 and 26 *supra.*

[40] *See, e.g., In the Matter of Vector Index Advisors, Inc. and Steven H. Adler,* Investment Advisers Act Release No. 1996 (Nov. 15, 2001) (adviser sent clients false account statements to hide its fraudulent activities). *See also Securities and Exchange Commission* v. *RCS Financial Services, Inc.,* (N.D. Ohio) Civil Action No. 98 CV 1047, Litigation Release No. 15748 (May 19, 1998); *In the Matter of Robert Pierce and Carrie L. Williams Pierce,* Investment Advisers Act Release No. 1620 (Mar. 17, 1997); *Securities and Exchange Commission* v. *Teresa V. Fernandez,* (S.D.N.Y.) 96 Civ. 8702 (JES), Litigation Release No. 15159 (Nov. 19, 1996); *United States* v. *Steven D. Wymer,* Criminal Action No. 92–2–RG (C.D. Cal), Litigation Release No. 13635 (May 12, 1993); *In re Thomas Walter McKibbin and Equitrust, Inc.,* Investment Advisers Act Release No. 1165 (May 1, 1989).

Steven D. Wymer, an investment adviser, testified before a Congressional subcommittee that his ability to misuse client assets was dependent upon custodians making him the exclusive recipient of account statements. He was thus able to deliver fabricated statements to clients to hide unauthorized transactions and losses. *See* Investment Adviser Industry Reform, Hearing before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, 103d Cong. 1st Sess. 88–89 (1993).

[41] Proposed rule 206(4)–2(a)(3). To avoid the situation in which an adviser would be violating the rule as a result of a qualified custodian's failure to deliver an account statement to a client, the rule would require the adviser to have a ''reasonable belief'' that the custodian is delivering the required account statements. An adviser could form a reasonable belief under the proposed rule if, for example, the qualified custodian provides the adviser with a copy of the account statement that was delivered to the client.

[42] Proposed rule 206(4)–2(a)(3)(ii). Our proposal in this regard has no effect on a qualified custodian's other legal obligations with respect to its customers.

[43] Proposed rule 206(4)–2(a)(3)(ii)(C). Our rules under the Exchange Act impose a similar requirement. *See* rule 17a–5(h)(2) [17 CFR 240.17a–5(h)(2)] (requiring an auditor, upon finding any material inadequacies in the audited broker-dealer's accounting system or procedures for safeguarding securities, to notify the broker-dealer, and requiring the broker-dealer to notify us within 24 hours of receiving the notice from the auditor).

[44] Proposed rule 206(4)–2(a)(3)(iii). The provision would also apply to advisers with respect to other pooled investment vehicles, including limited liability companies where the adviser also acts as the managing member of the limited liability company. Account statements must be sent directly to the limited liability company members or to their independent representative(s). Limited partnerships and other investment vehicles often engage an independent representative to receive account statements and monitor the status of assets in custody on behalf of all the limited partners.

For purposes of the rule, an ''independent representative'' would be a person that (i) acts as agent for investors in a pooled investment vehicle and by law or contract is obligated to act in the best interest of the investors; (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. *See* proposed rule 206(4)–2(c)(2).

[45] *See supra* discussions of ''custody'' under Section II. A of this Release.

[46] As discussed below in more detail, the custody rule, including proposed rule 206(4)–2(a)(3)(iii), would not apply to advisers with respect to pooled investment vehicles that are audited annually. *See* proposed rule 206(4)–2(b)(2).

We request comment on our understanding and expectations.

• We propose to require monthly account statements from qualified custodians so that clients may identify any irregularities earlier. We understand that most qualified custodians send monthly account statements to clients as a matter of practice.[47] We request comment on this understanding.

• The proposed rule would permit independent representatives to receive account statements from qualified custodians on behalf of investors in limited partnerships and other pooled investment vehicles. Are there any other types of clients that need independent representatives to receive account statements on their behalf?

• We also request comment on our proposal to require advisers with custody to continue sending quarterly account statements to clients and to continue undergoing annual surprise examinations if the qualified custodian does not send account statements directly to the adviser's clients. We understand that most custodians do send statements directly—is there a need for this alternative procedure? Should we require these advisers to obtain their clients' informed consent prior to using this alternative procedure? If not, should we require advisers that use this alternative procedure to disclose, to clients, the risks involved in receiving account statements quarterly from the adviser itself rather than monthly from a qualified custodian, or to make other disclosures?

• Should we require additional safeguards to deter misuse of clients' assets by advisers that send account statements to clients themselves—for example, should we require these advisers to send their statements to clients monthly rather than quarterly? Should the rule require surprise examinations to be conducted more often than annually? Are there other requirements or procedures that would further protect these advisers' clients' assets?

D. Exemptions

1. Registered Investment Companies

We propose to exempt advisers from the rule with respect to clients that are registered investment companies. 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.[48] We believe that applying rule 206(4)–2 in addition to those requirements may not increase safeguards on investment company assets.

2. Pooled Investment Vehicles

We also propose to exempt advisers from the rule with respect to client assets held in pooled investment vehicles such as limited partnerships or limited liability companies if the pooled investment vehicle (i) has its transactions and assets 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 90 days of the end of its fiscal year.[49] These investors will have established, by contract, a means to protect themselves from misuse of pool assets. Moreover, a periodic report by auditors may be more useful to them than receiving reports of the large number of transactions in pool assets.

• We request comment on our proposal to exempt advisers from the rule with respect to pooled investment vehicles that are subject to an annual audit. Should the rule expressly require the adviser to maintain the assets of the pooled vehicle with a qualified custodian?

