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Securities and Exchange Commission

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Custody of Funds or Securities of Clients by Investment Advisers; Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)–2 Under the Investment Advisers Act of 1940; Final Rules

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 275 and 279

[Release No. IA–2968; File No. S7–09–09]

RIN 3235–AK32

Custody of Funds or Securities of Clients by Investment Advisers

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission is adopting amendments to the custody and recordkeeping rules under the Investment Advisers Act of 1940 and related forms. The amendments are designed to provide additional safeguards under the Advisers Act when a registered adviser has custody of client funds or securities by requiring such an adviser, among other things: To undergo an annual surprise examination by an independent public accountant to verify client assets; to have the qualified custodian maintaining client funds and securities send account statements directly to the advisory clients; and unless client assets are maintained by an independent custodian (*i.e.,* a custodian that is not the adviser itself or a related person), to obtain, or receive from a related person, a report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board. Finally, the amended custody rule and forms will provide the Commission and the public with better information about the custodial practices of registered investment advisers.

DATES: *Effective Date:* March 12, 2010. *Compliance Dates:* An investment adviser required to obtain a surprise examination must enter into a written agreement with an independent public accountant that provides that the first examination will take place by December 31, 2010. An investment adviser also required to obtain or receive an internal control report because it or a related person maintains client assets as a qualified custodian must obtain or receive an internal control report within six months of the effective date. Section III of this Release contains additional information on the effective and compliance dates.

FOR FURTHER INFORMATION CONTACT: Vivien Liu, Senior Counsel, Melissa A. Roverts, Senior Counsel, Daniel S. Kahl, Branch Chief, or Sarah A. Bessin, Assistant Director, at (202) 551–6787 or *IArules@sec.gov,* Office of Investment Adviser Regulation, Division of Investment Management, U.S. Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–8549.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission") is adopting amendments to rule 204–2 [17 CFR 275.204–2], rule 206(4)–2 [17 CFR 275.206(4)–2] under the Investment Advisers Act of 1940 [15 U.S.C. 80b] (the "Advisers Act" or "Act"), to Form ADV [17 CFR 279.1], and to Form ADV–E [17 CFR 279.8].

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I. Background

Earlier this year we began a comprehensive review of our rules regarding the safekeeping of investor assets in connection with our bringing several fraud cases involving investment advisers and broker-dealers.[1] As part of this effort, we proposed amendments to rule 206(4)–2, the rule under the Advisers Act that governs an adviser's custody of client funds and securities ("client assets").[2] Our staff is currently reviewing potential recommendations to enhance the oversight of broker-dealer custody of customer assets. Thus today's adoption represents a first step in the effort to enhance custody protections, with consideration of additional enhancements of the rules governing custody of customer assets by broker-dealers to follow.

The amendments we proposed earlier this year to rule 206(4)–2 were designed to strengthen the existing custodial controls imposed by the rule. Under rule 206(4)–2, advisers, in most cases, must maintain client funds and securities with a "qualified custodian."[3] Qualified custodians under the rule include the types of financial institutions to which clients and advisers customarily turn for custodial services, including banks, registered broker-dealers, and registered futures commission merchants.[4] These institutions' custodial activities are subject to regulation and oversight.[5] In addition, advisers must have a reasonable belief that the qualified custodian sends account statements directly to advisory clients.[6] The rule also permits advisers (rather than custodians) to send account statements if the adviser is subject to an annual surprise verification of client assets by an independent public accountant.[7]

The proposed amendments were designed to eliminate certain exemptions in the rule, thus expanding the protections afforded advisory clients by requiring all registered advisers with custody of client assets to be subject to an annual surprise examination,[8] and requiring that they have a reasonable belief that qualified custodians send account statements directly to the

[1] Since the beginning of this year, the Commission has brought several enforcement actions against investment advisers and broker-dealers alleging fraudulent conduct, including misappropriation or other misuse of investor assets. *See* cases cited in footnote 11 of *Custody of Funds or Securities of Clients by Investment Advisers,* Investment Advisers Act Release No. 2876 (May 20, 2009) [74 FR 25354 (May 27, 2009)] (the "Proposing Release"). In addition to these actions, we have brought several others more recently alleging similar types of misconduct. *See, e.g., In re Stratum Wealth Management, LLC and Charles B. Ganz,* Advisers Act Release No. 2930 (Sept. 29, 2009) (settled action in which Commission alleged a registered investment adviser, through its sole owner and chairman, misappropriated over $400,000 from a client account during the course of nearly a year to pay for his personal expenses and falsified client account statements, among other things); *SEC* v. *Titan Wealth Management, LLC, et al.,* Litigation Release No. 21184 (Aug. 26, 2009) (complaint alleges a registered investment adviser misappropriated 80% of investor funds for personal use, to make Ponzi payments to certain investors or transfers to others); *In the Matter of Paul W. Oliver, Jr.,* Advisers Act Release No. 2903 (Jul. 17, 2009) (settled action in which Commission alleged a registered investment adviser's chairman aided and abetted misappropriations of more than $23 million in client funds by the investment adviser's co-founder and president); *SEC* v. *Weitzman,* Litigation Release No. 21078 (June 10, 2009) (settled action in which Commission's complaint alleged registered investment adviser's co-founder and principal stole more than $6 million in investor funds for his own personal use and falsified client account statements). *See also SEC* v. *Frederick J. Barton, Barton Asset Management, LLC, and TwinSpan Capital Management,* LLC, Litigation Release No. 21016 (Apr. 29, 2009) (default judgment entered against registered investment adviser and its direct and indirect majority owner for diverting approximately $493,100 of offering proceeds for personal use and for misappropriating $685,000 from one advisory client and $970,000 from another); *SEC* v. *Crossroads Financial Planning, Inc., et al.,* Litigation Release No. 20996 (Apr. 10, 2009) (complaint alleges registered investment adviser, through its president, chief operating officer and principal owner, misappropriated at least $2.3 million of client assets).

[2] We use the term "client assets" solely for ease of reference in this Release; it does not modify the scope of client funds or securities subject to the rule.

[3] Rule 206(4)–2(a)(1).

[4] Rule 206(4)–2(c)(3).

[5] *See* Proposing Release, at note 4.

[6] Rule 206(4)–2(a)(3)(i).

[7] Rule 206(4)–2(a)(3)(ii).

[8] Proposed rule 206(4)–2(a)(4).

clients.[9] When the adviser or its related person serves as qualified custodian for client assets, the proposed amendments would require that the adviser undergo an annual surprise examination and obtain, or receive from the related person, an internal control report with respect to custody controls, both of which must be performed or prepared by an independent public accountant that is registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB").[10] Amendments to Form ADV would require advisers to report current information to us about these custodial arrangements.

We received more than 1,300 comment letters on the proposed amendments. Most were from investment advisers, broker-dealers, banks, and their trade associations that would be affected by the amended rule and which objected to significant parts of our rulemaking initiative.[11] Commenters generally expressed their support for our goal of strengthening protections provided to advisory clients under the custody rule. Most urged us to make changes to our proposal particularly as it applies to advisers that have custody solely because of their authority to deduct advisory fees from client accounts. Many suggested that we update our guidance on the elements of the annual surprise examination performed by an independent public accountant.[12]

II. Discussion

We are today adopting amendments to rule 206(4)–2 to strengthen controls over the custody of client assets by registered investment advisers and to encourage the use of independent custodians. We are also adopting related amendments to rule 204–2, Form ADV, and Form ADV–E that will improve our ability to oversee advisers' custody practices. In response to comments, we made several modifications from the proposal. In addition, we are today publishing a companion release to provide guidance for accountants with respect to the surprise examination and internal control report required under rule 206(4)–2.

We believe these amendments, together with the guidance for accountants, will provide for a more robust set of controls over client assets designed to prevent those assets from being lost, misused, misappropriated or subject to advisers' financial reverses. We acknowledge that no set of regulatory requirements we could adopt will prevent all fraudulent activities by advisers or custodians. We believe, however, that this rule, together with our examination program's increased focus on the safekeeping of client assets, will help deter fraudulent conduct, and increase the likelihood that fraudulent conduct will be detected earlier so that client losses will be minimized.

A. Delivery of Account Statements and Notice to Client

As discussed above, rule 206(4)–2 currently requires advisers that have custody, with certain limited exceptions, to maintain client funds or securities with a "qualified custodian," which the adviser must have a reasonable basis for believing sends an account statement, at least quarterly, to each client for which the qualified custodian maintains funds or securities.[13] The requirement is designed so that advisory clients will receive a statement from the qualified custodian that they can compare with any statements (or other information) they receive from their adviser to determine whether account transactions, including deductions to pay advisory fees, are proper.[14]

We are adopting, as proposed, an amendment to the rule that eliminates an alternative to the requirement under which an adviser can send quarterly account statements to clients if it undergoes a surprise examination by an independent public accountant at least annually. We believe that direct delivery of account statements by qualified custodians will provide greater assurance of the integrity of account statements received by clients.

Most commenters that addressed this aspect of our proposal supported it as reflective of best practices followed by most advisers.[15] A few commenters objected to the proposal, suggesting that a client's desire for privacy may override the Commission's goal of investor protection.[16] In light of recent frauds, we believe generally that the protections provided by direct delivery of account statements by custodians are of substantially greater value than the privacy and confidentiality concerns that led us to permit this alternative.[17] Privacy concerns can be addressed through custodial contracts, or other agreements that restrict the custodian's use of confidential information, as one commenter suggested.[18]

As proposed, the amended rule requires that an adviser's reasonable belief that the qualified custodian sends account statements directly to clients

[9] Proposed rule 206(4)–2(a)(3). The proposed amendments, however, would not eliminate an exception to the direct delivery requirement currently available to advisers to pooled investment vehicles that are subject to an annual audit and distribute the audited financial statements to investors in the pool. *See* proposed rule 206(4)–2(b)(3).

[10] Proposed rule 206(4)–2(a)(6)(ii)(B).

[11] Other commenters included accountants, law firms, consultants, and investors. Of the 1,300 letters, approximately 1,100 were form letters or substantially similar letters submitted by smaller advisory firms.

[12] The comment letters are available for public inspection and photocopying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC (File No. S7–09–09). They are also available on our Web site at *http://www.sec.gov/comments/s7-09-09/s70909.shtml.*

[13] Rule 206(4)–2(a)(1). If the adviser is a general partner of a limited partnership or holds a similar position with another type of pooled investment vehicle, the account statement must be provided to the limited partners or other investors in the pooled investment vehicle. Rule 206(4)–2(a)(3)(iii). For convenience, we will presume in this Release that all advisers to pooled investment vehicles hold such a position.

[14] Rule 206(4)–2(a)(3)(i). The rule provides an exception to this requirement for an adviser to a pooled investment vehicle if the pooled investment vehicle is audited annually by an independent public accountant and distributes the audited financial statements to the investors in the pool. *See* rule 206(4)–2(b)(3).

[15] Comment letter of Compliance Solution Group (July 24, 2009) ("CAS Letter"); comment letter of CFA Institute Centre for Financial Market Integrity (Dec. 11, 2009) ("CFA Institute Letter"); comment letter from The Cornell Securities Law Clinic (July 28, 2009) ("Cornell Letter"); comment letter from E*Trade Financial Corp. (July 28, 2009) ("E*Trade Letter"); comment letter from Investment Adviser Association (July 24, 2009) ("IAA Letter"); comment letter from North American Securities Administrators Association, Inc. (Aug. 5, 2009) ("NASAA Letter"); comment letter from National Regulatory Services (July 28, 2009) ("NRS Letter"); comment letter from Timothy P. Turner (July 27, 2009) ("Turner Letter").

[16] Comment letter from American Bar Association (Committee on Federal Regulation of Securities) (July 28, 2009) ("ABA Letter"); NRS Letter; comment letter from The Private Equity Council (July 28, 2009) ("PEC Letter").

[17] *See Custody of Funds or Securities of Clients by Investment Advisers,* Investment Advisers Act Release No. 2176 (Sept. 25, 2003) [68 FR 56692 (Oct. 1, 2003)] ("2003 Adopting Release"), at Section II.C. Qualified custodians may use service providers to deliver their account statements. The rule does not prohibit this practice, so long as the statements are sent to the client directly and not through the adviser. *See* 2003 Adopting Release at n.30.

[18] *See* IAA Letter. In support of its assertion that a client's desire for privacy could override the Commission's goal of investor protection, the ABA argued that contractual or other alternative means of protecting confidentiality would be insufficient and potentially very costly, although they did not provide support for these assertions. We note, in addition to contractual protections, other privacy protections are relevant in this context. As discussed in the Proposing Release at n.60, a U.S. qualified custodian would, with respect to individual clients who obtain custodial services for their personal, family or household purposes, be subject to the limitations on information sharing in the privacy rules adopted pursuant to Title V of the Gramm-Leach-Bliley Act. *See, e.g.,* 12 CFR Parts 40, 216, 332, 573 (privacy rules adopted by the Office of the Comptroller of the Currency, the Federal Reserve Board, the Office of Thrift Supervision, and the National Credit Union Administration); 17 CFR Parts 160, 248 (privacy rules adopted by the Commodity Futures Trading Commission and the SEC).

must be formed by the adviser after "due inquiry."[19] We are not prescribing a single method for forming this belief, as was suggested by one commenter,[20] but rather are providing advisers with flexibility to determine how best to meet this requirement. For instance, an adviser could form a reasonable belief after "due inquiry" if the qualified custodian provides the adviser with a copy of the account statement that was delivered to the client.[21]

Rule 206(4)–2 requires investment advisers to notify their clients promptly upon opening a custodial account on their behalf and when there are changes to the information required in that notification.[22] We are amending the rule, as proposed, to require advisers to include a legend in the notice urging clients to compare the account statements they receive from the custodian with those they receive from the adviser.[23] Several commenters asserted that advisers may not (and are not required by rule 206(4)–2 to) send statements separate from the ones the custodian delivers and thus the proposed disclosure could confuse clients.[24] We agree and have, therefore, modified this notice requirement so that the cautionary legend must be included only if the adviser elects to send its own account statements to clients.[25] Finally, we had requested comment on whether to require advisers who choose to send statements to also include in those statements the cautionary legend urging clients to compare the information the adviser sends to clients with the information reflected in the qualified custodian's account statements.[26] We believe providing regular notice will serve to more effectively remind clients to take steps to protect their assets. Accordingly, we are amending the rule to require those investment advisers, in any subsequent statements they deliver to clients after the initial notice, to urge clients to compare the adviser's statements with the account statements they receive from the custodian.[27]

B. Annual Surprise Examination of Client Assets

The Commission is adopting the proposed amendment to rule 206(4)–2 to require registered advisers with custody of client assets to undergo a surprise examination (or an audit, if applicable) of those assets by an independent public accountant, except as discussed below.[28] We are also adopting several amendments to the custody rule and related forms that will strengthen the utility of the surprise examination as a means of deterring misuse of client assets and will improve our ability to identify potential misuse of those assets. We are revising the guidance we provide to accountants that are engaged to perform these examinations in order to modernize the surprise examination and make it more effective. We believe these changes, discussed below, will improve protection of client assets.

1. Applicability of Surprise Examination

We proposed to require that all advisers with custody obtain a surprise examination of client assets by an independent public accountant in order to provide "another set of eyes" on client assets, and thus an additional set of protections against their misappropriation. Because advisers with custody often have authority to access, obtain and, potentially, misuse client funds or securities, we believed the additional review provided by an independent public accountant would help identify problems that clients may not, and thus would provide deterrence against fraudulent conduct by advisers.[29]

Many commenters opposed the surprise examination requirement, arguing that it would provide little additional protection to client assets when assets are held with an independent qualified custodian that sends account statements directly to clients.[30] Almost all advisers that commented raised concerns about the high costs of the surprise examination and many asserted that the costs could drive smaller advisers that typically have custody only because of authority to deduct advisory fees out of business,[31] or, with respect to advisers that serve in capacities such as trustee on a limited basis, would cause them to cease providing such services to their clients.[32]

The focus of most commenters, however, was not on the utility of the surprise examination, but whether the proposed requirement should apply to certain advisers and advisory accounts, which we address below.[33] Some urged

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[19] Amended rule 206(4)–2(a)(3).

[20] Comment letter of Fifth Third Asset Management, Inc. (July 28, 2009) ("FTAM Letter").

[21] This practice is followed by many advisers today. Commenters suggested that we permit advisers to satisfy the requirement of forming a reasonable belief after "due inquiry" by accessing qualified custodian account statements through the custodian's Web site. *See* comment letter from Curian Capital LLC, Financial Wealth Management, Inc, LPL Financial Corporation, and SEI Investments Company (July 28, 2009) ("Curian Letter"). We believe that accessing account statements through the Web site merely confirms that they are available. If an adviser does not take additional steps to determine whether account statements were sent to clients, or that clients obtained statements through the Web site, the adviser would have an inadequate basis for forming a reasonable belief, after due inquiry, that the qualified custodian sends account statements to clients.

[22] Rule 206(4)–2(a)(2).