• We understand that this exemption would apply to most limited partnerships, limited liability companies and other pooled investment vehicles, and thus would eliminate a great number of issues and concerns that have arisen under the current rule and that have been addressed in numerous staff no-action or interpretive letters.[50] We ask for comment on this understanding.

3. Registered Broker-Dealers

We are not proposing to retain the current exemption from the rule for advisers that are also registered broker-dealers.[51] The proposed rule would permit advisers that are also registered broker-dealers (and advisers that are also other types of qualified custodians) to hold custody of their clients' funds and securities without being subject to annual surprise examinations so long as they send monthly statements to their clients. Broker-dealers already are required to send confirmations and account statements to their customers, including those that are advisory clients.[52] Most advisers that also are registered broker-dealers should therefore already be in compliance with the proposed rule and face no additional burdens.

E. Amendments to Part II of Form ADV

Advisers that have custody of client assets must include, in their disclosure statements (''brochures'') sent to clients, a balance sheet audited by an independent public accountant.[53] We adopted the audited balance sheet requirement, in part, to assist clients in determining whether their adviser may face financial pressure to misuse the assets entrusted to it.[54] A balance sheet, however, may give an imperfect picture of the financial health of an advisory firm—many profitable advisers have few financial assets. Moreover, rule 206(4)–4 [55] now requires advisers to disclose to their clients any financial condition that

[47] Broker-dealers that are members of the NASD, the NYSE or the American Stock Exchange (AMEX) are generally required to provide customers with immediate confirmations and account statements at least quarterly. While NYSE rules permit a member to send account statements to, for example, the investment adviser if the adviser holds power of attorney over the customer's account, such delivery would not satisfy the requirement under (a)(3)(i) of the proposed rule (account statements to clients by qualified custodian). *See* NASD Rules IM–2340, NASD Manual (CCH) 4292; NYSE rule 409, 2 New York Stock Exchange Guide (CCH) ¶ 2409; AMEX rule 419, 2 American Stock Exchange Guide (CCH) ¶ 9439. Banks effecting a purchase or sale of securities for a customer are required to provide immediate confirmations under regulations of the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation, subject to limited exceptions. These regulations permit banks and their customers to agree upon account statements at least quarterly in lieu of immediate confirmations for certain types of customer accounts, such as agency accounts for which the bank exercises investment discretion. 12 CFR 12.4, 12.5, 208.34, 344.5, 344.6 (2001). While these regulations generally require account statements to be sent quarterly, we understand that broker-dealers and banks send account statements to customers monthly as a matter of practice.

[48] 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].

[49] *See* proposed rule 206(4)–2(b)(2). For purposes of this clause, ''audit'' has the meaning under section 2(d) of Article 1 of Regulation S–X [17 CFR 210.1–02(d)].

We are not proposing to require that any pooled investment vehicle undergo an annual audit. We understand, however, that many hedge funds and other pooled accounts do undergo an annual audit, and we believe requiring an adviser to comply with the requirements of proposed rule 206(4)–2 for those accounts may be unnecessary.

[50] As discussed earlier, advisers should no longer find it necessary to rely on these staff letters. *See supra* note 26.

[51] Rule 206(4)–2(b) exempts advisers that are also broker-dealers from the custody rule if they are subject to and in compliance with the net capital requirement under rule 15c3–1 [17 CFR 240.15c3–1] under the Exchange Act.

[52] *See supra* note 47.

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

[54] *See Investment Adviser Requirements Concerning Disclosure, recordkeeping, Applications for Registration and Annual Filings,* Investment Advisers Act Release No. 664 (Jan. 30, 1979) [44 FR 7870 (Feb. 7, 1979)] (adopting Part II of Form ADV, including the requirement to include an audited balance sheet).

[55] 17 CFR 275.206(4)–4.

is reasonably likely to impair the adviser's ability to meet its contractual commitments to its clients, a disclosure requirement that did not exist in 1979 when the audited balance sheet requirement was adopted.[56] We believe that this current disclosure requirement is a better means to warn clients of when their assets may be at additional risk, and that clients should not have to rely for protection on reviewing balance sheet information. We are therefore proposing to eliminate the requirement that advisers with custody include a balance sheet in their client brochures.

- We request comment on this proposal. Have advisory clients found the balance sheet useful in evaluating the risks to their assets in advisers' custody? Should we retain the requirement?

III. General Request for Comment

The Commission requests comment on the rule amendments proposed in this Release, suggestions for additional changes to the rules and comment on other matters that might have an effect on the proposals contained in this Release. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1966, the Commission also requests information regarding the potential impact of the proposed rule on the economy on an annual basis. Commenters should provide empirical data to support their views.

IV. Cost-Benefit Analysis

The Commission is sensitive to the costs and benefits resulting from its rules. Rule 206(4)–2 seeks to protect clients' assets in the custody of advisers from misuse or misappropriation, by requiring advisers to send each client quarterly account statements and to have independent public accountants conduct annual surprise examinations of the custodied assets. In the 40 years since we adopted the rule, custody practices in the securities markets have changed, and some provisions of the rule have become outdated. In addition, advisers have complained about the cost of annual surprise examinations. Moreover, experience has shown that the current rule has limited deterrent effect on investment advisers determined to misuse client assets. Our proposed amendments to the rule would require advisers to maintain clients' assets with qualified custodians and excuse advisers from annual surprise examinations if the qualified custodians send monthly account statements to the clients directly.

We believe the vast majority of advisers already maintain their clients' assets with qualified custodians who prepare monthly account statements. These amendments will enhance the protections afforded to clients' assets while at the same time reducing advisers' compliance burden. We have identified certain costs and benefits that may result from the proposed rule amendments. We request comment on the costs and benefits of the proposed rule amendments, and encourage commenters to identify, discuss, analyze, and supply relevant data regarding these or any additional costs and benefits.

A. Background

Our rules currently require advisers with custody of client assets to deposit client funds in bank accounts that contain only client funds, and to segregate and identify client securities and hold them in a reasonably safe place.[57] Each quarter, these advisers must send clients account statements, and at least once each year, these advisers must have an independent public accountant conduct a surprise examination of all the client funds and securities in the advisers' custody.[58] In addition, advisers with custody of client funds or securities must include an audited balance sheet with the disclosure brochure they send to their clients.

Rule 206(4)–2 has not been substantively amended since its adoption over 40 years ago. The proposed amendments would make several changes to the existing rule, to modernize it to reflect developments in securities market custody practices. First, advisers with custody of client funds and securities would be required to maintain those assets in accounts with qualified custodians, such as a broker or a bank.[59] Under the current rule, advisers are required to maintain clients' funds in a bank, but they are not required to maintain clients' securities with a qualified custodian. Second, if the qualified custodian sends monthly account statements directly to the advisory clients, the adviser would not be required to send account statements. The current rule requires advisers to send each client a quarterly account statement itemizing the funds and securities in the advisers' custody and all transactions for the account. Third, if the qualified custodian sends monthly account statements directly to the advisory clients, the adviser would not be required undergo an annual surprise examination. Under the current rule, advisers with custody must have an independent public accountant conduct an annual verification of the accuracy of account statements provided to the adviser's clients. Fourth, for any advisers subject to the annual surprise examination requirement, their independent public accountants would be required to notify the Commission of any material discrepancies that they uncover in the examination. The current rule does not require any such notice. Fifth, we would eliminate the current requirement that advisers with custody include an audited balance sheet with their disclosure brochures.

In addition, the proposed amendments would add new provisions to the custody rule to enhance its transparency and reflect advisers' business practices. First, the proposed amendments insert a definition of ''custody'' into the rule (based on the definition currently used in Form ADV) together with examples to illustrate circumstances under which an adviser has custody.[60] Second, a special provision would require account statements to be sent directly to the limited partners (or beneficial owners in other types of pooled investment vehicles) if the adviser also serves as the general partner of the limited partnership and has custody (or holds a managing position in other types of pooled investment vehicles and has custody). Third, we would exempt client assets held in a limited partnership or other pooled investment vehicle from the requirements of the rule if the partnership is audited at least annually and the audited financial statements are delivered to limited partners.

Based on advisers' filings with us, we estimate that a relatively small portion of investment advisers registered with us—approximately 11 percent—have custody of clients' assets.[61] Of the 867

[56] *Financial and Disciplinary Information that Investment Advisers Must Disclose to Clients,* Investment Advisers Act Release No. 1083 (Sept. 25, 1987) [52 FR 36915 (Oct., 2, 1987)] (adopting rule 206(4)–4, which requires disclosure of an adviser's precarious financial condition).

[57] Rule 206(4)–2(a)(1) and (2).

[58] Rule 206(4)–2(a)(4) and (5).

[59] Under proposed rule 206(4)–2(c)(3), a qualified custodian could be a bank, a savings association, a broker-dealer, a futures commission merchant, or in certain instances a foreign custodial institution.

[60] Proposed rule 206(4)–2(c)(1) would provide that an adviser has custody of client assets when it holds, ''directly or indirectly, client funds or securities or [has] any authority to obtain possession of them.'' The examples, based on longstanding interpretation of the term currently used in the rule, address situations involving advisers' possession or control of clients' funds or securities, the authority to withdraw funds or securities from clients' accounts, or access to clients' funds or securities by virtue of the advisers' legal capacity.

[61] *See infra* note 80 and accompanying text (867 SEC-registered advisers report having custody, but

Continued

advisers who currently report having custody, many also report that they are broker-dealers (123) or banks (33).[62] Advisers that are also registered broker-dealers or banks would be ''qualified custodians'' under the proposed rule and may keep custody of their own clients' assets. We expect that all 156 of these advisers [63] would, in their capacity as qualified custodians, send monthly account statements to their advisory clients. Of the remaining 711 advisers that report having custody,[64] we estimate that 95 percent of them (675 advisers) [65] would arrange to have qualified custodians send monthly account statements to 99 percent of their clients, and would prepare their own statements for 1 percent of their clients.[66] We expect that the remaining 36 advisers [67] would prepare their own statements for all of their clients.[68]

B. Benefits

Improved protection for advisory clients. We have designed the proposed amendments to offer greater protection for advisory clients. As discussed above, the proposed amendments would exempt advisers from the requirements to send each client account statements and to undergo an annual surprise examination of the client's account if a qualified custodian sends monthly account statements directly to the advisory client. We expect that, as a result, most advisers will have qualified custodians deliver account statements directly to advisory clients, rather than pay the costs of annual surprise examinations. Clients' early identification of questionable transactions upon receipt of an accurate account statement from a qualified custodian on a monthly basis, rather than an annual surprise examination that may not occur for many months, should allow clients to move more swiftly and to reduce their assets' exposure to malfeasance by advisers. Similarly, we anticipate that the special provision for providing account statements for limited partnerships and other pooled investment vehicles should provide investors (or their independent representatives) the opportunity to identify any erroneous or unauthorized transactions or withdrawals by the partnership's adviser.

As discussed above, we expect that nearly all of the clients of advisory firms that currently have custody of their clients' assets will receive monthly statements from qualified custodians under the rule.[69] The potential benefit to each client is not, however, quantifiable. We also infer that most of these clients already receive monthly statements from qualified custodians, as a result of voluntary practices by their advisers. The potential benefit of having this practice institutionalized in a regulation is also not quantifiable.