[23] Proposed rule 206(4)–2(a)(2). One commenter suggested not only requiring the legend in the initial notice, as proposed, but also adding a requirement to include the legend as an annual reminder in the annual Form ADV delivery offer or in the annual privacy statement. *See* comment letter of The National Association of Personal Financial Advisors (July 21, 2009) ("NAPFA Letter"). We would not discourage advisers from adopting such a practice. As described above, we are adopting a regular notice requirement today for advisers.

[24] CAS Letter; comment letter from Dechert LLP (July 28, 2009) ("Dechert Letter"); IAA Letter; comment letter from MarketCounsel, LLC (July 28,2009) ("MarketCounsel Letter"); NRS Letter.

[25] Amended rule 206(4)–2(a)(2).

[26] *See* Proposing Release, at Section II.C. We did not receive comment on this particular approach.

[27] Amended rule 206(4)–2(a)(2).

[28] Amended rule 206(4)–2(a)(4).

[29] Some commenters agreed and expressed support of this proposal. *See* comment letter of Ascendant Compliance Management (July 27, 2009) (expressing support with respect to advisers that are registered as broker-dealers ("dual registrants")); CFA Institute Letter; comment letter of CLS Investments, LLC (July 28, 2009) ("CLS Letter") (expressing support with respect to dual registrants); comment letter of The Consortium (July 18, 2009) ("Consortium Letter") (supporting the requirement other than for advisers who have custody solely because of their authority to deduct advisory fees from client accounts); comment letter of First Manhattan Co. (July 28, 2009) ("FMC Letter") (expressing support with respect to dual registrants); NASAA Letter.

[30] *See, e.g.,* ABA Letter; comment letter of Advisor Solution Group (July 28, 2009) ("ASG Letter"); comment letter of Davis Polk & Wardwell LLP (July 28, 2009) ("Davis Polk Letter"); comment letter of Grandfield & Dodd, LLC (July 28, 2009) ("G&D Letter"); Form Letter F; comment letter of Financial Planning Association (July 28, 2009) ("FPA Letter"); IAA Letter; comment letter of Jackson, Grant Investment Advisers, Inc. (July 28, 2009) ("Jackson Letter"); MarketCounsel Letter; NRS Letter; comment letter of Pickard and Djinis LLP (July 28, 2009) ("Pickard Letter"); comment letter of SIFMA Asset Management Group (July 28, 2009) ("SIFMA(AMG) Letter").

[31] *See, e.g.,* comment letter of TD Ameritrade, Inc. (July 24, 2009) ("Ameritrade Letter"); CAS Letter; Cornell Letter; comment letter of Ronald P. Denk (July 3, 2009) ("Denk Letter"); comment letter of Janet Elder (July 1, 2009); Form Letter D; comment letter of Financial Services Institute (July 28, 2009) ("FSI Letter"); G&D Letter; comment letter of Thomas Hamilton (July 23, 2009); IAA letter; comment letter of The International Association of Small Broker Dealers and Advisors (May 27, 2009) ("IASBDA Letter"); comment letter of Carol K. Lampe (July 1, 2009); comment letter of Walter Marbert (July 1, 2009); comment letter of Scott A. McCord (July 1, 2009); NAPFA Letter; comment letter of Don Slabaugh (July 1, 2009); comment letter of Jeff Toadvine (July 1, 2009); comment letter of Anthony W. Welch (July 1, 2009).

[32] *See infra* note 38.

[33] Most commenters urged us to except advisers that have custody solely because of deducting advisory fees from the surprise examination requirement. *See, e.g.,* ASG Letter; comment letter of Certified Financial Planner Board of Standards, Inc. (July 28, 2009) ("CFP Board Letter"); comment letter of Center for Capital Markets Competitiveness, Chamber of Commerce (July 28, 2009) ("Chamber of Commerce Letter"); Curian Letter; Dechert Letter; E*Trade Letter; comment

that if we expand the surprise examination requirement, we should update our guidance to accountants on examination methodology, which dates back to 1966 and requires verification of all client assets, a potentially expensive procedure not required in most audits.[34]

We believe the surprise examination requirement will deter fraudulent conduct by investment advisers, and that it provides important protections to advisory clients, even when their assets are maintained by an independent qualified custodian.[35] If fraud does occur, a surprise examination will increase the likelihood that it is uncovered and thus reduce client losses.[36] Therefore, we are requiring advisers with custody of client assets to obtain a surprise examination (or an audit, if applicable in the case of a pooled investment vehicle) of client assets by an independent public accountant, other than as discussed below.[37]

We acknowledge the concerns raised by commenters with respect to the impact of the surprise examination requirement on smaller advisers whose client assets are maintained by an independent qualified custodian. For this reason, we have directed our staff to evaluate the impact of the surprise examination requirement on smaller advisers that have the authority to obtain possession of client funds or securities and whose client assets are maintained by an independent qualified custodian. We have also asked the staff to evaluate the impact of the surprise exam on these advisers' clients. Following the completion of the first round of surprise examinations of these advisers under the requirements of the amended rule, our staff will conduct a review and provide the Commission with the results of this review, along with any recommendations for amendments necessary to improve the effectiveness of the rule as it applies to these advisers, or address unnecessary burdens on them.

a. Advisers With Limited Custody Due to Fee Deduction

Commenters have persuaded us that the surprise examination will not provide materially greater protection to advisory clients when the adviser has custody of client assets *solely* because of its authority to deduct advisory fees from client accounts.[38] The principal risk associated with this limited form of custody is that a fee will be deducted to which the adviser is not entitled under the advisory contract. The amended rule addresses this risk by enabling the client to monitor the amount of advisory fees deducted by reviewing the account statement which, as discussed above, must be sent directly to the client by the qualified custodian.[39] Further, as several commenters noted the surprise examination may not be an effective tool to identify inappropriate fee deductions as it requires the accountant to verify client assets, not determine the accuracy of fees paid.[40] On balance, we believe that the magnitude of the risks of client losses from overcharging advisory fees does not warrant the costs of a obtaining a surprise examination. However, we do believe that appropriate controls should be in place regarding fee deduction, as discussed below.[41]

b. Pooled Investment Vehicle Audit

We proposed to require all registered investment advisers with custody of client assets to obtain an annual surprise examination, which included pooled investment vehicles subject to an annual financial statement audit. Several commenters asserted that a surprise examination would be duplicative of the annual financial statement audit and would not materially benefit investors.[42]

During the course of a financial statement audit, the accountant performs procedures comparable to those performed as part of a surprise examination, including verifying the existence of the pooled investment vehicle's funds and securities and obtaining confirmation from investors.[43] The financial statement audit also addresses additional matters important to pool investors that are not covered by the surprise examination, such as tests of valuations of pool investments, income, operating expenses, and, if

letter of GE Asset Management (July 24, 2009) ("GE Asset Letter"); G&D Letter; Form Letters B, F, and G; FPA Letter; IAA Letter; Jackson Letter; comment letter of The Money Management Institute (July 28, 2009) ("MMI Letter"); NRS Letter; SIFMA(AMG) Letter; comment letter of SIFMA Private Client Legal Committee (July 28, 2009) ("SIFMA(PCLC) Letter"); comment letter of Warshaw Burstein Cohen Schlesinger & Kuh, LLP (July 24, 2009) ("Warshaw Letter").

[34] Comment letter of The American Institute of Certified Public Accountants (July 28, 2009) ("AICPA Letter); comment letter of Center for Audit Quality (July 28, 2009) ("CAQ Letter"); Chamber of Commerce Letter; comment letter of Cohen Fund Audit Services, Ltd. (July 21, 2009) ("Cohen Letter"); Curian Letter; comment letter of Deloitte & Touche LLP (July 28, 2009) ("Deloitte Letter"); comment letter of Ernst & Young (July 28, 2009) ("E&Y Letter"); FPA Letter; FTAM Letter; comment letter of KPMG LLP (July 28, 2009) ("KPMG Letter"); comment letter of Managed Fund Association (July 28, 2009) ("MFA Letter"); MMI Letter; comment letter of McGladrey & Pullen LLP (July 28, 2009) ("M&P Letter"); comment letter of PricewaterhouseCoopers LLP (July 28, 2009) ("PWC Letter"); comment letter of Charles Schwab (July 28, 2009) ("Schwab Letter"); SIFMA(AMG) Letter; SIFMA(PCLC) Letter.

[35] We have recently brought enforcement cases in which we alleged advisers misappropriated client assets that were maintained by an independent qualified custodian. *See In re Stratum Wealth Management, LLC and Charles B. Ganz,* Advisers Act Release No. 2930 (Sept. 29, 2009); *In the Matter of Paul W. Oliver, Jr.,* Advisers Act Release No. 2903 (Jul. 17, 2009); *SEC* v. *Weitzman,* Litigation Release No. 21078 (June 10, 2009); *SEC* v. *Crossroads Financial Planning, Inc., et al.,* Litigation Release No. 20996 (Apr. 10, 2009).

[36] Under the amended rule, the independent public accountant conducting a surprise examination will verify client funds and securities of which an adviser has custody, including those maintained with a qualified custodian and those that are not required to be maintained with a qualified custodian, such as certain privately offered securities and mutual fund shares.

[37] Amended rule 206(4)–2(a)(4). An investment adviser required to obtain a surprise examination must enter into a written agreement with an independent public accountant that provides that the first examination will take place by December 31, 2010 or, for advisers that become subject to the rule after the effective date, within six months of becoming subject to the requirement. If the adviser itself maintains client assets as qualified custodian, however, the agreement must provide for the first surprise examination to occur no later than six months after obtaining the internal control report. *See infra* Section III.B.1.

[38] Amended rule 206(4)–2(b)(3). This exception would also be available to such an adviser when the adviser can rely on amended rule 206(4)–2(b)(6). *See infra* Section II.C.2. of this Release. The exception would not be available, however, to an adviser that has custody under the rule for other reasons. Several commenters opposed applying the surprise examination requirement to advisers that serve as trustees for their clients. *See* comment letter of Allegheny Investments (July 28, 2009); Consortium Letter; G&D Letter; IAA Letter; NRS Letter; comment letter of Bruce Siegel (July 28, 2009). Some explained that most advisers that serve as trustees do so as a convenience to existing clients and either do not charge a separate fee or charge only a minimal fee for this service, and that requiring surprise examinations for these advisers will discourage advisers from serving as trustees and result in clients paying higher fees for this service. An adviser acting as trustee typically has significant authority over the assets in the trust, which would likely include the ability to access and, potentially, misuse those assets. We believe that the broad access that trustees typically have to trust assets makes the protections of the surprise examination important for these advisory clients to protect against potential abuse.

[39] Many commenters expressed similar views in their letters. *See* ASG Letter; CFP Board Letter; Dechert Letter; E*Trade Letter; FMC Letter; GE Asset Letter; G&D Letter; Form Letters B, F, and G; IAA Letter; Jackson Letter; MMI Letter; NRS Letter; SIFMA(AMG) Letter; SIFMA(PCLC) Letter; Warshaw Letter.

[40] ABA Letter; Dechert Letter; FMC Letter; IAA Letter; MMI Letter; Pickard Letter; comment letter of Seward & Kissel LLP (July 29, 2009) ("S&K Letter").

[41] *See infra* notes 140 and 141 and accompanying text.

[42] *See* comment letter of Adams Street Partners, LLC (July 28, 2009) ("Adams Street Letter"); Davis Polk Letter; Deloitte Letter; IAA Letter; MFA Letter; comment letter of The Bank of New York Mellon (July 28, 2009) ("Mellon Letter"); comment letter of National Society of Compliance Professionals, Inc. (July 28, 2009) ("NSCP Letter"); comment letter of National Venture Capital Association (July 28, 2009) ("NVCA Letter"); PEC Letter; SIFMA(AMG) Letter; S&K Letter; Warshaw Letter.

[43] *See* AICPA, *Audit and Accounting Guide,* Investment Companies, (May 1, 2009).

applicable, incentive fees and allocations that accrue to the adviser.[44]

We believe that these and other procedures performed by the accountant during the course of a financial statement audit provide meaningful protections to investors, and that the surprise examination would not significantly add to these protections. Although the annual audit is not required to be performed at a time of the accountant's choosing (as is a surprise examination), we believe other elements of the audit incorporate an element of uncertainty similar to the surprise element of the surprise examination, with corresponding benefits to investors. Specifically, in the course of an annual audit, the auditor will select transactions to test during the period that the adviser will not be able to anticipate.

We have therefore amended the rule to deem an adviser to a pooled investment vehicle that is subject to an annual financial statement audit by an independent public accountant, and that distributes the audited financial statements prepared in accordance with generally accepted accounting principles to the pool's investors,[45] to have satisfied the annual surprise examination requirement ("annual audit provision").[46]

In addition, at the suggestion of several commenters,[47] we are limiting the rule's recognition of such audits as satisfying the surprise verification requirement to those audits performed by an independent public accountant registered with, and subject to regular inspection by, the PCAOB.[48] We have greater confidence in the quality of such audits.[49]

We note that under rule 206(4)–2, an adviser to a pooled investment vehicle that distributes to its investors audited financial statements is not required to have a reasonable belief that a qualified custodian delivers account statements to investors.[50] As a consequence, investors in pooled investment vehicles do not have the benefit of regularly receiving reports that the assets underlying their investments are properly held. We are therefore concerned that the current protections of the rule may be insufficient, and we have directed our staff to explore ways in which we could remedy this potential shortcoming while respecting the confidential nature of proprietary information.

2. Commission Reporting

We are also adopting a number of rule and form amendments that will result in the Commission and the public receiving greater information about the custody practices of advisers and thus a greater ability to identify potential risks to clients. Under amended rule 206(4)–2, each investment adviser subject to the surprise examination requirement must enter into a written agreement with an independent public accountant to conduct the surprise examination. The agreement must require the accountant, among other things, to notify the Commission within one business day of finding any material discrepancy during the course of the examination, and to submit Form ADV–E to the Commission accompanied by the accountant's certificate within 120 days of the time chosen by the accountant for the surprise examination, stating that the accountant has examined the funds and securities and describing the nature and extent of the examination.[51] The agreement also must provide that, upon resignation or dismissal, the accountant must file within four business days a statement regarding the termination along with Form ADV–E.[52] Accountants will file Form ADV–E with us electronically, through the Investment Adviser Registration Depository ("IARD").[53] We are adopting these amendments as proposed. The information they provide will assist the Commission's examination staff and the public in identifying risks raised by the investment adviser's custodial practices and in determining the frequency and scope of our staff's examination of an investment adviser.

The new requirement that accountants file Form ADV–E within 120 days of the time chosen by the accountant for the surprise examination is designed to require more timely completion of these examinations. Several commenters suggested that we extend the filing deadline to 180 days, asserting that more complex surprise examinations may take more time.[54] We note that these commenters' estimate of the duration of a surprise examination was based on the nature and extent of procedures contemplated under the existing guidance for accountants,[55] which many asserted was unnecessarily time consuming. As discussed more fully below, our revised guidance for accountants should address many of these concerns.[56] As a result, we believe that 120 days will be sufficient for an accountant to complete the examination.

Several commenters suggested we modify the requirement regarding the accountant's filing of a statement upon termination. Some argued that these filings should not be made available to

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[44] *Id.*

[45] Amended rule 206(4)2(b)(4)(i) requires that the audited financial statements be distributed within 120 days of the end of the pooled investment vehicle's fiscal year. In 2006, our staff issued a letter indicating that it would not recommend enforcement action to the Commission under section 206(4) of the Act or rule 206(4)–2 against an adviser of a fund of funds relying on the annual audit provision of rule 206(4)–2 if the audited financial statements of the fund of funds are distributed to investors in the fund of funds within 180 days of the end of its fiscal year. *See ABA Committee on Private Investment Entities,* SEC Staff Letter (Aug. 10, 2006). The amendments we are adopting today do not affect the views of the staff expressed in that letter.

[46] Amended rule 206(4)–2(b)(4). We note that an adviser that relies on the annual audit provision must nonetheless undergo an annual surprise examination of non-pooled investment vehicle assets of which it has custody.

[47] ABA Letter; Adams Street Letter; comment letter of Coalition of Private Investment Companies (July 31, 2009) ("CPIC Letter"); MFA Letter.

[48] Amended rule 206(4)–2(b)(4). The independent public accountant must be registered with, and subject to regular inspection by, the PCAOB as of the commencement of the professional engagement period, and as of each calendar year-end. Several commenters suggested other approaches, including enhancing the audit performed on the pool to include verification of securities (SIFMA(AMG) Letter), requiring an internal control report only instead of both the report and a surprise examination (ABA Letter; PEC Letter), and requiring several specific custody controls for advisers to pooled investment vehicles (CPIC Letter). We have considered the alternative approaches, some of which are beyond the scope of the proposal, and we believe, for the reasons discussed above, that our amendment to this aspect of the rule strikes the right balance.

[49] *See infra* note 122 and accompanying text.

[50] Rule 206(4)–2(b)(4).

[51] Amended rule 206(4)–2(a)(4)(i) and (ii). The written agreement will also require, in accordance with the current requirements of rule 206(4)–2, the independent public accountant to perform the surprise examination. Advisers must maintain copies of these written agreements under rule 204–2(a)(10). The obligation to maintain the records will apply for five years from the end of the fiscal year during which the last entry was made, the first two years in an appropriate office of the investment adviser. Rule 204–2(e)(1).