In addition, as discussed above, we estimate that a few advisers will not avail themselves of the option to have qualified custodians send monthly account statements to some or all of their clients, and that approximately 28,845 clients will continue to be protected primarily by annual surprise examinations of these advisers as a result.[70] The proposed amendments would require independent public accountants conducting these examinations to advise the Commission of any material discrepancies they discover in the examination. This will enhance the safety of these clients' assets, because the Commission will be able to act promptly and preempt further losses resulting from malfeasance by the adviser. The potential benefit to clients in this regard is not quantifiable.

The rule will also provide greater protection for advisory clients by requiring advisers to maintain clients' securities with a qualified custodian. Based on our examination experience, it is rare for an adviser to retain physical custody of any particular client's securities. Thus, advisory clients are already receiving this benefit as a matter of practice in most instances. The potential benefit of having this practice institutionalized in a regulation is not quantifiable.

Remove unnecessary regulatory requirements. We estimate that approximately 744 advisers are currently required to undergo annual surprise examinations.[71] The Commission staff has estimated, in connection with Paperwork Reduction Act analyses, that on average, an adviser spends approximately 335 hours and pays an additional $8,000 annually in connection with undergoing annual surprise examinations under the existing rule.[72] The proposed amendments to rule 206(4)–2 would provide these advisers with the opportunity to avoid the costs of these annual surprise examinations. As discussed above, we estimate that only 36 advisers will continue to incur the costs of an annual surprise examination with respect to all their clients, and another 675 will only incur these costs with respect to one percent of their clients.[73] The new compliance requirements under the amended rule 206(4)–2 would focus on investment advisers ascertaining whether qualified custodians are sending monthly account statements to each of the adviser's clients. This sets forth a much simpler and less expensive compliance procedure.

We request comment on our estimates of the number of advisers that would avail themselves of the opportunity to avoid the time and costs of an annual surprise examination under the rule. We also request comments quantifying the reduction in costs that would be obtained through the new compliance procedure.

In addition, for other advisers who have custody but rely on procedures set out in staff no-action letters in lieu of complying with the annual surprise examination requirement, the proposed amendments would eliminate the cost of compliance with the procedures set forth in those letters. The number of advisers who have custody but rely on procedures set out in staff no-action letters in lieu of complying with the annual surprise examination requirement is difficult to estimate.[74] We request comments quantifying the costs advisers incur in connection with the alternative procedures under the staff no-action letters, how many

this may under-represent the number of advisers who actually have custody).

[62] *See infra* note 82 and accompanying text.

[63] 123 + 33 = 156.

[64] 867 − 123—33 = 711.

[65] 711 × 0.95 = 675.

[66] We base this estimate on our experience examining investment advisers. As we discuss, *infra* note 90 and accompanying text, we estimate that SEC-registered investment advisers have a mean of 670 clients each. Thus, we estimate that this group of advisers would be preparing their own statements for an aggregate group of 4,725 clients (670 mean clients per adviser × 0.01 = 7 clients per adviser × 675 advisers = 4,725 clients).

[67] 867 − 123 − 33 − 675 = 36.

[68] We estimate that these 36 advisers would have 24,120 clients in the aggregate (36 × 670 = 24,120). *See supra* note 66.

[69] *See supra* notes 61–68 and accompanying text.

[70] *See supra* notes 66 and 68. We estimate the aggregate number of clients at 28,845 (4,725 + 24,120).

[71] As we discuss at notes 61–68 *supra* and accompanying text, 867 advisers report having custody. Of these, 123 report that they are also broker-dealers. Broker-dealers are exempt from the current rule. 867 − 123 = 744 non-exempt advisers with custody.

[72] This estimate is based on the estimate that an adviser (i) spends 0.5 hours per client in connection with the annual surprise examination, (ii) has an average of 670 clients (0.5 x 670 = 335), and (iii) pays $8,000 in fees to an independent public accountant. *See infra* notes 87–88 and accompanying text.

[73] These 675 advisers would benefit from reducing the hours and other costs they spend on surprise examinations. As discussed below, *infra* notes 90 and 93, each of these 675 advisers would spend approximately 3.5 hours and pay $1,000 annually in connection with undergoing annual surprise examinations under the proposed rule.

[74] *See infra* note 80 and accompanying text.

advisers incur such costs, and the reduction in costs that would be obtained through the new compliance procedure.

The proposed amendments would also 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. The elimination of this balance sheet requirement would reduce advisers' compliance burden. 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.[75] We request comment on our estimate of these costs and the number of advisers who would be relieved from these costs as a result of the proposed amendments.

We do not anticipate that eliminating the balance sheet requirement will reduce protections to clients. Many profitable advisers have few financial assets, and a balance sheet may give an imperfect picture of the financial health of an advisory firm. Moreover, some clients may not have experience in interpreting the financial information presented in a balance sheet. Finally, rule 206(4)–4 [76] now requires advisers to disclose to their clients any financial condition that is reasonably likely to impair the adviser's ability to meet its contractual commitments to its clients, and this disclosure is likely to be more useful to clients than a balance sheet; accordingly, we do not expect any reduction in investor protection to result from the proposed change.

Improved clarity and transparency of the rule. We anticipate that investment advisers will find it easier to understand and to comply with the rule as a result of the proposed amendments, and that this increased transparency may result in cost savings for advisers. We adopted rule 206(4)–2 in 1962 and the rule was designed to operate in the securities markets of that time. The proposed amendments would improve the clarity and transparency of the rule by inserting a definition of ''custody'' into the rule and by incorporating current custodial practices into our requirements. The definition of ''custody'' is based on the definition that has been used in the instructions to Form ADV since 1985, but our proposed amendments make the definition easier to use 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. Similarly, advisers relying on certain procedures set out in staff no-action letters discussed above, as an alternative to the annual surprise examination requirement, will no longer need to refer to this body of letters. We request comment on the costs advisers currently incur in this regard, such as attorneys' fees, and on the likely savings advisers would experience under the proposed amendments to the rule.