[52] Amended rule 206(4)–2(a)(4)(iii). The written agreement must require that the statement include (i) the date of such termination or removal, and the name, address, and contact information of the accountant, and (ii) an explanation of any problems relating to examination scope or procedure that contributed to such termination. *Id.* One commenter specifically expressed support for these time frames. CFA Institute Letter.

[53] Until the IARD system is upgraded to accept Form ADV–E, accountants performing surprise examinations should continue paper filing of Form ADV–E. Advisers will be notified as soon as the IARD system can accept Form ADV–E.

[54] IAA Letter; M&P Letter; PWC Letter. *See also* Dechert Letter; KPMG Letter; SIFMA(AMG) Letter (advocating for an extension, but not specifying that it be 180 days). One commenter suggested that we shorten it to 45–60 days. CFA Institute Letter.

[55] *Statement of the Commission describing nature of examination required to be made of all funds and securities held by an investment adviser and the content of related accountant's certificate,* Accounting Series Release No. 103, Investment Advisers Act Release No. 201 (May 26, 1966) ("ASR No. 103").

[56] *See* Section II.B.4. of this Release.

the public,[57] that they should not be required if the accountant was terminated for innocuous reasons,[58] and that the adviser should have primary responsibility to report accountant dismissals, so that the accountant would submit a report only if the adviser failed to do so.[59] We have not revised the requirement in response to these comments. We believe it is important that the public have access to the termination statements to permit clients and prospective clients to assess for themselves the reasons for the termination of an accountant's engagement or an accountant's removal from consideration for being reappointed. Disclosure of a termination, even for apparently innocuous reasons, could provide useful information to advisory clients and to our staff. For example, identifying frequent changes in accountants could put clients and prospective clients on notice to inquire about the reasons for these events. Finally, while advisers are responsible for reporting accountant dismissals on Form ADV, the accountant's statement serves as an independent check on the adviser's filing and, as such, is important to increasing the effectiveness of the surprise examination requirement.

3. Privately Offered Securities

We are adopting, as proposed, amendments to rule 206(4)–2 to no longer permit the accountant conducting the annual verification of client assets to forego examining certain privately offered securities, as defined in the rule.[60] As a result, advisers that maintain custody of privately offered securities on behalf of clients will be subject to the surprise examination requirement.[61]

Several commenters supported expanding the rule in this respect.[62] Others, however, asserted that the risk of fraud or misappropriation is low with respect to privately offered securities because they are not easily transferable, while the costs and practical difficulties of including these securities in a surprise exam may be considerable.[63] While privately offered securities may present little risk with respect to transferability, they present significant risks in other regards. First, it is difficult for advisory clients to verify that these assets actually exist because ownership of such securities is recorded only on the issuers' books. Second, clients may have to rely on the information provided by the adviser to confirm their ownership of privately offered securities, as well as the existence of the underlying investment, when the adviser maintains custody of these securities.[64] Because clients are more dependent on the adviser with respect to the safeguarding of these securities, advisory clients may be exposed to additional risks when their advisers acquire these securities on their behalf. To mitigate these risks and to provide assurance that privately offered securities are properly safeguarded, we believe that it is appropriate to require an independent third-party to verify client ownership with the issuers of the securities by requiring that these securities be subject to the surprise examination requirement under the amended rule.[65]

It is our understanding that many accountants today do verify private securities in the course of a surprise examination, and several commenters requested that we provide guidance as to the procedures that an accountant should undertake with respect to the surprise examination of privately offered securities.[66] In our companion release, we provide guidance for accountants regarding conducting a surprise examination of client assets, including privately offered securities.[67]

4. Guidance for Accountants

In the Proposing Release, we requested that commenters address whether, and if so how, we should revise the guidance for accountants that we issued regarding the surprise examination.[68] Commenters that responded all generally agreed that our existing guidance, which we published in 1966, is inadequate because it neither reflects today's custodial practices nor adequately recognizes certain commonly accepted auditing practices.[69] In a companion release, we are providing updated guidance for accountants that addresses the surprise examination, as well as the internal control report required under amended rule 206(4)–2 and the relationship between them.[70] Our guidance discusses the relevant auditing and attestation standards that apply to these engagements, and, among other things, the nature and extent of the accountant's procedures with respect to the surprise examination. The revised guidance for accountants will

[57] E*Trade Letter (arguing more broadly that no Form ADV–E filings should be made public, regardless of the reason for filing); IAA Letter; S&K Letter; Turner Letter.

[58] Davis Polk Letter; E*Trade Letter; IAA Letter.

[59] KPMG Letter.

[60] The amended rule retains the current definition of "privately offered securities" as securities that are (i) acquired from the issuer in a transaction or chain of transactions not involving any public offering, (ii) uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client, and (iii) transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer. *See* amended rule 206(4)–2(b)(2).

[61] We received various suggestions from commenters, some conflicting, regarding our approach to privately offered securities. *See* ABA Letter (suggesting that the Commission only subject privately offered securities held by the adviser or by related persons to surprise examinations, arguing that such a limitation would reduce costs and target the assets at greatest risk of misappropriation); MFA Letter (proposing that the Commission affirmatively state that some assets, such as bank loans and swaps, are not securities for purposes of rule 206(4)–2 and are, therefore, not subject to the rule). Others advocated expanding the annual verification requirement. *See* CPIC Letter (suggesting that the custody rule cover all assets held by private funds, not just securities and funds and proposing that all non-traditional assets should be held in the name of the custodian and all cash flows should be required to go through the custodian). We have considered the comments and, for the reasons discussed above, we believe our amendment to this aspect of the rule strikes the right balance with respect to privately offered securities.

[62] ABA Letter; CFA Institute Letter; CPIC Letter; comment letter of The New York State Society of Certified Public Accountants (July 27, 2009).

[63] Davis Polk Letter; MFA Letter; NVCA Letter; PWC Letter.

[64] Rule 206(4)–2 does not require advisers, with one limited exception, to maintain these assets with a qualified custodian because of the difficulties raised by recording ownership of the securities only on the books of the issuer. Rule 206(4)–2(b)(2). *See also* 2003 Adopting Release, at Section II.B.

[65] Under amended rule 206(4)–2 an adviser may maintain custody of privately offered securities without being subject to the requirements that apply to advisers that maintain custody of client assets as qualified custodians set forth in paragraph (a)(6) of the rule, such as the internal control report, because the adviser need not be a qualified custodian to maintain custody of those securities. Amended rule 206(4)–2(b)(2). If, however, the adviser holding the privately offered securities also has custody of other client funds or securities as qualified custodian, the adviser is subject to the requirements set forth in paragraph (a)(6) of the rule.

[66] MFA Letter; comment letter of The Association of Global Custodians (Aug. 03, 2009) ("AGC Letter"); MarketCounsel Letter; comment letter of Sullivan & Cromwell (July 28, 2009).

[67] *See infra* note 70 and accompanying text. In the Proposing Release we requested comment on whether we should require the accountant performing the surprise examination to perform testing on the valuation of securities, including privately offered securities. One commenter stated that, although valuation is a very important issue closely related to client assets, it covers an area that goes beyond custody. Dechert Letter. We agree and are therefore not requiring accountants to perform testing of valuation as part of the surprise examination.

[68] Proposing Release, at Section II.

[69] AICPA Letter; CAQ Letter; Chamber of Commerce Letter; Cohen Letter; Curian Letter; Deloitte Letter; E&Y Letter; FTAM Letter; KPMG Letter; MFA Letter; MMI Letter; M&P Letter; PWC Letter; Schwab Letter; SIFMA(AMG) Letter; SIFMA(PCLC) Letter.

[70] *See Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)–2 Under the Investment Advisers Act of 1940,* Investment Advisers Act Release No. 2969 (Dec. 30, 2009) ("Accounting Release").

modernize the procedures for the surprise examination.

C. Custody by Adviser and Related Person

As amended, rule 206(4)–2 imposes additional requirements when advisory client assets are maintained by the adviser itself or by a related person rather than with an independent qualified custodian. As proposed, the amended rule requires, in addition to the surprise examination discussed above,[71] that when an adviser or its related person serves as a qualified custodian for advisory client funds or securities under the rule, the adviser obtain, or receive from its related person, no less frequently than once each calendar year, a written report, which includes an opinion from an independent public accountant with respect to the adviser's or related person's controls relating to custody of client assets ("internal control report"), such as a Type II SAS 70 report.[72] The amended rule also requires, in these circumstances, that the accountant issuing the internal control report, as well as the accountant performing the surprise examination, be registered with, and subject to regular inspection by, the PCAOB.[73] The adviser must maintain the internal control report in its records and make it available to the Commission staff upon request.[74]

[71] *See supra* notes 28–37 and accompanying text. Several commenters asserted that the surprise examination would be duplicative of existing regulatory requirements (*see, e.g.,* comment letter of American Bankers Association (July 28, 2009)("American Bankers Letter"); comment letter of LPL Financial (July 28, 2009) ("LPL Letter"); Mellon Letter; Schwab Letter; and SIFMA(PCLC) Letter). As we discuss later, the surprise examination requirement is important and not duplicative because it works in concert with the internal control report to protect advisory clients and because there are no existing regulatory requirements specifically focused on risks that may arise in the self or affiliated custody context. *See infra* notes 85–87 and accompanying text. Other commenters agreed that the surprise examination and internal control report are independently valuable and not duplicative (*see* E&Y Letter and NASAA Letter).

[72] Amended rule 206(4)–2(a)(6)(ii). As discussed in more detail below, other types of reports could also satisfy the internal control report requirement. *See infra* notes 98–100 and accompanying text.

[73] Amended rule 206(4)–2(a)(6)(i) and (ii)(C). The Commission's standards for the independence of accountants is set forth in Article 2, Rule 2–01 of Regulation S–X [17 CFR 210.2–01]. *See* 2003 Adopting Release at n.32. Article 2–01 does not preclude the accountant performing the surprise examination from also preparing the internal control report. The determination, however, of whether an accountant is independent under Article 2–01 includes consideration of all the relevant facts and circumstances.

[74] Amended rule 204–2(a)(17)(iii).

1. Internal Control Report

Related person custody arrangements can present higher risks to advisory clients than maintaining assets with an independent custodian. As we pointed out in the Proposing Release, several of the recent enforcement actions in which we have alleged misappropriation of client assets have involved advisers or related persons that maintained client assets.[75] We requested comment on whether we should prohibit advisers from advising clients whose assets are maintained with the adviser or a related person.

Some commenters supported requiring an "independent" qualified custodian,[76] although many commenters opposed the requirement.[77] Several argued that use of an independent custodian would be an impractical requirement for many types of advisory accounts held by smaller investors with broker-dealers, such as wrap fee accounts, in which a client receives bundled advisory and brokerage services from a single firm (or related firms) regulated as both an investment adviser and a broker-dealer.[78] It is common for institutional clients to maintain assets in a custodial account, often with a bank that is unaffiliated with the client's adviser. We are concerned, however, that requiring an independent custodian could make unavailable many advisory accounts popular with smaller investors, which are today maintained by the adviser or its affiliated brokerage firm or bank. Therefore, we are not amending the rule to require use of an independent custodian, although we encourage the use of custodians independent of the adviser to maintain client assets as a best practice whenever feasible.

To address the custodial risks associated with an affiliated custodial relationship, we proposed requiring, in addition to the surprise examination, an adviser to obtain, or receive from its related person, an annual internal control report, which would include an opinion from an independent public accountant with respect to the adviser's or related person's custody controls. We were concerned that the surprise examination alone would not adequately address custodial risks associated with self or related person custody because the independent public accountant seeking to verify client assets would rely, in part, on custodial reports issued by the adviser or the related person.

Several commenters expressed their support for the proposed internal control report requirement.[79] Two stated that our approach appropriately targets the frauds we are concerned about.[80] One large custodian urged us to require all qualified custodians to obtain an internal control report.[81] Another agreed with our assessment that when the adviser or its related person acts as qualified custodian, there is increased risk to clients because the adviser may "misappropriate assets as a result of collusion with [its] affiliated custodians."[82] Other commenters, including those representing banks and broker-dealers, however, objected to the internal control report requirement, arguing that qualified custodians are already subject to extensive regulatory oversight and that the additional requirement would be duplicative of existing legal and regulatory requirements.[83] They argued that we would be imposing an unnecessary additional regulatory burden on affected custodians.

The internal control report requirement we are adopting today will provide important additional safeguards for client assets maintained with the adviser or a related person. As discussed in more detail below, the adviser must obtain or receive an internal control report that demonstrates that it, or its related person, has established appropriate custodial

[75] *See supra* note 1.

[76] *See, e.g.,* NASAA Letter; comment letter of The National Association of Active Investment Managers (July 27, 2009) ("NAAIM Letter"); NVCA Letter; comment letter of Kay Conheady (June 4, 2009); comment letter of Carol Y. Godsave (June 15, 2009); comment letter of Michael A. Pagano (June 26, 2009); comment letter of Robert J. Reed (June 1, 2009); comment letter of Robert N. Veres (June 27, 2009).

[77] *See, e.g.,* ABA Letter; AGC Letter; CLS Letter; Curian Letter; Davis Polk Letter; Dechert Letter; E*Trade Letter; FPA Letter; comment letter of Lincoln Investment (July 28, 2009); LPL Letter; comment letter of National Planning Holdings, Inc. (July 28, 2009) ("NPH Letter"); Pickard Letter; Schwab Letter; SIFMA(PCLC) Letter; comment letter of L.A. Schnase (July 3, 2009) ("Schnase Letter"); comment letter of State Street Corporation (July 28, 2009).

[78] ABA Letter; Curian Letter; Davis Polk Letter; E*Trade Letter; Pickard Letter; Schnase Letter; Schwab Letter; SIFMA(PCLC) Letter.

[79] AICPA Letter; CFP Board Letter; Cornell Letter; comment letter of Diamant Asset Management, Inc. (July 20, 2009); E&Y Letter; FMC Letter; IAA Letter; NASAA Letter; NPH Letter; Pickard Letter; comment letter of T. Rowe Price Associates, Inc. (July 28, 2009) ("T. Rowe Letter").

[80] CFP Board Letter; IAA Letter.

[81] Schwab Letter.

[82] ABA Letter.

[83] LPL Letter; MMI Letter; NSCP Letter; comment letter of Pershing LLC (July 28, 2009) ("Pershing Letter"); SIFMA(PCLC) Letter; American Bankers Letter; comment letter of J.P. Morgan (Aug. 26, 2009).

controls.[84] As we noted in the Proposing Release, the internal control report can significantly strengthen the utility of the surprise examination when the adviser or a related person acts as qualified custodian for client assets because it provides a basis for the independent public accountant performing the surprise examination to obtain additional comfort that the confirmations received from the related custodian are reliable.[85] The requirement to obtain an internal control report therefore serves both to inform the surprise examination process and may itself act as a deterrent to fraud by advisers that may consider misappropriating client assets directly or through a related person.[86]

We have carefully considered commenters' concerns about regulatory duplication in designing the internal control report requirement. We are adopting this requirement because there is no existing regulatory requirement applicable to investment advisers or other entities, such as broker-dealers and banks, that serve as qualified custodians that we believe is specifically focused on internal control risks that may arise in the affiliated custody context. We have, however, developed our guidance for accountants to permit accountants, when preparing an internal control report, to rely on their own relevant audit work performed for other purposes, including audit work performed to meet existing regulatory requirements, which should increase efficiencies in the audit process and help address commenters' concerns about duplication.[87]

We do not believe that the internal control report requirement will be unduly burdensome. A qualified custodian would only have to obtain an internal control report if it maintains the funds or securities of its own advisory clients or those of advisory clients of related persons. As one securities industry commenter noted, custodians often provide Type II SAS 70 reports to clients who demand a rigorous evaluation of internal control as a condition of obtaining their business.[88] A related person custodian therefore may be able to use a Type II SAS 70 report it is already obtaining and providing to other clients to satisfy the rule's requirement, and may also be able to use the same internal control report to satisfy the rule's requirement for several related advisers whose clients use the custodian.

The elements of the required internal control report are set forth in the companion release we are issuing today, which includes guidance for accountants regarding the overall objectives and scope of the internal control examination.[89] The internal control report must include the accountant's opinion as to whether the qualified custodian's internal controls have been placed in operation as of a specific date, and are suitably designed, and are operating effectively to meet control objectives related to custodial services, including the safeguarding of funds and securities of advisory clients during the year.[90] In order for the accountant to be able to form this opinion, the internal control report should address control objectives and associated controls related to the areas of client account setup and maintenance, authorization and processing of client transactions, security maintenance and setup, processing of income and corporate action transactions, reconciliation of funds and security positions to depositories and other unaffiliated custodians, and client reporting.[91]

We have revised the amended rule to state that, for the internal control report to satisfy the rule's requirements, the independent public accountant preparing the report must verify that the client funds and securities are reconciled to a custodian other than the adviser or its related person.[92] Reconciliation of custodial records to depositories is a key control objective of the internal control report, which will report on, among other things, tests of controls designed to meet this specific objective.[93] Internal control reports regarding custody, such as Type II SAS 70 reports, however, may not necessarily include specific procedures performed by the accountant that are designed to verify the reconciliation of funds and securities of unaffiliated custodians. Verification with unaffiliated custodians serves as a critical check on potential collusion when the adviser or its related person acts as custodian. The accountant preparing the internal control report is in the best position to perform this check because the accountant will have access to the information necessary to verify assets when testing controls over the custodian's reconciliation processes. For this reason, we are requiring this verification to be performed in connection with, and reported in, the internal control report.

As described in our guidance for accountants, the accountant's verification that client funds and securities are reconciled to an unaffiliated custodian (*e.g.,* the Depository Trust Corporation) can be accomplished in one of two ways.[94] The accountant may either obtain direct confirmation, on a test basis, with unaffiliated custodians or perform other procedures designed to verify that the data used in reconciliations performed by the qualified custodian is obtained from unaffiliated custodians and is unaltered.[95]

We noted several specific control objectives in the Proposing Release that we suggested might be included in the scope of an internal control report prepared under the proposed rule.[96] Some commenters urged that we establish minimum control objectives that need to be addressed as part of the internal control report as a means of ensuring consistency in practice.[97] In response to these comments, we are identifying certain minimum control objectives within our revised guidance for accountants.

We are not requiring that a specific type of internal control report be provided under the rule as long as the objectives noted above are addressed. This flexibility should permit

[84] Amended rule 206(4)–2(a)(6). An investment adviser subject to this requirement must obtain or receive an initial internal control report within six months of becoming subject to the requirement. *See infra* Section III.B.2. of this Release.

[85] Proposing Release, at Section II.B.2.

[86] *See id.*

[87] For example, accountants for broker-dealers perform a variety of procedures as part of a broker-dealer's financial statement audit and to satisfy related requirements under the Securities Exchange Act of 1934 ("Exchange Act"), including reconciliation procedures required for broker-dealers under the Exchange Act. *See infra* note 95.

[88] SIFMA(AMG) Letter (noting that obtaining such a report is an "industry best practice").

[89] *See* Accounting Release.

[90] Amended rule 206(4)–2(a)(6)(ii)(A).

[91] *See* Accounting Release.

[92] Amended rule 206(4)–2(a)(6)(ii)(B).

[93] *See* Proposing Release at Section II.B.2.

[94] *See* Accounting Release.

[95] In meeting this requirement, the accountant can also incorporate its own work performed pursuant to other regulatory requirements, such as requirements under the Exchange Act. Under rule 17a–13 under the Exchange Act, most brokers and dealers are required to conduct a securities count at least once each calendar quarter, which includes, among other things, a physical examination and count of all securities held, verification (through confirmation or other form of outside documentation) of all securities deposited or otherwise subject to the broker-dealer's control or direction, and reconciliation of the results of such count and verification to the broker-dealer's records. Under rule 17a–5, the broker-dealer's independent accountant provides a supplemental report on internal control which addresses, among other things, the broker-dealer's compliance with rule 17a–13. *See* Rules 17a–13 and 17a–5 under the Exchange Act [17 CFR Parts 240.17a–13 and 17a–5].

[96] *See* Proposing Release, at Section II.B.2.

[97] *See, e.g.,* AICPA Letter; Deloitte Letter.

accountants of qualified custodians to leverage audit work they have performed to satisfy existing regulatory requirements to which these custodians are subject, or work currently performed as part of internal control reports prepared to meet client demand. In the Proposing Release, we indicated that a Type II SAS 70 report would be sufficient to satisfy the requirements of the internal control report.[98] As we noted in our guidance for accountants, a report issued in connection with an examination of internal control conducted in accordance with AT Section 601, *Compliance Attestation* ("AT 601") under the standards of the American Institute of Certified Public Accountants [99] would also be sufficient, provided that such examination meets the objectives set forth in our guidance.[100]

2. Related Persons

We are amending rule 206(4)–2, as proposed, to provide that an adviser has custody of any client securities or funds that are directly or indirectly held by a "related person" in connection with advisory services provided by the adviser to its clients.[101] A related person is defined by the rule as a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser.[102] We received some support for this proposal.[103] Several commenters urged us to instead adopt the approach our staff has taken in no-action letters in which the staff expressed the view that custody of client assets by a related person would not be attributed to the adviser if the related person was operationally separate.[104] Those letters expressed our staff's views regarding the scope of the custody rule which, at that time, did not explicitly address the applicability of the rule to an entity related to the adviser as parent company, sister company or wholly-owned subsidiary that holds or has access to client assets.[105] We believe that the authority or influence an adviser may have over such related persons presents sufficient risks as a result of a related person's ability to obtain client assets, that we should treat the adviser itself as having custody over the client assets.[106] Therefore, we are adopting the amendment as proposed.[107]

We are, however, addressing commenters' concerns in a different way by providing a limited exception from the surprise examination requirements in circumstances when the adviser is deemed to have custody solely as a result of a related person having custody.[108] The exception is available to an adviser that is (i) deemed to have custody solely as a result of certain of its related persons holding client assets, and (ii) "operationally independent" of the custodian.[109]

As discussed above, a key premise of our approach to the custody rule is that client assets may be at greater risk when they are maintained by a related person of the investment adviser. As commenters suggested, however, firms under common ownership that are operationally independent of each other present substantially lower client custodial risks than those that are not because misuse of client assets would tend to require collusion among employees, not significantly different than would be necessary to engage in similar misconduct between unaffiliated organizations.[110]

Under the amended rule, a related person that holds, or has authority to obtain possession of, advisory client assets would be presumed not to be operationally independent of the adviser unless the adviser can meet the rule's conditions, which are similar to the factors that our staff has used to evaluate whether an adviser has custody of client funds and securities indirectly under the rule as a consequence of the custody of a related person,[111] and no other circumstances exist that can reasonably be expected to compromise the operational independence of the related person.[112] An adviser that is able to satisfy these conditions and overcome the presumption that it is not operationally independent of its related person would not have to obtain a surprise examination of client assets held by a related person, including a related person that is a qualified custodian. The adviser would, however, have to comply with the other provisions of the rule (unless an exception is available), including notifying the client where the assets are maintained, forming a reasonable belief after due inquiry that the qualified custodian sends the client account statements, and obtaining an internal control report from a related person that is a qualified custodian.[113] We believe that the conditions set out in the rule appropriately accomplish our objective of identifying advisers that are not operationally independent and thus present sufficient custodial risks that

[98] *See* Proposing Release, at Section II.B.2.

[99] AT 601 provides guidance to accountants for engagements related to either a firm's compliance with the requirements of particular laws or rules, or the effectiveness of the firm's internal controls over compliance with those particular requirements.

[100] We have made technical changes to the description of the internal control report in amended rule 206(4)–2(a)(6)(ii)(A) to reflect that our adopted rule permits use of internal control reports other than the Type II SAS 70.

[101] Amended rule 206(4)–2(d)(2) (defining "custody").

[102] Amended rule 206(4)–2(d)(7). For advisers that are part of multi-service financial organizations, for example, such related person custodians may include broker-dealers and banks.

[103] *See* CFA Institute Letter; Cornell Letter; FPA Letter; NAAIM Letter.

[104] *See, e.g.,* IAA Letter; Mellon Letter; MMI Letter; NRS Letter; Pershing Letter. Several other commenters suggested similar approaches, including revising the definition of custody based on the factors the staff considered in these no-action letters (T. Rowe Letter), and not considering firms under common control to be deemed related persons under the rule (IAA Letter; Pickard Letter; Schnase Letter; SIFMA(PCLC) Letter). We are not adopting either of these approaches for the same reasons as explained above.

[105] *See, e.g., Crocker Investment Management Corp.,* SEC Staff Letter (Apr. 14, 1978) ("*Crocker*").

[106] *See* Proposing Release, Section II.B.1. We note that under rule 206(4)–2, as amended, only client assets held by a related person "in connection with advisory services" provided by the adviser would be attributable to the adviser. *See* rule 206(4)–2(d)(2). Consequently, an adviser will not be deemed to have custody of client assets held with a qualified custodian that is a related person of the adviser if the adviser does not provide advice with respect to such assets.

[107] Amended rule 206(4)–2. In light of our amended definition of custody, our staff is withdrawing several no-action letters to the extent such letters are inconsistent with this definition, including *Crocker* and *Pictet et Cie,* SEC Staff Letter (Jun. 22, 1980). Advisers, including those firms that have relied on these letters in the past, must comply with the amended rule.

[108] Amended rule 206(4)–2(b)(6).

[109] *Id.*

[110] MMI Letter; Davis Polk Letter. This conclusion is implicit in our staff's no-action letter upon which the staff has relied to determine whether an adviser indirectly has custody of client assets when its related person does. *See Crocker, supra* note 105.

[111] Amended rule 206(4)–2(d)(5) (defining "operationally independent"). The conditions set out in the rule are: (i) Client assets in the custody of the related person are not subject to claims of the adviser's creditors; (ii) advisory personnel do not have custody or possession of, or direct or indirect access to client assets of which the related person has custody, or the power to control the disposition of such client assets to third parties for the benefit of the adviser or its related persons, or otherwise have the opportunity to misappropriate such client assets; (iii) advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision; and (iv) advisory personnel do not hold any position with the related person or share premises with the related person. We would not consider a related person that shared management persons with the adviser, including an owner that was actively involved in the management of the two firms, to be operationally independent.

[112] For example, the management of the adviser and related person could be controlled by persons with close familial relationships such as spouses, siblings, or parents and adult children.

[113] We believe these safeguards remain important because even when an adviser has demonstrated that a related person is operationally independent, the risks to client assets raised by common control may be greater than if client assets were maintained by an independent custodian.

the adviser should be subject to a surprise examination.

We emphasize that an adviser that has custody due to reasons in addition to, or other than, a related person having custody cannot rebut the presumption contained in the rule. Thus, for example, an adviser that has custody because it serves as a trustee with respect to client assets held in an account at a broker-dealer that is a related person could not rely on the exception from the surprise examination on the grounds that the broker-dealer was operationally independent and that the factors discussed above were met.[114] Such an adviser would be subject to the surprise examination requirement *and* would have to receive an internal control report from the related person qualified custodian.[115] We are also amending rule 204–2 to require an adviser whose client assets are held by a related person but does not undergo a surprise examination to make and keep a memorandum describing the relationship with the related person in connection with advisory services the adviser provides to clients and including an explanation of the adviser's basis for determining that it has overcome the presumption that it is not operationally independent of the related person with respect to the related person's custody of client assets.[116]

3. PCAOB Registration and Inspection

Under the amendments, the surprise examination and internal control report required when the adviser or its related person serves as qualified custodian for client assets may be satisfied only when performed or prepared by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB.[117] We have greater confidence in the quality of the surprise examination and the internal control report when prepared by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB.

Many commenters supported this requirement, agreeing with us that PCAOB registration would provide an important quality check on the independent accountants performing these services.[118] Two of those commenters asserted that PCAOB registration would serve to discourage accounting fraud in the higher risk situation posed by an adviser or its related person maintaining client assets.[119] Commenters opposing the requirement expressed concern that the PCAOB's authority is limited to inspecting accountants with respect to audits of public issuers, which does not include the surprise examinations and internal control reports meeting the requirements of rule 206(4)–2.[120] One commenter urged us to exempt offshore advisers from this requirement, asserting that some foreign countries do not have enough accountants registered with the PCAOB to support a competitive marketplace for their services.[121]

We acknowledge that the PCAOB does not currently inspect auditor engagements required solely as a result of rule 206(4)–2. We nonetheless believe a requirement that excludes accountants that are not registered with and examined by the PCAOB will provide greater confidence in the quality of the independent public accountant and complement the enhanced controls under the rule that apply when client assets are not maintained by an independent qualified custodian and in audits of certain pooled investment vehicles.[122] While PCAOB inspection is focused on public company audit engagements, we believe that requiring that the accountant not only be registered with the PCAOB but subject to its inspection can provide indirect benefits regarding the quality of the accountant's other engagements.

We recognize that there may be fewer PCAOB-registered and inspected independent public accountants in certain foreign jurisdictions. Based on discussions with accounting firms, however, we do not expect advisers will have significant difficulty in finding a local auditor that is eligible under the rule. Many PCAOB-registered independent public accountants currently have practices in those jurisdictions in which most offshore advisers and funds are domiciled.[123] In addition, some accounting firms have international practices, which may ameliorate concerns regarding offshore availability. Finally, we will continue to monitor the situation as the rule is implemented and consider any issues that may arise.

D. Liquidation Audit

As proposed, the amended rule requires that advisers to pooled investment vehicles that distribute the pool's audited financial statements to investors under the rule's annual audit provision must, in addition to obtaining an annual audit, obtain a final audit of the pool's financial statements upon liquidation of the pool and distribute the financial statements to pool investors promptly after the completion of the audit.[124] This amendment is designed to assure that the proceeds of the liquidation are appropriately accounted for so that pool investors can take timely steps to protect their rights.

One commenter thought that liquidation audits should not be required as the costs outweigh the benefits.[125] We disagree. We believe that a liquidation audit is an important control to protect assets at a time they

[114] We have also amended the rule so that the exception from the surprise examination requirement with respect to client assets of advisers that have custody as a result of their ability to deduct advisory fees from client assets applies to such advisers when their client assets are held by a custodian that is not a related person of the adviser as well as when the adviser can rely on amended rule 206(4)–2(b)(6). *See* amended rule 206(4)–2(b)(3). For the reasons described above, when the related person custodian is operationally independent, we do not believe the custodial risks raised warrant the costs of obtaining a surprise examination.

[115] Under the rule, an adviser whose client assets are maintained by a related person qualified custodian that is not operationally independent from the adviser, must obtain a surprise examination of those assets as if it held the assets itself and were required to obtain a surprise examination with respect to those assets. As a result, for example, a broker-dealer that is also a qualified custodian of its client's advisory assets could not avoid obtaining a surprise examination by creating an operationally integrated subsidiary to provide investment advice.

[116] *See* amended rule 204–2(b)(5).

[117] Amended rule 206(4)–2(a)(6). The independent public accountant must be registered with, and subject to regular inspection by, the PCAOB as of the commencement of the professional engagement period, and as of each calendar year-end.

[118] Surprise exam and internal control report—E&Y Letter; NAAIM Letter; internal control report only—CPIC Letter; IAA Letter; Pickard Letter; NASAA Letter; surprise examination only—ABA Letter; Curian Letter; FPA Letter; Turner Letter.

[119] CPIC Letter; FPA Letter.

[120] CAS Letter; CAQ Letter; Chamber of Commerce Letter; FTAM Letter.

[121] ABA Letter.

[122] The PCAOB performs regular inspections with respect to any registered public accounting firm that, during any of the three prior calendar years, issued an audit report with respect to at least one issuer. Under the amended rule, an adviser's use of an independent public accountant that is registered with the PCAOB but not subject to regular inspection would not satisfy the rule's requirements. *See* PCAOB rule 4003.

[123] *See http://www.pcaobus.org/Registration/Registered_Firms_by_Location.pdf.* We also note that our staff has issued a letter indicating that it would not recommend enforcement action to the Commission under section 206(4) of the Advisers Act or rule 206(4)–2 under the Act against offshore advisers to offshore pooled investment vehicles if those advisers did not comply with certain substantive rules under the Advisers Act, including the custody rule. *See ABA Subcommittee on Private Investment Entities,* SEC Staff Letter (Aug. 10, 2006). The amendments we are adopting today do not affect the views of the staff expressed in that letter.

[124] Amended rule 206(4)–2(b)(4). Each such set of audited financial statements must be prepared in accordance with generally accepted accounting principles.

[125] S&K Letter.

may be particularly vulnerable to misappropriation.

E. Pooled Investment Vehicles

The custody rule's application to investment advisers to pooled investment vehicles will change in several aspects as a result of the amendments we are adopting today. Because a detailed discussion of each of these changes appears throughout multiple different sections of this Release, we are providing a centralized summary here.

Under amended rule 206(4)–2, advisers to pooled investment vehicles may be deemed to comply with the surprise verification requirements of the rule by obtaining an audit of the pool and delivering the audited financial statements to pool investors within 120 days of the pool's fiscal year-end.[126] The audit must be conducted by an accounting firm registered with, and subject to regular inspection by, the PCAOB.[127] If the pooled investment vehicle does not distribute audited financial statements to its investors, the adviser must obtain an annual surprise examination and must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement of the pooled investment vehicle to its investors in order to comply with the custody rule.[128] The rule requires the accounting firm performing the surprise examination to verify privately offered securities, along with other funds and securities, held by a pool that is not subject to a financial statement audit.[129] Regardless of whether an adviser to a pooled investment vehicle obtains a surprise examination or satisfies that requirement by obtaining an audit, if the pooled investment vehicle's assets are maintained with a qualified custodian that is either the adviser to the pool or a related person of the adviser, the adviser to the pool would have to obtain, or receive from the related person, an internal control report.[130] Finally, the rule requires advisers to pools complying with the rule by distributing audited financial statements to investors to also obtain an audit upon liquidation of the pool when the liquidation occurs prior to the fund's fiscal year-end.[131]

F. Delivery to Related Persons

The Commission is adopting a new provision in rule 206(4)–2 that would preclude advisers from using layers of pooled investment vehicles to avoid meaningful application of the protections of the Rule. Specifically, we are adding a new paragraph (c), which provides that sending an account statement (paragraph (a)(5)) or distributing audited financial statements (paragraph (b)(4)) will not meet the requirements of the rule if all of the investors in a pooled investment vehicle to which the statements are sent are themselves pooled investment vehicles that are related persons of the adviser.