C. Costs

The proposed amendments would require that all client funds or securities be maintained with a qualified custodian. This requirement may impose costs on advisers that are not already maintaining clients' securities in accounts with qualified custodians. Based on our experience in examining advisers' operations, however, we estimate 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. We estimate that the additional cost of this requirement, if any, would therefore be minimal.

In addition, while the proposed amendments would exempt most advisers that have custody from the costs of undergoing annual surprise examinations and sending account statements, that exemption would be conditioned on qualified custodians sending monthly account statements directly to the advisers' clients. This condition may impose costs on some advisers. Our understanding is that, in most instances, qualified custodians are already delivering monthly account statements to advisers' clients as a matter of practice.[77] However, qualified custodians that are not delivering account statements directly to clients and that would have to do so at the request of advisers may pass on the new costs to advisers. These costs are necessary for the protection of advisory clients and we estimate that they should be no greater, at an aggregate level, than the costs incurred under the current account statement delivery requirement. Moreover, an investment adviser has the option to continue under the old approach,[78] in the unlikely event that the costs are greater. We request comments quantifying the costs that advisers would incur under either approach.

D. Request for Comment

• The Commission requests comments on the potential costs and benefits identified in this release, as well as any other costs or benefits that may result from the proposals.

• We encourage comments to identify, discuss, analyze, and supply relevant data regarding these or additional costs and benefits.

V. Paperwork Reduction Act

The proposed amendments contain several ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995,[79] and the Commission has 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 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 rule and the form contain currently approved collection of information numbers under OMB control numbers 3235–0241 and 3235–0049, respectively. 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.

[75] *See infra* note 96 and accompanying text. pp

[76] 17 CFR 275.206(4)–4. When we adopted the balance sheet requirement in 1979, rule 206(4)–4 was not in existence. *See supra* note 54.

[77] Based on our experience in examining advisers, we estimate that less than 1% of advisory clients (excluding investors in pooled investment vehicles) do not receive account statements directly from custodians.

[78] Proposed rule 206(4)–2(a)(3)(ii).

[79] 44 U.S.C. 3501 to 3520.

A. Rule 206(4)–2

According to our records, 867 out of the 7,583 advisers registered with the Commission have custody of client funds or securities.[80] These records also show that 123 advisers registered with us that report having custody are also registered broker-dealers exempted from the current rule. The proposed amendments would remove this exemption, but these advisers should be in compliance with the proposed rule without facing additional burdens.[81]

The current rule requires advisers registered with us that have custody of clients' assets to send account statements to those clients at least quarterly and to undergo an annual surprise examination to verify the custodied assets. The proposed amendments would exempt advisers from these two requirements if qualified custodians send monthly account statements directly to the advisory clients. As discussed in detail below, we estimate that of the 867 advisers that reported to have custody of client assets, 156 would be fully exempted from these two requirements, 675 would be exempted from the requirements with respect to 99 percent of their clients and 36 would remain subject to both requirements with respect to all of their clients.

We estimate that advisers that are registered broker-dealers (123 firms) or banks (33 firms) would be exempt from these two requirements with respect to all of their clients.[82] We further estimate, based on our experience in examining advisers, that 95 percent of the other 711 advisers that have custody would use this exemption with respect to approximately 99 percent of their clients; these 675 advisers[83] would still be required to send account statements and undergo an annual surprise examination with respect to 1 percent of their clients; and 36 advisers would still be subject to these requirements with respect to all of their clients.

In addition, the proposed amendments would further reduce burdens by exempting all advisers from the custody rule with respect to their clients that are investment companies or audited limited partnerships.[84]

The above analysis shows that the proposed amendments would generally reduce the paperwork burden for advisers. The currently approved annual aggregate burden of collection of information under rule 206(4)–2 is 21,625 hours. This approved annual aggregate burden was based on estimates that (i) 173 advisers were subject to the rule, (ii) the advisers had, on average, 50 clients each, and (iii) each of these advisers spent an average of 2.5 hours annually in responses with respect to each client.[85] In addition, the approved annual burden includes an aggregate cost estimate of $692,000. This cost was based on an estimate that an adviser would pay an independent public accountant $4,000 to conduct the annual surprise examination.[86]

Updating those prior calculations based on current information from advisers registered with us, however, we would now estimate that (i) 744 advisers are subject to the existing rule, and (ii) advisers registered with us have, on average, 670 clients each. We would continue to estimate that the burden on each adviser is 2.5 hours annually for each client. These current data would increase the annual aggregate burden under the current rule to 1,246,200 hours.[87] In addition, we would now estimate the cost an adviser would incur in obtaining an annual surprise examination in the form of accounting fees would be $8,000, and these current data would increase the aggregate cost estimate to $5,952,000.[88]

As stated above, however, for purposes of estimating the burden hours under the proposed amendments, we now estimate that the number of advisers subject to the collections of information with respect to all of their clients for whom they have custody would decrease to 36 (5 percent of the 711 advisers that have custody and are not broker-dealers or banks), and a further 675 advisers (711 advisers × 95 percent) would be subject to these burdens with respect to only 1 percent of their clients.[89] Assuming an average of 670 clients per adviser registered with us, the aggregate annual burden that advisers would face under the proposed amendments would decrease to 72,113 hours.[90] In addition, the proposed amendments would require an independent public accountant to notify our Office of Compliance Inspections and Examinations upon finding any material discrepancy during the course of conducting an annual surprise examination of the client funds and securities in an adviser's custody. Of the 711 annual surprise examinations that would occur under the proposed

[80] Based on information filed through the IARD system as of June 2002, 867 advisers registered with us report on their Form ADVs that they have custody. There may be additional advisers registered with us that would be deemed to have custody under the proposed revised rule but that are relying on staff letters (*see supra* notes 23 and 26) to avoid application of the current rule to their advisory business, and therefore do not report on their Form ADV that they have custody.