Investment advisers to pooled investment vehicles may from time to time use special purpose vehicles (SPVs) to facilitate investments in certain securities by one or more pooled investment vehicles that the advisers manage. These SPVs are typically established or controlled by the investment adviser or its related persons who often serve as general partners of limited partnerships (or managing members of limited liability companies, or persons who hold comparable positions for another type of pooled investment vehicle). Therefore, a literal application of the rule could result in account statements and financial statements designed to permit investors to protect their interests being sent to the adviser itself, rather than to the parties the rule was designed to protect.[132]

To comply with the rule, as amended, the investment adviser could either treat the SPV as a separate client, in which case the adviser will have custody of the SPV's assets, or treat the SPV's assets as assets of the pooled investment vehicles of which it has custody indirectly. If the adviser treats the SPV as a separate client, rule 206(4)–2 requires the adviser to comply separately with the custody rule's audited financial statement distribution or account statement and surprise examination requirements (*e.g.,* distribute audited financial statements of the SPV pursuant to the requirements of rule 206(4)–2). Accordingly, advisers should distribute the audited financial statements or account statements of the SPV to the beneficial owners of the pooled investment vehicles. If, however, the adviser treats the SPV's assets as assets of the pooled investment vehicles of which it has custody indirectly, such assets must be considered within the scope of the pooled investment vehicle's financial statement audit or surprise examination.

G. Compliance Policies and Procedures

Rule 206(4)–7 under the Advisers Act requires registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules.[133] As we stated in 2003 when we adopted that rule, these policies and procedures must address, among other things, the safeguarding of client assets from conversion or inappropriate use by advisory personnel.[134] We believe that an adviser's maintenance of strong policies and procedures, in addition to the measures we are adopting today, is an essential component of a comprehensive approach to addressing the potential risks raised by an adviser's custody of client assets. We are therefore taking this opportunity to provide guidance regarding the types of policies and procedures relating to safekeeping of client assets that advisers should consider including in their compliance programs.

Compliance with rule 206(4)–7 requires an adviser with custody to adopt controls over access to client assets that are reasonably designed to prevent misappropriation or misuse of client assets, develop systems or procedures to assure prompt detection of any misuse, and take appropriate action if any misuse does occur.[135] Commenters on our Proposing Release suggested several policies and procedures that advisers should consider adopting in order to comply with rule 206(4)–7,[136] many of which we have incorporated into this guidance.

Advisers with custody of client assets should consider the value of instituting the following policies and procedures as part of their compliance programs: [137]

[126] Amended rule 206(4)–2(b)(4). *See supra* note 45.

[127] Amended rule 206(4)–2(b)(4)(ii).

[128] Amended rule 206(4)–2(b)(4).

[129] Section II.B.3. of this Release. Accounting firms that perform surprise examinations under the amended rule are required to report material deficiencies to our staff and also report on Form ADV–E the termination of an engagement as well as the results of the surprise examination.

[130] *See* paragraphs (a)(6), and (b)(4) of amended rule 206(4)–2. This applies only where the use of a qualified custodian is required by the rule.

[131] Amended rule 206(4)–2(b)(4)(iii).

[132] In certain circumstances, the use of SPVs could constitute a violation of section 208(d) of the Act, which prohibits an investment adviser, "indirectly, or through or by any other person, to do any act or thing which it would be unlawful for such person to do directly under" the Act or any of our rules.

[133] 17 CFR 275.206(4)–7.

[134] *Compliance Programs of Investment Companies and Investment Advisers,* Investment Advisers Act Release No. 2204 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)] ("Compliance Rule Release"), at Section II.A.1.

[135] *See id.*

[136] *See, e.g.,* Comment letter of Investment Adviser Association (March 6, 2009); CPIC Letter.

[137] In addition to these policies and procedures, an adviser should consider: (i) Policies and procedures to establish that it has a basis for its reasonable belief that qualified custodians send account statements to advisory clients; and (ii) if the adviser has overcome the presumption that it

• Conducting background and credit checks on employees of the investment adviser who will have access (or could acquire access) to client assets to determine whether it would be appropriate for those employees to have such access;

• Requiring the authorization of more than one employee before the movement of assets within, and withdrawals or transfers from, a client's account, as well as before changes to account ownership information;

• Limiting the number of employees who are permitted to interact with custodians with respect to client assets and rotating them on a periodic basis; and

• If the adviser also serves as a qualified custodian for client assets, segregating the duties of its advisory personnel from those of custodial personnel to make it difficult for any one person to misuse client assets without being detected.[138]

Advisers should consider including in their policies and procedures a requirement that any problems be brought to the immediate attention of the management of the adviser. Advisers also should consider developing policies regarding the ability of individual employees to acquire custody of client assets, because their custody may be attributable to the firm, which will thereby acquire responsibility for those assets under the rule. Many firms preclude employees from acquiring custody by prohibiting them from, for example, becoming trustees for client assets or obtaining powers of attorney for clients separate and apart from the advisory firm.[139] Advisers that permit employees to serve in capacities whereby the firm acquires custody of client assets should take steps to assure themselves that their employees' custodial practices conform to the firm's policies and procedures, and that the adviser's chief compliance officer ("CCO") has access to sufficient information to enforce those policies and procedures.

The adviser's custody of client assets presents elevated compliance risks for the adviser and its clients. Advisers and their CCOs therefore must accord these risks appropriate attention in the adviser's compliance program. Accordingly, the adviser should consider developing procedures by which the CCO periodically tests the effectiveness of the firm's controls over the safekeeping of client assets. For example, the CCO could periodically test the reconciliation of account statements prepared by advisers with account statements as reported by qualified custodians. In addition, the CCO could compare, on a sample basis, client addresses obtained from the clients' qualified custodians to which the custodian sends client statements, with client addresses maintained by the adviser, to look for inconsistencies or patterns that suggest possible manipulation of address information as a means for concealing misappropriation from these accounts by advisory personnel.

Advisers that have custody as a result of their authority to deduct advisory fees directly from client accounts held at a qualified custodian should have policies and procedures in place that address the risk that the adviser or its personnel could deduct fees to which the adviser is not entitled under the terms of the advisory contract, which would violate the contract and which may constitute fraud under the Advisers Act. The adviser's policies and procedures should take into account how and when clients will be billed; be reasonably designed to ensure that the amount of assets under management on which the fee is billed is accurate and has been reconciled with the assets under management reflected on statements of the client's qualified custodian; and be reasonably designed to ensure that clients are billed accurately in accordance with the terms of their advisory contracts.[140] Examples of policies and procedures such an adviser should consider include:[141]

• Periodic testing on a sample basis of fee calculations for client accounts to determine their accuracy;

• Testing of the overall reasonableness of the amount of fees deducted from all client accounts for a period of time based on the adviser's aggregate assets under management; and

• Segregating duties between those personnel responsible for processing billing invoices or listings of fees due from clients that are provided to and used by custodians to deduct fees from clients' accounts and those personnel responsible for reviewing the invoices and listings for accuracy, as well as the employees responsible for reconciling those invoices and listings with deposits of advisory fees by the custodians into the adviser's proprietary bank account to confirm that accurate fee amounts were deducted.

Because different controls may be appropriate for different advisers in designing effective compliance programs, we are not suggesting a single set of policies and procedures. As we noted in 2003 when we adopted rule 206(4)–7, we recognize that advisers are too varied in their operations and size for such an approach to work.[142] Policies and procedures that are appropriate for a 500 employee firm that also operates as a broker-dealer will be unlikely to work (or be necessary) for a five person firm that provides asset allocation advice. Advisers with only a few employees may, for example, find segregation of duties impractical, but for advisers with a large number of employees such a control may be highly effective. Advisers to pooled investment vehicles should consider whether these practices, or others, should cover investor accounts in the pool, for example, to prevent an employee from misappropriating assets from the pool by processing false investor withdrawals. We have therefore provided the guidance set out above primarily in the form of examples; we expect advisers to tailor their custody policies and procedures to fit both the size and the particular risks that are raised by their business model.

H. Amendments to Form ADV

We are adopting several amendments to Part 1A and Schedule D of Form ADV. The amendments require registered advisers to report to us more

is not operationally independent of its related person under amended rule 206(4)–2(d)(5), policies and procedures reasonably designed to ensure that it continues to overcome the presumption set forth in that provision as long as it continues to rely on the provision. *See supra* Sections II.A and II.C.2. of this Release.

[138] An adviser utilizing a segregation of duties approach should also consider having different personnel authorize custodial transfers from client accounts than those who reconcile client account balances at the adviser with the custodian's records of client transactions and holdings.

[139] When a supervised person of an adviser serves as the executor, conservator or trustee for an estate, conservatorship or personal trust solely because the supervised person has been appointed in these capacities as a result of family or personal relationship with the decedent, beneficiary or grantor (and not as a result of employment with the adviser), we would not view the adviser to have custody of the funds or securities of the estate, conservatorship, or trust. *See* 2003 Adopting Release at n.15.

[140] Our staff has taken the view that, under some arrangements, clients may pay advisory fees deducted directly from assets held in their advisory accounts without causing the adviser to have custody of those assets and being subject to the custody rule. Under these arrangements, a client will instruct its qualified custodian as its agent to determine the amount of the advisory fee and to remit the amount of the fee to the adviser. Our staff therefore takes the view, under these circumstances, that the adviser has no access to the client's funds or securities. *See* Staff Responses to Questions About Amended Custody Rule, at Section III. Fee Deduction, Question III.3, available at *http://www.sec.gov/divisions/investment/custody_faq.htm.*

[141] Some of these suggestions came from commenters. *See, e.g.,* CPIC Letter.

[142] Compliance Rule Release, at Section II.A.1.

detailed information about their custody practices in their registration form and to update the information. The information will enhance our ability to identify compliance risks associated with custody of client assets.[143] The amendments primarily affect only those advisers that have custody of client assets under rule 206(4)–2.

Item 7. We are adopting the amendments to Item 7 and Section 7.A. of Schedule D that we proposed to require each adviser to report *all* related persons who are broker-dealers and to identify which, if any, serve as qualified custodians with respect to the adviser's clients' funds or securities.[144] We did not receive comments on these proposed amendments. We also are amending Section 7.A. of Schedule D to require an adviser to report whether it has determined that it has overcome the presumption that it is not operationally independent from a related person broker-dealer qualified custodian, and thus is not required to obtain a surprise examination for the clients' assets maintained at that custodian.

Item 9. We are adopting amendments to Item 9 to require each registered adviser to report to us: (i) Whether the adviser or a related person has custody of client assets, and if so, both the total U.S. dollar amount of those assets as well as the number of clients for whose accounts the adviser or its related person has custody; [145] (ii) if the adviser, or a related person, acts as an adviser to a pooled investment vehicle, whether (a) the pool is audited, and (b) the qualified custodians send account statements to pool investors; [146] (iii) whether an independent public accountant conducts an annual surprise examination of client assets; [147] and (iv) whether an independent public accountant prepares an internal control report with respect to the adviser or its related person; [148] and (v) whether the adviser or a related person serves as qualified custodian for the adviser's clients.[149] In addition, we are amending Schedule D to require that advisers (i) identify and provide certain information about the accountants that perform audits or surprise examinations and that prepare internal control reports; [150] and (ii) to identify related persons, such as banks, that serve as qualified custodians with respect to their clients' funds or securities, but are not otherwise reported in Item 7. We also are amending Schedule D to require an adviser to report whether it has determined that it has overcome the presumption that it is not operationally independent from a related person qualified custodian, and thus is not required to obtain a surprise examination for the clients' assets maintained at that custodian.[151]

Several commenters generally supported these amendments to Form ADV, and many requested clarification or modification to parts of the form.[152] In response to several commenters' requests for clarification or modification of Item 9,[153] we have added an instruction to clarify that an adviser must separately report the amount of assets of which it has custody, excluding those assets maintained by a related person qualified custodian, and the amount of assets of which a related person has custody, including when the related person serves as a qualified custodian.[154]

I. Amendments to Form ADV–E

We are adopting, as proposed, three amendments to the instructions to Form ADV–E. First, we have amended the form instructions to require that the form and the accompanying accountant's examination certificate be filed electronically with the Commission through the IARD.[155] Advisers will, however, continue to file form ADV on paper until the IARD system begins accepting electronic filings of Form ADV–E, which we expect to occur sometime in late 2010. Investment advisers will be notified at that time. The second and third amendments we are adopting conform Form ADV–E instructions to amended rule 206(4)–(2), which, as discussed above, requires that (i) the surprise examination certificate must be filed within 120 days of the time chosen by the accountant for the surprise examination,[156] and (ii) a termination statement be filed by an accountant within four business days of its resignation, dismissal, or removal.[157]

J. Required Records

We also are adopting amendments, as proposed, to rule 204–2 to require an adviser to maintain a copy of (i) the internal control report that such adviser is required to obtain or receive from its related person, pursuant to amended rule 206(4)–2(a)(6), and (ii) the memorandum describing the basis upon which the adviser determined that the presumption that any related person is not operationally independent, pursuant to amended rule 206(4)–2(d)(5), has

[143] These revisions respond in part to concerns raised by the Government Accountability Office in its August 2007 report on our examination program, which concluded that our examination staff should continue to assess and refine the risk algorithm to enhance the risk assessment process, which would include the identification and collection of additional data through Form ADV. *See* United States Government Accountability Office, *Securities and Exchange Commission; Steps Being Taken to Make Examination Program More Risk-Based and Transparent* (August 2007), available at *http://www.gao.gov/new.items/d071053.pdf*.

[144] The item had required an adviser to identify on Schedule D of Form ADV each related person that is an investment adviser, but made reporting of the names of related person broker-dealers optional.

[145] Items 9.A. and 9.B of Part 1A of Form ADV.

[146] Item 9.C.(1) and (2) of Part 1A of Form ADV.

[147] Item 9.C.(3) of Part 1A of Form ADV.

[148] Item 9.C.(4) of Part 1A of Form ADV. Two commenters suggested that we eliminate the requirements in Item 9.C. that require an adviser to disclose the actions taken by the adviser's qualified custodian and accountant pursuant to the proposed custody rule (as well as corresponding portions of Schedule D), stating that advisers cannot guarantee third-party actions and that reporting compliance with aspects of the custody rule is an inappropriate use of Form ADV. *See* IAA Letter; MMI Letter. These items do not require an adviser to guarantee actions of third parties, but merely require the adviser to report on obligations it has (*e.g.,* to form a reasonable belief) under the revised custody rule, which if not met would result in the adviser's violation of the rule.

[149] Item 9.D. of Part 1A of Form ADV.

[150] In addition to providing the accountant's name and address, advisers must indicate whether the accountant is registered with and subject to regular inspection by the PCAOB. Advisers must also indicate whether the accountant's report contained an unqualified opinion. Section 9.C. of Schedule D to Part 1A of Form ADV. One commenter stated that we should not require advisers to report whether the accountants they, or their related persons, engage are registered with and subject to inspection by the PCAOB because this information is readily available on the PCAOB's Web site. *See* AICPA Letter. An adviser, or related person custodian, would have to collect this information in the course of retaining an accountant to perform the necessary engagements to comply with the revised custody rule, and we expect that accountants would make these representations to their clients. As a result, reporting this information should not be burdensome to advisers.

[151] Section 9.D. of Schedule D to Part 1A of Form ADV.

[152] Cornell Letter; IAA Letter; MMI Letter; NRS Letter; Turner Letter.

[153] IAA Letter; NSCP Letter; ASG Letter; CAS Letter.

[154] We also are revising an existing instruction to Item 9.A. to specify that in addition to advisers that have custody only because they have authority to deduct fees that if they also have custody because a related person maintains client assets but the adviser has overcome the presumption of not being operationally independent they may continue to answer "no" to Item 9.A. Advisers must report information about these custody arrangements in Item 9.B.

It will be several months before FINRA, which operates the IARD for us, completes reprogramming the IARD to implement this change to Item 9. In the interim, advisers registered with the Commission should provide responses following the amended instruction.

[155] Instruction 3(a) to Form ADV–E. Several comments supported electronic filing and the amendments to Form ADV–E generally. *See* Cornell Letter; IAA Letter; Turner Letter.

[156] Instruction 3(i) to Form ADV–E.

[157] Instruction 3(ii) to Form ADV–E. Commenters suggested that we revise the timing of the filing and that we do not make the filing available to the public. We have addressed these comments in Section II.B.2 of this Release. *See supra* notes 54 and 57 and accompanying text.

been overcome, for five years from the end of the fiscal year in which, as applicable, the internal control report or memorandum is finalized. Requiring an adviser to retain a copy of these items will provide our examiners with important information about the safeguards in place at an adviser or related person that maintains client assets. Information from these records will also assist our staff in assessing custody-related risks at a particular adviser.

III. Effective and Compliance Dates

A. Effective Date

The effective date of the amendments to rules 206(4)–2, 204–2, and Forms ADV and ADV–E is March 12, 2010.

B. Compliance Dates and Related Rule Amendments

Advisers registered with us must comply with amended rules 206(4)–2, 204–2, and Forms ADV and ADV–E, as amended, on and after March 12, 2010, the effective date of these amendments, except as described below. Immediately upon the effective date advisers that have custody of client assets must promptly upon opening a custodial account on a client's behalf, and following any changes to the custodial account information, as specified in rule 206(4)–2(a)(2) send a notification to the client, including a legend urging the client to compare the account statements the client receives from the custodian with those the client receives from the adviser. Such legend should also be included in any account statements that advisers send to these clients after they are required to send the notification discussed above. In addition, immediately upon the effective date, each adviser that has custody of client assets must have a reasonable belief (except with respect to pooled investment vehicles the financial statements of which are audited and delivered to investors) that a qualified custodian sends account statements directly to clients at least quarterly, in accordance with rule 206(4)–2(a)(3). We believe 60 days is sufficient for advisers to comply with the amended rule regarding the three requirements described above because they are modifications to the existing rule requirements.

Compliance dates for other provisions of amended rules 206(4)–2, 204–2, and Forms ADV and ADV–E are described below.[158]

1. Surprise Examinations

An investment adviser required to obtain a surprise examination must enter into a written agreement with an independent public accountant that provides that the first examination will take place by December 31, 2010 or, for advisers that become subject to the rule after the effective date, within six months of becoming subject to the requirement.[159] If the adviser itself maintains client assets as qualified custodian, however, the agreement must provide for the first surprise examination to occur no later than six months after obtaining the internal control report.[160] We believe these compliance dates will provide sufficient time for an adviser to hire an independent public accountant for purposes of the surprise examination and for the accountant to perform the surprise examination.

2. Internal Control Reports

An investment adviser also required to obtain or receive an internal control report because it or a related person maintains client assets as a qualified custodian must obtain or receive an internal control report within six months of becoming subject to the requirement. As noted above, an adviser obtaining an internal control report because it (rather than a related person) also serves as a qualified custodian of its clients' assets (*e.g.,* a broker-dealer) need not undergo a surprise examination until six months after obtaining the internal control report.

3. Audits of Pooled Investment Vehicles

An investment adviser to a pooled investment vehicle may rely on the annual audit provision if the adviser (or a related person) becomes contractually obligated to obtain an audit of the financial statements of the pooled investment vehicle for fiscal years beginning on or after January 1, 2010 by an independent public accountant registered with, and subject to regular inspection by, the PCAOB.

4. Forms ADV and ADV–E

Investment advisers registered with us must provide responses to the revised Form ADV in their first annual amendment after January 1, 2011.[161] Until the IARD system is upgraded to accept Form ADV–E, accountants performing surprise examinations should continue paper filing of Form ADV–E. Investment advisers will be notified as soon as the IARD system can accept filings of Form ADV–E.[162]

IV. Paperwork Reduction Act

Certain provisions of rule 206(4)–2, Form ADV, and Form ADV–E that we are amending today contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[163] In the Proposing Release, the Commission published notice soliciting comment on the collection of information requirements. The Commission submitted the collection of information requirements to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11 under control numbers 3235–0241, 3235–0049, and 3235–0361, respectively. The titles for the collections of information are "Rule 206(4)–2, Custody of Funds or Securities of Clients by Investment Advisers," "Form ADV," and "Form ADV–E, cover sheet for each certificate of accounting of client securities and funds in the custody of an investment adviser," under the Advisers Act.[164] An

[158] Some commenters requested that we delay the compliance date by 12–24 months from the effective date of the rule. *See* Curian Letter; CAQ Letter; Dechert Letter; Deloitte Letter; E&Y Letter; KPMG Letter; PWC Letter. In determining the compliance dates for the amended rules and forms, we balanced the urgency of enhancing investor protection afforded under the Advisers Act, the need to provide sufficient time for advisers to comply with the requirements under the amended rules, and the extent of changes we made from the proposal on which the commenters' requests were based.

[159] An adviser could first become subject to the surprise examination requirement by, for example, registering with the Commission or accepting custody of a client's assets.

[160] An independent public accountant conducting a surprise examination on an adviser that also serves as the qualified custodian for its clients (*i.e.,* self custody) would have to verify the existence of client assets with the adviser itself. Because of the added assurance of having an internal control report, we believe that investors would be better served if the first round of surprise examinations is conducted with the benefit of the internal control report. An adviser with multiple related persons that serve as qualified custodians must undergo a surprise examination within six months of receiving the last internal control report it is required to receive.

[161] Based on discussions with our contractor, we anticipate that IARD will reflect the changes to Form ADV we are adopting today and accept electronic filing of Form ADV–E in the fourth quarter of 2010. Form ADV–Es filed with us on paper before electronic filing will be available upon request through the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549.

[162] We urge advisers in the meantime to confirm that their email contact information on Form ADV is correct and to update the information promptly if necessary.

[163] 44 U.S.C. 3501.

[164] We also are adopting amendments to rule 204–2 that require approximately 337 advisers to maintain the internal control reports they obtain, or receive from related persons, and if these advisers have determined that the presumption that a related person is operationally independent has been overcome, a memorandum describing the basis upon which that determination was made. In addition, rule 204–2(a)(10) already requires an adviser to maintain all written agreements relating to its business as such, which would require an

Continued

agency may not sponsor, or conduct, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB 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 client funds and securities ("client assets"). The collections of information under Form ADV are necessary for use by staff of the Commission in its examination and oversight program, and some advisory clients also may find them useful. The respondents are investment advisers seeking to register with the Commission or to update their registrations. The collections of information under Form ADV–E are necessary for use by staff of the Commission in its examination and oversight program, and some advisory clients also may find them useful. The respondents are investment advisers registered with us that have custody of client assets and are subject to an annual surprise examination requirement under rule 206(4)–2. All responses required by the rule are mandatory. With the exception of an accountant's notification of any material discrepancies identified in a surprise examination pursuant to rule 206(4)–2(a)(4)(ii), responses provided to the Commission are not kept confidential.

A. Rule 206(4)–2

The Commission is adopting amendments to the custody rule under the Advisers Act. The amendments are designed to provide additional safeguards under the Advisers Act when a registered adviser has custody of client funds or securities by requiring such an adviser, among other things: (i) To undergo an annual surprise examination by an independent public accountant to verify client assets; (ii) to have a reasonable basis after due inquiry, for believing that the qualified custodian maintaining client funds and securities sends account statements directly to the advisory clients; and (iii) unless client assets are maintained by an independent custodian (*i.e.,* a custodian that is not the adviser itself or a related person) to obtain or receive a report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the PCAOB.

The amendments to rule 206(4)–2 that we are adopting today differ from our proposed amendments in three respects that affect our Paperwork Reduction Act analysis. First, we are providing an exception to the surprise examination requirement for advisers that have custody because they have authority to deduct advisory fees from client accounts and advisers that have custody solely because a related person holds the adviser's client assets and the related person is operationally independent of the adviser.[165] Second, advisers to pooled investment vehicles that are subject to an annual audit and that distribute audited financial statements to investors in the pools are deemed to comply with the surprise examination requirement as long as the accountant performing the annual audit is registered with, and subject to regular inspection by, the PCAOB.[166] Third, if an adviser sends account statements to its clients, it must not only insert a legend in the required notice to clients upon opening accounts on their behalf, but must also insert the legend in subsequent account statements sent to those clients urging the client to compare the account statements from the custodian with those from the adviser.[167]

We requested comment on the Paperwork Reduction Act analysis contained in the Proposing Release. A number of commenters expressed concerns that the paperwork burdens associated with our proposed amendments to rule 206(4)–2 were understated.[168] In response to these comments as well as the differences in the amendments we are adopting from those we proposed, as described above, and the guidance for accountants published in a companion release,[169] we have adjusted our Paperwork Reduction Act estimates as discussed below.

Annual surprise examination. The current approved annual burden for rule 206(4)–2 is 415,303 hours, 21,803 of which relate to the requirement to obtain a surprise examination and the delivery of quarterly account statements by the adviser. We estimated in the Proposing Release that 9,575 advisers registered with the Commission would be subject to the surprise examination.[170] As noted above, the amended rule we are adopting today excludes certain advisers with custody from the requirement to undergo an annual surprise examination and deems certain advisers to audited pooled investment vehicles to have complied with the requirement.[171] Advisers that have custody for other reasons, however, such as because they or their related person serves as the qualified custodian for client assets, or because they serve as the trustee of a client trust, must undergo an annual surprise examination.[172] As a result, we now estimate that 1,859 advisers will be subject to the surprise examination requirement under the amended rule 206(4)–2.[173]

adviser to maintain the written agreement concerning the surprise examination required by the amended rule. The current approved collection of information burden for rule 204–2 is 1,945,109 hours and has an estimated cost of $13,551,390 under OMB control number 3235–0278. The two new retention requirements and the additional written agreements that will be maintained as a result of more surprise examinations will result in a negligible increase to the currently approved burden for rule 204–2.

[165] Amended rule 206(4)–2(b)(3) and amended rule 206(4)–2(b)(6).

[166] Amended rule 206(4)–2(b)(4).

[167] Amended rule 206(4)–2(a)(2).

[168] *See, e.g.,* ASG Letter; MMI Letter; Schwab Letter. These commenters did not provide empirical data that is relevant to our estimates of burden hours in this Paperwork Reduction Act analysis, but did provide cost estimates that we have considered in Section V of this Release.

[169] *See* Accounting Release.

[170] Based on Form ADVs filed as of February 2009. *See* the Proposing Release at n.77 for explanation of our estimate.

[171] Amended rule 206(4)–2(b)(3) (exception from surprise examination for advisers that have custody because they have authority to deduct fees from client accounts) and amended rule 206(4)–2(b)(4)(deems advisers to audited pooled investment vehicles that distribute audited financial statements to pool investors to comply with the surprise examination requirement if the audit is conducted by a public accountant registered with, and subject to regular inspection by, the PCAOB). *See supra* Section II.B.1 of this Release.

[172] Under amended rule 206(4)–2 an adviser has custody if its related person has custody of its client assets. Amended rule 206(4)–2(d)(2). A related person is defined as a person directly or indirectly controlling or controlled by the adviser, and any person under common control with the adviser. Amended rule 206(4)–2(d)(7).

[173] Based on Form ADVs filed as of November 2, 2009 (unless indicated otherwise, all data we use in this release were as of November 2, 2009), there were 3,689 advisers that answered "yes" to Form ADV, Part 1A Items 9.A or 9.B (indicating that they or a related person has custody of client assets. This excludes advisers that have custody solely because they have authority to deduct fees from clients' accounts). We exclude from this number (i) 38 of these advisers that only have clients that are investment companies (Item 5.D(4)); (ii) 703 (or 90%, which is based on staff observation that the vast majority of pooled investment vehicles are subject to an annual audit) of the 781 of these advisers that only have clients that are pooled investment vehicles (Items 5.D(6) or 5.D(4)); (iii) 1,030 (or 80%) of the 1,288 advisers that have some clients that are pooled investment vehicles (10% of which is based on the number of advisers (from IARD data) that have both pooled investment vehicle clients and non-pooled investment vehicle clients that will not have to undergo a surprise examination because they do not have custody under the rule of the non-pooled investment vehicle client assets that would require a surprise examination and 10% of which is based on an

For purposes of estimating the collection of information burden we have divided the estimated 1,859 advisers into 3 subgroups. First, we estimate that 337 advisers have custody because (i) they serve as qualified custodians for their clients and are also broker-dealers, banks or futures commission merchants,[174] or (ii) they have a related person that serves as qualified custodian for clients in connection with advisory services the adviser provides to the clients.[175] We estimate that these advisers will be subject to an annual surprise examination with respect to 100 percent of their clients (or 2,315 clients per adviser) based on the assumption that all of their clients maintain custodial accounts with the adviser or related person.[176] We estimate that each adviser will spend an average of 0.02 hours for each client to create a client contact list for the independent public accountant. The estimated total annual aggregate burden with respect to the surprise examination requirement for this group of advisers is 15,603 hours.[177]

A second group of advisers, estimated at 1,315,[178] are those that have custody because they have broad authority to access client assets held at an independent qualified custodian, such as through a power of attorney or acting as a trustee for a client's trust. Based on our staff's experience, advisers that have access to client assets through a power of attorney, acting as trustee, or similar legal authority typically do not have access to all of their client accounts, but rather only to a small percentage of their client accounts pursuant to these special arrangements. We estimate that these advisers will be subject to an annual surprise examination with respect to 5 percent of their clients (or 116 clients per adviser) [179] who have these types of arrangements with the adviser. We estimate that each adviser will spend an average of 0.02 hours for each client to create a client contact list for the independent public accountant. The estimated total annual aggregate burden with respect to the surprise examination requirement for this group of advisers is 3,051 hours.[180]

A third group of advisers, estimated at 207,[181] provide advice to pooled investment vehicles that are not undergoing an annual audit, and therefore will be subject to the surprise examination with respect to 100 percent of their pooled investment vehicle clients (which we estimate to be 5 funds and 250 investors per adviser providing advisory services exclusively to pooled investment vehicles, and 2 funds and 100 investors per adviser not providing advisory services exclusively to pooled investment vehicles).[182] We estimate that the advisers to these pooled investment vehicles will spend 1 hour for the pool and 0.02 hours for each investor in the pool to create a contact list for the independent public accountant, for an estimated total annual burden with respect to the surprise examination requirement for these advisers of 1,296 hours.[183] These estimates bring the total annual aggregate burden with respect to the surprise examination requirement for all three groups of advisers to 19,950 hours.[184] This estimate does not include the collection of information discussed below relating to the written agreement required by paragraph (a)(4) of the rule.

Written agreement with accountant. Consistent with the proposal, amended rule 206(4)–2 requires that an adviser subject to the surprise examination requirement must enter into a written agreement with the independent public accountant engaged to conduct the surprise examination and specify certain duties to be performed by the independent public accountant.[185] As stated in the Proposing Release, we believe that written agreements are commonplace and reflect industry practice when a person retains the services of a professional such as an accountant, and they are typically prepared by the independent public accountant in advance. We therefore estimate that each adviser will spend 0.25 hour to add the required provisions to the written agreement, with an aggregate of 465 hours for all advisers subject to surprise examinations.[186] Therefore the total annual burden in connection with the surprise examination is estimated at 20,415 hours under the amended rule.[187]

Audited pooled investment vehicles. The rule currently excepts, and the amended rule continues to except,

estimate of the pooled investment vehicles that are subject to an annual audit). We further estimate that of the 396 advisers we estimate that are currently using related person qualified custodians, 59 (or 15%) will choose to use independent qualified custodians and, as a result, will no longer retain custody of client assets under the rule that would require these advisers to undergo the surprise examination. *See infra* note 282 for explanation of this estimate. (3,689 − 38 − 703 − 1,030 − 59 = 1,859).

[174] We estimate that 91 investment advisers that are also banks, registered broker-dealers or futures commission merchants would custody client assets as a qualified custodian under the rule.

[175] Based on IARD data, we also estimate that 305 investment advisers have a related person bank, registered broker-dealer or futures commission merchant that is a qualified custodian for advisory client assets. 91 (advisers that are also banks or broker-dealers) + 305 (advisers using related persons as custodians) = 396. 396 − 59 (advisers that will stop using related persons as custodians) = 337 (*see supra* note 173 for explanation of 59 advisers removed).

[176] In the Proposing Release, we estimated that each adviser had, on average, 1,092 clients. *See* Proposing Release at n.79. That estimate was based on the average number of clients of all advisers registered with us (excluding the two largest firms). We now base our estimate on IARD data of all the advisers that will be subject to the surprise examination under the amended rule (also excluding these two largest firms). This new estimate excludes from the calculation about 6,000 advisers that have custody solely because of deducting fees, which tend to have fewer clients. As a result the estimated average number of clients for the advisers that will be subject to the surprise examination under the amended rule is increased.

[177] 337 advisers × 2,315 (average number of clients subject to the surprise examination requirement) × 0.02 hour = 15,603 hours. As addressed later, some of these advisers will not have to obtain a surprise examination as a result of the exception to the surprise examination requirement under amended rule 206(4)–2(b)(6) for an adviser that has custody because of its related person's custody of client assets and that can overcome the presumption that it is not operationally independent of the related person custodian. *See infra* note 283. We do not have data or another resource to provide an estimate of the number of advisers that use related person custodians that will be able to overcome the presumption. This estimated annual hour burden may, as a result, overestimate the collection of information requirement as advisers that have overcome the presumption will not have to create client contact lists.

[178] This estimate is based on the total number of advisers subject to surprise examinations less those described above in the first group (custody as a result of serving as, or having related person serving as qualified custodians) and below in the third group (advisers to pooled investment vehicles) 1,859 − 337 − 207 = 1,315. *See infra* note 182 and accompanying text.

[179] Based on the IARD data, we estimate that the average number of clients of advisers subject to the surprise examination requirement is 2,315. (2,315 × 5% = 116).

[180] 1,315 × 116 × 0.02 = 3,051.