[81] Advisers that are also registered broker-dealers would be "qualified custodians" under the proposed rule and may keep custody of their own (and other advisers') clients' assets. Broker-dealer rules already require these firms to send account statements to their customers and we understand that broker-dealers generally send customers monthly account statements, as a matter of practice. Therefore these advisers should not be subject to the annual surprise examination requirement. *See supra* note 47.

[82] As noted earlier, 123 advisers registered with us that report having custody are also broker-dealers. Another 33 advisers registered with us that report having custody also report that they are actively engaged in business as a bank. As is the case for broker-dealers, banks would be qualified custodians under the rule and may keep custody of their own (and other advisers') clients' assets. *See supra* note 81. In addition, many of these 33 advisers that are banks may also use the exemption provided under proposed rule 206(4)–2(b)(1) (exempting advisers from the custody rule with respect to any client that is a registered investment company). Section 202(a)(11)(A) of the Advisers Act [15 U.S.C. 80b–2(a)(11)(A)] excludes banks from the definition of "investment adviser" except to the extent they advise a registered investment company, and many of these banks may therefore have only registered investment companies as their advisory clients.

[83] 0.95 × 711 = 675.

[84] *See supra* Section II. D. of this Release.

[85] The approved burden was based on an estimated 173 advisers that are subject to the custody rule (a total of 628 advisers with custody minus 455 broker-dealers exempted from the custody rule). The approved burden was also based on an estimate that these 173 advisers responded, on average, 5 times annually (4 times to prepare quarterly account statements and 1 time to respond to the annual surprise examination requirement) with respect to each of their 50 clients at an average of 0.5 hours per response, thus spending an estimated 2.5 hours per client annually. The total burden for each adviser was therefore estimated to be 125 hours annually (50 clients × 2.5 hours = 125 hours) and the annual aggregate burden for all advisers was estimated to be 21,625 hours (173 advisers × 125 hours = 21,625 hours).

[86] 173 advisers × $4,000 accounting fees = $692,000.

[87] 744 advisers x 670 clients × 2.5 hours annually per adviser per client = 1,246,200 hours.

[88] 744 advisers × $8,000 accounting fees = $5,952,000.

[89] As discussed earlier, 867 advisers registered with us currently report having custody of clients' funds or securities. We estimate that 123 broker-dealers and 33 banks will not be required to send quarterly account statements or undergo an annual surprise examination under the rule as proposed to be revised. We further estimate that, of the remaining 711 advisers that have custody, 95% (675 advisers) will use qualified custodians to deliver account statements to 99% of their clients, leaving an average of 7 clients per adviser for whom the adviser must send account statements and undergo an annual examination. The other 5% of advisers with custody (36 advisers) would be subject to the collections of information under the rule with respect to all of their clients (an average of 670 clients per adviser).

[90] 675 advisers would have 5 responses with respect to each of 7 clients annually for an average of 35 annual responses per adviser, or an aggregate of 23,625 annual responses. An additional 36 advisers would have 5 responses with respect to each of 670 clients annually for an average of 3,350 annual responses per adviser, or an aggregate of 120,600 annual responses. 23,625 + 120,600 = 144,225 total annual responses under the proposed rule. Each response is assumed to take approximately 0.5 hours, for a total hour burden of 72,112.5 (rounded to 72,113) hours annually for all advisers in the aggregate.

amended rule, we anticipate that not more than 1 examination per year would yield a material discrepancy, and that the burden on an accountant in providing notice to the Commission would be no more than 0.5 hours. This new requirement would not increase the total annual aggregate burden under the proposed amendments. [91]

The aggregate cost estimate for accounting fees for the annual surprise examination would be $288,000 for the 36 advisers who will be subject to the collection of information for all of their clients. [92] We estimate that 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. [93] As a result, the aggregate cost estimate would decrease to $963,000. [94]

We believe, however, that using the average of 670 clients per adviser affected by the rule may overstate the burden significantly. The 670 number is a mean, but a few large advisers represent a significant portion of the total client base, so the typical number of clients for advisers registered with us should be much smaller.

B. Form ADV, Part II, Item 14

We propose to eliminate 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.[95] This would reduce paperwork burden for advisers that have custody of client assets. We would continue to require an adviser to provide an audited balance sheet if the adviser requires prepayment of advisory fees of more than $500 per client and more than six months in advance.

In the currently approved annual aggregate burden of collection of information, we inadvertently failed to include an estimate of the cost advisers incur to pay their independent public accountants to prepare audited balance sheets. We estimate that the current aggregate annual cost of this requirement for advisers registered with us is $11,460,000. This aggregate is based on our estimate that (i) each adviser who must obtain an audited balance sheet in order to comply with the requirement pays approximately $15,000 on average in accounting fees, (ii) 184 advisers incur these costs under the advance fees provision, and (iii) 580 additional advisers incur these costs under the custody provision.[96]

For purposes of calculating this cost estimate under the proposed amendments, the 580 advisers that we estimate are currently incurring accountants' fees to comply with the balance sheet requirement under the custody provision will no longer incur these costs. Therefore, we estimate that the number of advisers subject to this requirement will be reduced to 184, and the aggregate annual cost of this requirement will be reduced to $2,760,000, for an average annual cost for each adviser registered with us of $364.[97]

C. Request for Comment

We request comment whether these estimates are reasonable. Any information received by the Commission related to the proposed rule amendments would not be kept confidential. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to:

- Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility;
- Evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information;
- Determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and
- Determine whether there are ways to minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 3208, Washington, DC 20503, and also should send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549–0609 with reference to File No. S7–28–02. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives the comment within 30 days after publication of this release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7–28–02, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 Fifth Street, NW, Washington, DC 20549.