[181] Based on IARD data, we estimate that there are 781 advisers that provide advisory services exclusively to pooled investment vehicles. *See supra* note 173. We further estimate, based on our staff's experience, that only ten percent of advisers to pooled investment vehicles will be subject to an annual surprise examination because the pooled investment vehicles they advise do not undergo an annual audit. We further estimate, based upon staff experience, that ten percent of the 1,288 advisers that provide services not exclusively to pooled investment vehicles will be subject to an annual surprise examination because the pooled investment vehicles they advise do not undergo an annual audit. (781 × 10%) + (1,288 × 10%) = 78 + 129 = 207.

[182] The number of funds per adviser is estimated based on the information we collected from Item 5.C. of Form ADV filed by advisers that provide advisory services only to pooled investment vehicles. The estimate of 250 investors per adviser is a staff estimate used in the currently approved collection of information burden.

[183] [(78 × 5) + (78 × 250 × 0.02)] + [(129 × 2) + (129 × 100 × 0.02)] = [390 + 390] + [258 + 258] = 1,296.

[184] 1,296 + 15,603 + 3,051 = 19,950. By contrast, our estimate in the Proposing Release for the surprise examination as proposed was 177,242 hours.

[185] Amended rule 206(4)–2(a)(4).

[186] 1,859 × 0.25 = 465.

[187] 19,950 + 465 = 20,415.

advisers to pooled investment vehicles from having a qualified custodian send quarterly account statements to the investors in a pool if it is audited annually by an independent public accountant and the audited financial statements are distributed to the investors in the pool. The currently approved annual burden in connection with the required distribution of audited financial statements is 393,500 hours.[188] As explained in the Proposing Release, we overestimated the burden for this delivery requirement in the past.[189] The collection of information burden imposed on an adviser relating to the mailing of audited financial statements to each investor in a pool that it manages should be minimal, as the financial statements could be included with account statements or other mailings. We estimate, consistent with the estimate in the proposing release, that the average burden for advisers to mail audited financial statements to investors in the pool is 1 minute per investor.[190] Under our revised estimate of the number of advisers to audited pooled investment vehicles,[191] we estimate that the aggregate annual hour burden in connection with the distribution of audited financial statements is 4,861 hours.[192]

The amended rule requires that an adviser to a pooled investment vehicle that is relying on the annual audit provision must have the pool audited and distribute the audited financial statements to the investors in the pool promptly after completion of the audit if the fund liquidates at a time other than its fiscal year-end. We estimate that 5 percent of pooled investment vehicles are liquidated annually at a time other than their fiscal year-end, which results in an additional burden of 243 hours per year.[193] As a result, the total annual hour burden in connection with the distribution of audited financial statements in connection with annual audit and liquidation audit under the amended rule is estimated to be 5,104 hours.[194]

Notice to clients. The amended rule also requires each adviser, if the adviser sends account statements in addition to those sent by the custodian, to add a legend in its notification to clients upon opening a custodial account on their behalf, and in any subsequent account statements it sends to those clients, urging them to compare the account statements from the qualified custodian to those from the adviser.[195] Although the legend requirement is new, it will be placed in a notification that is currently required to be sent to clients at specified times. We believe that the increase in this collection of information burden, if any, is negligible. We estimate that 80 percent of the 2,986 advisers would be subject to this collection of information,[196] and that each adviser will on average open a new custodial account for 5% of its clients per year, either because the adviser has new clients that request that the adviser open an account on their behalf, or because the adviser selects a new custodian and moves its existing clients' accounts to that custodian. We further estimate that the adviser will spend 10 minutes per client drafting and sending the notice. The total hour burden relating to this requirement is estimated at 41,724 hours per year.[197]

Based on the above estimates, we anticipate that the estimated total information collection burden under amended rule 206(4)–2 would be 67,243 hours.[198] This represents a decrease of 348,060 hours from the currently approved burden,[199] primarily due to our change of methodology in estimating the collection of information with respect to distribution of audited financial statements to investors in pooled investment vehicles.[200]

Annual aggregate cost. The currently approved collection of information for the custody rule includes an aggregate accounting fee of $281,000. Based on the amendments we are adopting today, we estimate a total annual aggregate accounting fee of $122,965,000.[201] The increase in estimated aggregated cost is attributable to an increase in the number of advisers that will be subject to the surprise examination, an increase in the estimated cost for the surprise examination, and the estimated cost for an adviser to obtain, or to receive from its related persons, an internal control report when the adviser or related person serves as qualified custodian for the adviser's clients' assets.

In the Proposing Release, we estimated that advisers subject to the surprise examination would on average pay an accounting fee of $8,100 annually.[202] Many commenters asserted that this estimate was too low.[203] In revising our estimates, we have considered the commenters' estimates,[204] engaged in further discussions with industry participants and accounting firms, including accounting firms that are registered with, and subject to regular inspection by, the PCAOB, and considered the cost implications for the surprise examination of certain aspects of our guidance for accountants that we are issuing today.[205] We now estimate that of the 1,859 advisers subject to the surprise examination requirement, 337 advisers will be subject to the surprise examination with respect to 100 percent of their clients and will each spend an

[188] We estimated that 3,148 advisers to pooled investment vehicles were subject to this information collection under the current rule. We further estimated that each adviser had, on average, 250 investors in the funds it advises, and that each adviser spent 0.5 hours per investor annually for delivering audited financial statements to its 250 investors. $3{,}148 \times 250 \times 0.5 = 393{,}500$.

[189] We previously estimated that an adviser would spend 0.5 hours per investor sending investors audited financial statements. This estimate incorrectly included time for preparation of the audited financial statements, which after the audit should have been readily available to the adviser for distribution.

[190] Proposing Release at n. 94.

[191] Based on IARD data, 2,069 advisers with custody of client assets provided advice to pooled investment vehicles as of November 2, 2009. Of these 2,069 advisers, we estimate that 781 advisers will each on average provide advice to five pooled investment vehicles that have a total of 250 investors. 5 (pools) × 50 (investors) = 250. We estimate that of these 781 advisers, 703 (or 90%) will have their pooled investment vehicles audited and distribute the audited financial statements to the investors in the pool. We further estimate that of the remaining 1,288 advisers, on average, each provides advice to two pooled investment vehicles that have a total of 100 investors. 2 (pools) × 50 (investors) = 100. We estimate that of these 1,288 advisers, 1,159 (or 90%) will have their pooled investment vehicles audited and will distribute the audited financial statements to the investors in the pool.

[192] $[(703 \times 250 \times 1)/60] + [(1{,}159 \times 100 \times 1)/60] = 2{,}929 + 1{,}932 = 4{,}861$.

[193] 4,861 (total burden hours relating to distribution of audited financials) × 0.05 = 243.

[194] 4,861 + 243 = 5,104.

[195] Amended rule 206(4)–2(a)(2).

[196] We understand that advisers having custody solely because of deducting fees do not typically open custodial accounts on behalf of their clients. Excluding those advisers and 703 advisers to audited pooled investment vehicles to which the notice requirement does not apply, we estimate that 2,986 advisers may be subject to this information collection (advisers that answered "yes" to Item 9A. or B. of Part 1A. of Form ADV). *See supra* note 173 and accompanying text. Based on our staff's observation, we further estimate that clients of 80% of these advisers will receive account statements from their advisers in addition to the account statements from the qualified custodian. $[0.8 \times 2{,}986 = 2{,}389]$.

[197] $[(2{,}986 \times 0.8 \times 2{,}096$ (average number of clients for the advisers with custody of client assets) $\times 0.05) \times 10]/60 = 41{,}724$ hours.

[198] 20,415 (surprise examination) + 5,104 (distribution of audited financial statements) + 41,724 (notice to clients) = 67,243.

[199] $415{,}303 - 67{,}243 = 348{,}060$ hours.

[200] *See supra* note 188 and accompanying text.

[201] *See infra* note 211 and accompanying text.

[202] *See* Proposing Release at n.102 and accompanying text.

[203] *See infra* notes 276 to 278 and accompanying text.

[204] We note that commenters based their cost estimates for surprise examinations on the current guidance for accountants, which requires verification of 100% of client assets. We believe that these estimates would have been significantly lower if they had reflected the modernized procedures for the surprise examination described in the guidance for accountants issued in a companion release. *See* Accounting Release.

[205] *Id.*

average of $125,000 annually,[206] 262 medium sized advisers will be subject to the surprise examination requirement with respect to 5% of their clients and will each spend an average of $20,000 annually, and 1,260 small sized advisers will be subject to the surprise examination requirement with respect to 5% of their clients and will each spend an average of $10,000 annually, with an aggregate annual accounting fee of $59,965,000 for all advisers subject to the surprise examination.[207]

We understand that the cost to prepare an internal control report relating to custody will vary based on the size and services offered by the qualified custodian. We estimated in the Proposing Release that, on average, an internal control report would cost approximately $250,000 per year for each adviser subject to the requirement.[208] We estimate that under amended rule 206(4)–2, 252 advisers will be subject to the requirement of obtaining or receiving an internal control report.[209] Therefore the total cost attributable to this requirement will be $63,000,000.[210] The total estimated accounting fee under the amended rule 206(4)–2 is therefore estimated at $122,965,000.[211]

One-time computer system programming costs. As stated above, the amended rule would require an adviser that has an obligation under the rule to provide a notice to clients upon opening a new account on behalf of the client or changes to such account and that sends account statements to its client to include in the account statement a legend urging the client to compare its account statement with those sent by the qualified custodian. We expect that the requirement would cause advisers that are subject to the notice requirement and that send account statements to clients to reprogram their computer system to include the legend in account statements to clients. We estimate that half of the advisers that are subject to the rule or 1,195 advisers will hire a computer programmer to modify their computer system to automatically add the legend to client account statements at an average cost of $1,000 each.[212] We believe the other half routinely use off-the-shelf software to provide client account statements and will bear little or no direct costs because we expect the software vendors will not pass the reprogramming costs on to their customers (*i.e.* the advisers) due to a very low per unit cost. Based on the above estimates, we believe that the total one-time computer system programming cost would be $1,195,000 for the advisers subject to this requirement.[213]

PCAOB registration. For an investment adviser to rely on the provision in amended rule 206(4)–2 that deems pooled investment vehicles to have satisfied the surprise examination requirement if audited financial statements are distributed to investors in the pool, the accountant that audits the pooled investment vehicle's financial statements must be registered with, and subject to regular inspection by, the PCAOB.[214] We acknowledge that not all pooled investment vehicle audits are performed by accountants meeting the PCAOB requirement as this is a new requirement. However, our staff has reviewed several third-party databases that contain the identity of accountants that perform these audits, and substantially all the pools that identified accountants were audited by PCAOB registered and inspected firms or their affiliates.[215] Moreover, a representative of venture capital firms stated that the "vast majority" of venture capital funds are audited and, as far as it could determine, all venture capital fund audits are conducted by PCAOB registered accounting firms that are subject to PCAOB inspection.[216] As a result, we do not believe there will be a substantial dislocation of pooled investment vehicle auditors as a result of the amended rule. For those pools that will have to change accounting firms, we do not believe based on discussions with accountants that there will be additional costs to retain an accounting firm registered with, and subject to inspection by, the PCAOB, as accountants that perform these financial statement audits are likely to be with national accounting firms or accounting firms that specialize in auditing pooled investment vehicles and that charge equivalent fees to accountants registered

[206] As stated in *infra* note 282, we estimate, based on IARD data, that there will be 396 advisers that do not currently use an independent qualified custodian and will be subject to the surprise examination with respect to 100% of their clients. We expect 15% of these advisers will choose to use independent custodians instead of incurring these costs to comply with the rule. $(396 \times 85\%) = 337$.

We note that the costs of reporting to the Commission (i) regarding "material discrepancy" pursuant to amended rule 206(4)–2(a)(4)(ii) and (ii) upon termination of engagement pursuant to amended rule 206(4)–2(a)(4)(iii) are included in the estimated accounting fees.

[207] $(337 \times \$125{,}000) + (262 \times \$20{,}000) + (1{,}260 \times \$10{,}000) = \$42{,}125{,}000 + \$5{,}240{,}000 + \$12{,}600{,}000 = \$59{,}965{,}000$. *See infra* notes 282 to 286 and accompanying text for explanation of the estimated amounts. We also note that we may have overestimated the costs for the surprise examination for advisers that have custody because a related person has custody of client assets in connection with advisory services. As we have indicated, as a result of the exception to the surprise examination requirement under amended rule 206(4)–2(b)(6) for an adviser that has custody because of its related person's custody of client assets and that can overcome the presumption that it is not operationally independent of the related person custodian, some of the 337 advisers may not have to obtain a surprise examination. Those advisers that overcome the presumption may, however, incur outside legal expenses to assist with that determination. *See infra* note 283.

[208] One commenter, the Chamber of Commerce, generally stated that the Commission's estimate of $250,000 was too low, but did not provide alternative data. *See* the Chamber of Commerce Letter. Another commenter, Securities Industry and Financial Markets Association, however, concurred with our cost estimate of $250,000. *See* SIFMA(PCLC) Letter. A third commenter, Managed Funds Association, estimated that the internal control report of a hedge fund adviser would cost approximately $500,000 and over $1 million in some cases. *See* MFA Letter. We understand that advisers to pooled investment vehicles typically do not maintain client assets as qualified custodians and, as a result few advisers to pooled investment vehicles would have to obtain an internal control report. Rather, it is more likely that the internal control report would be for a related person broker-dealer, which costs we believe are accurately reflected in the comment letter sent by the Securities Industry and Financial Markets Association. *See* SIFMA(PCLC) Letter. After further consultation with several accounting firms that have experience in preparing Type II SAS 70 reports, including accounting firms that are registered with the PCAOB, we believe our estimate of $250,000 is reasonable. Moreover, we are not requiring that a specific type of internal control report be provided under the rule as long as the objectives noted above are addressed. This flexibility should permit accountants of qualified custodians to leverage audit work they have performed to satisfy existing regulatory requirements to which these custodians are subject, which may reduce the costs for advisers to comply with the internal control report requirement.

[209] Of the 337 advisers (*see supra* note 206 for this estimate) that will be subject to both the surprise examination and internal control report requirement, we further estimate, based on consultation with several accounting firms, that 10% of these advisers already obtain an internal control report for purposes other than the custody rule. In addition, we believe that some related persons may serve as the qualified custodian for more than one affiliated adviser. We estimate that this will reduce the number of required internal control reports by an additional 15%. *See infra* notes 289 and 290 and accompanying text for explanation of this estimate. $337 - (337 \times 10\%) - (337 \times 15\%) = 337 - 34 - 51 = 252$.

[210] $\$250{,}000 \times 252 = \$63{,}000{,}000$. *See supra* note 207 and *infra* notes 275 to 292 and accompanying text for explanation of our estimate of costs of the internal control report.

[211] $59,965,000 (accounting fee for surprise examination) + $63,000,000 (accounting fee for internal control report) = $122,965,000.

[212] As stated above, we estimated that there will be 2,389 advisers subject to this requirement. *See supra* note 196 and accompanying text. 2,389/2 = 1,195.

[213] $1{,}195 \times \$1{,}000 = \$1{,}195{,}000$. *See infra* note 294 for explanation of the estimate.

[214] Amended rule 206(4)–2(b)(4).

[215] These databases do not distinguish between funds managed by registered advisers from those managed by exempt advisers (who would not be subject to the rule).

[216] NVCA Letter.

with, and subject to inspection by, the PCAOB.[217]

B. Form ADV

In connection with our proposed amendments to Form ADV, we submitted cost and burden estimates of the collection of information requirements to the Office of Management and Budget ("OMB"). We estimated that these amendments would increase the annual information collection burden in connection with Form ADV from 22.25 hours to 22.50 hour for each adviser.[218] The total information collection burden resulting from the amendments would be 3,068 hours.[219] We solicited comment in the Proposing Release on our estimates, but did not receive comments. We do not believe that the amendments to Form ADV we are adopting today will result in a collection of information requirement different than what we estimated in the Proposing Release. Therefore, we are not revising our PRA burden and cost estimates submitted to the OMB with respect to Form ADV.