VI. Initial Regulatory Flexibility Analysis

The Commission has prepared the following Initial Regulatory Flexibility Analysis (''IRFA'') regarding proposed rule 206(4)–2 in accordance with section 3(a) of the Regulatory Flexibility Act.[98]

A. Reasons for Proposed Action

Rule 206(4)–2 seeks to protect clients' assets in the custody of advisers by requiring advisers to deposit client funds in bank accounts and to segregate and identify client securities and hold them in safekeeping. The rule also protects custodied assets by requiring advisers to send each client quarterly account statements and to have an independent public accountant conduct an annual surprise examination of the custodied assets. We have not amended the rule substantively since we adopted it over 40 years ago. Since then, custodial practices have changed and, as a result, portions of the rule have become outdated or inconsistent with modern custodial practices. Advisers' business practices have also evolved, increasing the likelihood that advisers may obtain custody of client assets in circumstances that we may not have anticipated in 1962.

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[91] As noted, supra note 90, the total hour burden is estimated at 72,112.5, rounded up to 72,113 hours. Adding 0.5 hours brings the total to 72,113, leaving the rounded number unchanged.

[92] 36 advisers × $8,000 accounting fees = $288,000.

[93] 675 advisers × $1,000 accounting fees = $675,000.

[94] $288,000 + $675,000 = $963,000.

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

[96] $15,000 fees × (184 advisers with advance fees + 580 additional advisers with custody) = $11,460,000. 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 estimate 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.

[97] (184 × $15,000)/7,583 = $364.

[98] 5 U.S.C. 603(a).

As part of our ongoing effort to review and modernize federal securities law, we are proposing comprehensive amendments to rule 206(4)–2. These amendments are designed to harmonize the 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 would require advisers to maintain client funds and securities with a broker-dealer, bank, or other ''qualified custodian.'' If the qualified custodian sends monthly account statements directly to an adviser's clients, the adviser would be relieved from sending its own account statements and from undergoing an annual surprise examination of those clients' accounts. The proposed amendments would exempt advisers from the rule with respect to clients that are registered investment companies, as well as with respect to limited partnerships and other pooled investment vehicles that are subject to annual audit by an independent public accountant.

The proposed amendments would 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 (or their counsel) will no longer need to refer to other materials such as staff no-action letters for these examples. Finally, the proposed amendments would 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.

B. Objectives and Legal Basis

The objectives of the proposed amendments to rule 206(4)–2 are threefold. First, the amendments would enhance the protections afforded to client assets. The proposed amendments would exempt advisers from the requirements to send each client account statements and to undergo annual surprise examinations of the client's account if the qualified custodian sends account statements directly to the advisory client monthly. Qualified custodians' delivery of account statements directly to clients should provide clients with confidence that any erroneous or unauthorized transactions by an adviser have been reflected. We believe nearly all advisers already maintain their clients' assets with qualified custodians, and will avail themselves of the option to avoid the costs of preparing statements and surprise examinations by electing to have the qualified custodian send account statements directly to the client.

Second, the amendments would harmonize the rule with current custodial practices. For example, the requirement under the current rule for advisers to segregate, identify, and safekeep client securities assumes that securities are held as physical certificates. Now that most securities are held in book-entry form, the proposed amendments' requirement to maintain the securities with a qualified custodian would better reflect modern market practices.

Third, the amendments clarify circumstances under which advisers have custody of client assets, by providing a definition of custody that includes examples illustrating application of the definition. 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.

The Commission is proposing to amend rule 206(4)–2 pursuant to the 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)]. Section 206(4) gives us authority to issue rules designed to prevent fraudulent, deceptive, or manipulative acts or practices. Section 211 gives us authority to clarify, by rule, persons and matters within our jurisdiction and to prescribe different requirements for different classes of persons, as necessary or appropriate to the exercise of our authority under the Act.

C. Small Entities Subject to Rule

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.[99] The Commission estimates that as of May 21, 2002 approximately 28 SEC-registered investment advisers that have custody of client assets were small entities.[100]

D. Reporting, Recordkeeping, and Other Compliance Requirements

The proposed rule would impose no new reporting and recordkeeping 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 proposed amendments would not materially increase the effort necessary on advisers' behalf to comply with the Commission's rules. To the contrary, the proposed 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 annual surprise examination.[101] In addition, we are proposing to amend 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 advisers' compliance costs.

E. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission believes that there are no rules that duplicate, overlap, or conflict with the proposed rule.

F. Significant Alternatives

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 proposed 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 proposed amendments is to decrease regulatory burdens on advisers, and small advisers, as well as large ones, will benefit from

[99] 17 CFR 275.0–7(a).

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

[101] Under the proposed amendments, an adviser would not be required to send quarterly account statements or undergo a surprise examination with respect to accounts for which a qualified custodian that sends monthly account statements directly to clients.

the proposed rule. Moreover, the proposed 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 proposed 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 proposed 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.

G. Solicitation of Comments

We encourage written comments on matters discussed in this IRFA. In particular, the Commission seeks comment on:

• The number of small entities that would be affected by the proposed rule; and

• Whether the effect of the proposed rule on small entities would be economically significant.

Commenters are asked to describe the nature of any effect and provide empirical data supporting the extent of the effect.

VII. Statutory Authority

We are proposing 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 proposing amendments to Part II of 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)].

Text of Proposed Rule

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be 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; and

(3) *Account statements to clients.* (i) *By qualified custodian.* You have a reasonable basis for believing that the qualified custodian sends, to each of your clients for which it maintains funds or securities, a monthly account statement, 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 whose funds or securities are maintained with a qualified custodian, 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;

(B) An independent public accountant verifies all of those funds and securities by actual examination at least once each calendar year at a time chosen by the accountant without prior notice to you, and files a certificate on Form ADV–E (17 CFR 279.8) with the Commission within 30 days after 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.

(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), or to their independent representative.

(b) *Exceptions.* You are not required to comply with this section (17 CFR 275.206(4)–2) with respect to the account of:

(1) An investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 to 80a–64); or

(2) A limited partnership (or limited liability company, or another type of pooled investment vehicle) that has its transactions and assets audited (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 90 days of the end of its fiscal year.

(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 or control of client funds (but not of checks drawn by clients and made payable to third parties) or securities, unless you receive them inadvertently and you return them to the sender within one business day 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 legal ownership of or access to client funds or securities.

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

(i) Acts as agent 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 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));

(ii) 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);

(iii) 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;

(iv) 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; and

(v) With respect to securities for which the primary market is in a country other than the United States, and cash and cash equivalents reasonably necessary to effect transactions in those securities, a financial institution that customarily holds financial assets in that country and that holds the client 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.*, unless otherwise noted.

4. By amending Item 14 of Part II of Form ADV (referenced in § 279.1) by adding ''(unless applicant is registered or registering only with the Securities and Exchange Commission),'' after the words ''client funds or securities''.

Dated: July 18, 2002.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 02–18698 Filed 7–24–02; 8:45 am]

BILLING CODE 8010–01–U

DEPARTMENT OF ENERGY

Federal Energy Regulatory Commission

18 CFR Part 284

[Docket No. PL02–6–000]

Notice of Inquiry Concerning Natural Gas Pipeline Negotiated Rate Policies and Practices

July 17, 2002.

AGENCY: Federal Energy Regulatory Commission.

ACTION: Notice of inquiry.

SUMMARY: The Federal Energy Regulatory Commission (Commission) is issuing this Notice of Inquiry to seek comments on its negotiated rate policies and practices, established in Alternatives to Traditional Cost-of-Service Ratemaking for Natural Gas Pipelines, Regulation of Negotiated Transportation Services of Natural Gas Pipelines, Statement of Policy and Request for Comments, 74 FERC ¶ 61,076 (1996). Specifically, the Commission is undertaking a review of the recourse rate as a viable alternative and safeguard against the exercise of market power of interstate gas pipelines, as well as the entire spectrum of issues related to its negotiated rate program, and welcomes comments on these issues.

DATES: Written comments must be received by the Commission by August 26, 2002. Reply comments must be received by the Commission 30 days after the filing date for initial comments.

ADDRESSES: Office of the Secretary, Federal Energy Regulatory Commission, 888 First Street, NE., Washington, DC 20426.

FOR FURTHER INFORMATION CONTACT: Michael G. Henry, Office of the General Counsel, Federal Energy Regulatory Commission, 888 First Street, NE., Washington, DC 20426 (202) 208–0532.

SUPPLEMENTARY INFORMATION:

Natural Gas Pipeline Negotiated Rates Policies and Practices

1. In this notice of inquiry (NOI), the Federal Energy Regulatory Commission (Commission) presents an opportunity for comments regarding its Negotiated Rates Policies and Practices, established in Alternatives to Traditional Cost-of-Service Ratemaking for Natural Gas Pipelines, Regulation of Negotiated Transportation Services of Natural Gas Pipelines, Statement of Policy and Request for Comments, 74 FERC ¶ 61,076 (1996). Specifically, the Commission is undertaking a review of the recourse rate as a viable alternative and safeguard against the exercise of market power of interstate gas pipelines, as well as the entire spectrum of issues related to its negotiated rate program, and welcomes comments on these issues.

Background

2. Since 1996 pipelines have had the option to use negotiated rates as an alternative to cost-of-service ratemaking. The Commission introduced negotiated rates to allow pipelines choosing not to seek market base rates by establishing a lack of market power or to undertake an incentive rate program, to adopt another alternative to traditional cost-of-service regulation. The original program was developed at a time when there was a great deal of concern about capacity ''turnback'' as a result of Order Nos. 436 and 636, and other factors.[1] Because the industry was shifting from traditional supply sources to other sources, many existing pipeline shippers no longer needed the same amount of firm capacity from their traditional pipeline's supply regions, and as a result sought to ''turn back'' transmission capacity when their transportation contracts expired. The negotiated rates program was thus developed to help pipelines market that turned-back capacity to new shippers, such as electric generators, as well as to help retain local distribution customers whose existing contracts were expiring.

3. Under the negotiated rates program, instead of cost-of-service regulation, the pipeline and a shipper may negotiate rates that vary from the pipeline's otherwise applicable tariff. A recourse rate that is on file in the pipeline's tariff is always available for those shippers preferring traditional cost-of-service rates. The Commission recognized, however, that potential problems could occur if capacity became constrained, as for example, if shippers that were willing to pay more than the maximum rate through a negotiated rate were bidding against shippers that were bidding the maximum recourse rate. The Commission required that, in those situations, customers bidding more than the maximum rate would be treated as

[1] *See, e.g.,* 74 FERC ¶ 61,079 at 61,225–26 (1996).