C. Form ADV–E

The currently approved collection of information for Form ADV–E is 9 hours. We estimate that this collection of information will increase to 112 hours based on the amendments.[220] This increase results primarily from an increase in the estimated number of advisers that will be subject to the requirement of completing Form ADV–E under the amended rule 206(4)–2 and the additional collections of information required by the amendments to the rule.[221]

For the currently approved annual hour burden for Form ADV–E, we estimated that 231 advisers would be subject to the annual surprise examination requirement, including the requirement to complete Form ADV–E, and that each of the advisers would spend approximately 0.05 hour to complete Form ADV–E. We now estimate that 1,859 advisers will be required to undergo an annual surprise examination and complete Form ADV–E, and that the total annual hour burden for Form ADV–E in connection with the surprise examination requirement will therefore increase to 93 hours.[222]

In addition, amended rule 206(4)–2 requires an adviser subject to the surprise examination to enter into a written agreement with the independent public accountant that specifies the accountant's duties, including filing Form ADV–E upon the termination of its engagement. Based on an assumption that advisers change their independent public accountants every five years on average and an estimate that advisers spend approximately 0.05 hours to complete Form ADV–E, advisers will be required each year to complete Form ADV–E with respect to an accountant's termination with an annual burden of 19 hours.[223] The total annual hour burden for advisers to complete Form ADV–E in connection with the surprise examination and the termination statement will be 112 hours.[224]

V. Cost-Benefit Analysis

A. Background

The Commission is sensitive to the costs and benefits resulting from its rules. Rule 206(4)–2, the custody rule, seeks to protect clients' funds and securities in the custody of registered advisers from misuse or misappropriation by requiring advisers to maintain their clients' assets with a qualified custodian, such as a broker-dealer or a bank. The custody rule, as amended, requires all registered advisers that have custody of client assets to have a reasonable belief, formed after due inquiry, that a qualified custodian sends an account statement directly to each advisory client for which the qualified custodian maintains assets.[225] The amended rule also requires advisers that have custody of client assets to undergo an annual surprise examination by an independent public accountant with the exception of advisers that have custody solely because of their authority to deduct advisory fees from client accounts,[226] and advisers that have custody solely because a related person holds the adviser's client assets and the related person is operationally independent of the adviser.[227] In addition, advisers to pooled investment vehicles are deemed to comply with the surprise examination requirement if the pools are subject to an annual financial statement audit by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB, and if the audited financial statements are delivered to the pool's investors.[228]

We are also adopting amendments to the rule to impose additional requirements when advisory client assets are maintained by the adviser itself or by a related person rather than with an independent qualified custodian. The amended rule requires, in addition to the surprise examination discussed above,[229] that the adviser obtain, or receive from its related person, no less frequently than once each calendar year, a written report, which includes an opinion from an independent public accountant with respect to the adviser's or related person's controls relating to custody of client assets, such as a Type II SAS 70 report.[230] The amended rule also requires, in these circumstances, that the independent public accountant issuing the internal control report, as well as the independent public accountant performing the surprise examination, be registered with, and subject to regular inspection by, the PCAOB.[231] The adviser must maintain the internal control report in its records and make it available to the Commission or staff upon request.[232]

Finally, we are adopting several amendments to Form ADV and Form ADV–E. The amendments to Form ADV require registered advisers to report to us more detailed information about their custody practices. The amendments to

[217] Two commenters expressed concerns about costs with respect to the requirement of PCAOB registration for accountants performing surprise examinations and preparing internal control reports for advisers that serve, or have related persons serve, as the qualified custodian for their client assets. *See* Consortium Letter; Chamber of Commerce Letter. These comments, however, were not directed to the costs of engaging PCAOB registered accountants for audits of pooled investment vehicles, and the commenters that did recommend the PCAOB requirement did not indicate there would be increased costs for such a requirement. *See, e.g.,* CPIC Letter, MFA Letter.

[218] *See* the Proposing Release at n.169 and accompanying text. We received no comments on the estimate and we are keeping the estimate unchanged.

[219] *See* the Proposing Release at n.170 and accompanying text. We received no comments on the estimate and we are keeping the estimate unchanged.

[220] We requested comment on our estimates of the collection of information burden relating to Form ADV–E and received no comment.

[221] Form ADV–E is the cover sheet for the required filing with the Commission by the accountant performing the surprise examination pursuant to amended rule 206(4)–2(a)(4)(i) and (iii). The adviser completes Form ADV–E and provides it to the accountant, which results in an estimated hour burden for the advisers.

[222] $1{,}859 \times 0.05 = 93$.

[223] $1{,}859/5 = 372$. $372 \times 0.05 = 19$.

[224] $93 + (372 \times 0.05) = 93 + 19 = 112$.

[225] Amended rule 206(4)–2(a)(3). We have retained the exception from the account statement delivery requirement for certain advisers to pooled investment vehicles. Amended rule 206(4)–2(b)(4).

[226] Amended rule 206(4)–2(b)(3). This exception would also be available to such an adviser when the adviser can rely on amended rule 206(4)–2(b)(6). *See* Section II.C.2. of this Release. The exception would not be available, however, to an adviser that has custody under the rule for other reasons.

[227] Amended rule 206(4)–2(b)(6).

[228] Amended rule 206(4)–2(b)(4).

[229] Amended rule 206(4)–2(a)(6).

[230] Amended rule 206(4)–2(a)(6)(ii). As discussed in the costs section below, other types of reports could also satisfy the internal control report requirement.

[231] Amended rule 206(4)–2(a)(6)(i) and (ii)(C).

[232] Amended rule 204–2(a)(17)(iii).

Form ADV–E require that the form and the accompanying accountant's examination certificate, or statement upon termination, be filed electronically with the Commission through the IARD and conform Form ADV–E instructions to amended rule 206(4)–(2).

In the Proposing Release, we requested comment and empirical data regarding the costs and benefits of the amendments. Most of the 1,300 commenters expressed their support for our goal of strengthening protections provided to advisory clients under the custody rule. One opined that the benefits of the proposed additional safeguards to investors whose assets are held in custodial accounts outweigh the costs to advisers.[233] Many, however, generally expressed concern about the costs, particularly to small advisers, of our proposal as it would have applied to advisers that have custody solely because of their authority to deduct advisory fees from client accounts.[234] As noted above, we have provided an exception from the surprise examination requirement for these advisers. Several commenters provided comments on the costs and benefits in the Proposing Release, which we address below.

B. Benefits

Improved protection for advisory clients. The rule and form amendments we are adopting today are designed to strengthen controls over the custody of client assets by registered investment advisers and to encourage the use of independent custodians. They will also improve our ability to oversee advisers' custody practices and, together with the guidance for independent public accountants that we are issuing, may prevent client assets from being lost, misused, misappropriated or subject to advisers' financial reverses. The benefits to investors are difficult to quantify, and commenters did not submit empirical data on potential benefits. We believe, however, that these benefits will be substantial, including, generally, increased confidence investors will have when obtaining advisory services from registered investment advisers. In addition, we believe the amendments to the rule could, to a limited extent, promote efficiency and capital formation as a result of such increased investor confidence. In particular, increased investor confidence could lead to more efficient allocation of investor assets, which could result in an increase in the assets under management of investment advisers and, depending on how those assets are invested, a potential increase in the availability of capital.

As described above, the amended custody rule requires investment advisers registered with us that have custody of client assets, subject to certain exceptions, to obtain a surprise examination of client assets by an independent public accountant. As a result, advisers that have custody because, for example, they or their related person serves as qualified custodian for client assets, or because they serve as trustee of a client trust or have a power of attorney over client affairs, must undergo an annual surprise examination.[235] The surprise examination requirement should significantly contribute to deterring fraudulent conduct by investment advisers because advisers subject to the surprise examination will know their clients' assets are subject to verification at any time, and therefore may be less likely to engage in misconduct. If fraud does occur, the surprise examination requirement will increase the likelihood that fraudulent conduct will be detected earlier so that client losses will be minimized.[236] The additional review provided by an independent public accountant will also benefit advisory clients because it may help identify problems that clients may not be in the position to uncover through the review of account statements. We estimate that the rule will require 1,859 advisers [237] to obtain an annual surprise examination, and as a result provide the benefits identified above with respect to 956,237 clients.[238]

As amended, rule 206(4)–2 requires, in addition to the surprise examination discussed above, that when an adviser or its related person serves as a qualified custodian for advisory client assets, the adviser obtain, or receive from its related person, no less frequently than once each calendar year, a written report, which includes an opinion from an independent public accountant with respect to the adviser's or related person's controls relating to custody of client assets ("internal control report"), such as a Type II SAS 70 report.[239] The amended rule also requires, in these higher risk situations, that the independent public accountant issuing the internal control report, as well as the independent public accountant performing the surprise examination, be registered with, and subject to regular inspection by, the PCAOB.[240]

The internal control report requirement will provide important benefits to advisory clients by imposing additional safeguards when client assets are maintained with the adviser or a related person. First, the internal control report will indicate whether the qualified custodian (the adviser or its related person) has established appropriate custodial controls by including an accountant's opinion regarding whether the custodian's internal controls are suitably designed and are operating effectively to meet control objectives related to custodial services, including the safeguarding of funds and securities.[241] Second, to satisfy the rule's requirements, the independent public accountant preparing the internal control report must verify that client assets are reconciled to a custodian other than the adviser or its related person, which will serve as a critical check when the custodian is not independent.[242] Third, an internal control report may also significantly strengthen the utility of the surprise examination when the adviser or a related person custodian maintains client assets because the independent public accountant performing the surprise examination may obtain additional comfort that confirmations received from the qualified custodian in the course of the surprise examination are reliable. Clients of approximately 337 advisers will benefit from the protections provided by the internal control report requirement.[243]

As noted above, the amended rule provides a limited exception from the surprise examination requirement in certain circumstances when the adviser

[233] CFA Institute Letter.

[234] Of the 1,300 comment letters, approximately 1,100 were form letters or substantially similar letters submitted by smaller advisory firms that, in part, generally expressed concerns regarding the costs of the proposal as it related to the surprise examination for advisers with custody solely due to authority to withdraw advisory fees.

[235] *See* Section II. B of this Release.

[236] The independent public accountant conducting a surprise examination is required to verify client assets of which an adviser has custody, including those maintained with a qualified custodian and those that are not required to be maintained with a qualified custodian, such as certain privately offered securities and mutual fund shares.

[237] *See supra note* 173 and accompanying text for explanation of this estimate.

[238] [337 (advisers) × 2,315 (average number of clients for advisers subject to the surprise examination)] + (1,522 × 2,315 × 0.05 (percentage of clients whose assets are subject to the surprise examination)) = 780,155 + 176,172 = 956,237.

[239] Amended rule 206(4)–2(a)(6)(ii). As discussed in more detail below, other types of reports could also satisfy the internal control report requirement.

[240] Amended rule 206(4)–2(a)(6)(i) and (ii)(C).

[241] *See* Accounting Release.

[242] Amended rule 206(4)–2(a)(6)(ii)(B).

[243] *See supra* notes 174 and 175 and accompanying text for explanation of the estimated number. Because these advisers serve, or have a related person serve, as the qualified custodian for their client assets, they are subject to the internal control report requirement. Amended rule 206(4)–2(a)(6).

is deemed to have custody solely as a result of a related person having custody.[244] The exception is available to an adviser that is (i) deemed to have custody solely as a result of certain of its related persons holding client assets, and (ii) "operationally independent" of its related person.[245] Advisers that can overcome the presumption that they are not operationally independent of their related person will benefit from the cost savings of not having to obtain a surprise examination under these circumstances.[246] Clients may also benefit from this provision in two respects. First, it may encourage advisers with a choice of related person qualified custodians to use those that are operationally independent over those that are not, which may lower custodial risks to clients. Second, while clients will not have the benefit of the surprise examination under these circumstances, they will benefit from the protections of the internal control report that the adviser must receive from a related person that is a qualified custodian.

When the adviser or its related person serves as qualified custodian for client assets, the surprise examination and internal control report must be performed or prepared by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB.[247] We are also amending rule 206(4)–2 to require that in order to be deemed to comply with the surprise examination requirement, advisers to audited pooled investment vehicles must have the pool's annual audited financial statements prepared by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB and distribute the audited financial statements to the investors in the pool.[248] Advisory clients and pool investors will benefit by having greater confidence in the quality of the surprise examination, the internal control report and pooled investment vehicle audits when performed or prepared by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB. While PCAOB inspection is focused on public company audit engagements, we believe that requiring that the accountant not only be registered with the PCAOB but be subject to its inspection can provide indirect benefits regarding the quality of the accountant's other engagements.

The amendments also eliminate the alternative, currently provided in the rule, under which an adviser with custody can send its own account statements to clients if the adviser is subject to an annual surprise examination. Instead, all advisers with custody are required to have a reasonable belief, after due inquiry, that the qualified custodian sends account statements directly to clients. As a result, we expect that clients of approximately 190 advisory firms that currently send their own account statements to clients will, under the amended rule, receive account statements directly from qualified custodians.[249] Where the qualified custodian is independent, this change provides advisory clients confidence that erroneous or unauthorized transactions will be reflected in the account statement. As a result, this change may deter advisers from engaging in fraudulent activities and allow clients to detect any unauthorized activity in their accounts promptly, thereby averting or reducing losses. Clients of these 190 advisers will benefit from this amendment and will start receiving account statements directly from qualified custodians.

The amended rule requires advisers to include a legend in the notice that they are currently required to send to their clients upon opening a custodial account on their clients' behalf if the adviser sends its own account statements to clients and in any subsequent account statements it sends to clients.[250] The legend will urge clients to compare the account statements they receive from the custodian with those they receive from the adviser. As discussed above, client review of periodic account statements from the qualified custodian is an important measure that can enable clients to discover improper account transactions or other fraudulent activity. Raising clients' awareness of this safeguard under the custody rule at account opening and with each subsequent account statement sent by the adviser may cause clients to uncover any unauthorized transactions by their advisers in their accounts more promptly, thereby averting or reducing losses. We estimate that 250,367 clients would receive notices and subsequent account statements containing this additional information.[251]

Under the amended rule, each adviser that is required to undergo an annual surprise examination must enter into a written agreement with an independent public accountant to perform the surprise examination. The written agreement will require the independent public accountant to, among other things, (i) file Form ADV–E accompanied by a certificate within 120 days of the time chosen by the accountant for the surprise examination stating that it has examined the client assets and describing the nature and extent of the examination, (ii) report to the Commission any material discrepancies discovered in the examination within one business day, and (iii) upon the accountant's termination or dismissal, or removal from consideration for reappointment, file Form ADV–E within 4 business days accompanied by a statement explaining any problems relating to examination scope or procedure that contributed to the resignation, dismissal, removal, or other termination. These filings and reports will provide our staff additional information to assist in establishing advisers' risk profiles for purposes of prioritizing examinations. The rule will result in the electronic filing of Form ADV–E and the accountant statement on the IARD system.[252] Clients will benefit from electronic filing of the Form ADV–E because it will allow them to easily access important information about the surprise examinations performed on their advisers. We estimate that 4,303,585 advisory clients will benefit from the amendment.[253] Furthermore, the availability to the general public of Form ADV–E information on the Commission's web site may result in additional benefits, including deterring misconduct before it occurs and providing additional information for

[244] Rule 206(4)–2(b)(6).

[245] *Id.*

[246] We have estimated that each of these surprise examinations would cost an adviser $125,000. *See infra* notes 282—283 and accompanying text.

[247] Amended rule 206(4)–2(a)(6)(i) and (ii)(C).

[248] Amended rule 206(4)–2(b)(4).

[249] Based on ADV–E filings, there were 190 advisers that underwent surprise examinations during 2008.

[250] Amended rule 206(4)–2(a)(2).

[251] We estimated that approximately 2,986 advisers open accounts on behalf of their clients. Based on our staff's observation, we further estimate that 80% of these advisers send account statements to their clients. (2,986 × 0.8 = 2,389). We estimate that each year these 2,389 advisers on average open accounts for about 5% of their 2,096 clients (average number of clients of the advisers with custody of client assets) who are either new clients or whose accounts have been transferred to new qualified custodians and that these advisers also send their own account statements to clients. (2,389 × (2,096 × 0.05) = 250,367).

[252] Until the IARD system is upgraded to accept Form ADV–E, accountants performing surprise examinations should continue paper filing of Form ADV–E. Investment advisers will be notified as soon as the IARD system can accept filings of Form ADV–E.

[253] 1,859 × 2,315 (average number of clients of the advisers subject to the surprise examination) = 4,303,585.

clients to consider when deciding which investment adviser to select.

We are adopting the amendments to Item 7 and Section 7.A. of Schedule D that we proposed to require each adviser to report *all* related persons who are broker-dealers and to identify which, if any, serve as qualified custodians with respect to the adviser's clients' funds or securities.[254] We are also amending Item 9 to require advisers that have custody (or whose related persons have custody) of client assets to provide additional information about their custodial practices under the custody rule. In addition, the revised Schedule D of Form ADV requires an adviser to provide additional details including information about the independent public accountants that perform annual audits, surprise examinations or that prepare internal control reports,[255] whether a report prepared by an independent public accountant contains an unqualified opinion,[256] and about any related person that serves as a qualified custodian for the adviser's clients.[257] We also are amending Schedule D to require an adviser to report whether it has determined that it has overcome the presumption that it is not operationally independent from a related person qualified custodian, and thus is not required to obtain a surprise examination for the clients' assets maintained at that custodian. These disclosures will provide our staff more information to determine advisers' risk profiles and prepare for examinations. Moreover, this information will be filed electronically when IARD accepts these filings, and as a result the information will be available to the public through the Commission's Web site. Clients will benefit directly from these amendments by obtaining more information about their advisers' custodial practices. They may also benefit indirectly because advisers will be incentivized to implement strong controls and practices to avoid receiving a qualified opinion from an independent public accountant.

Finally, under the amended rule, an adviser to pooled investment vehicles that is deemed to comply with the surprise examination requirement and that is excepted from the account statement delivery requirement by having the pooled investment vehicle audited and distributing the audited financial statements to the investors must, in addition to obtaining an annual audit, obtain a final audit of the fund's financial statements upon liquidation of the fund and distribute the financial statements to fund investors promptly after the completion of the audit.[258] This amendment provides fund investors the information necessary to protect their rights and to make sure that the proceeds of the liquidation are appropriately accounted for.

Improved clarity of the rule. We anticipate that investment advisers will find it easier to understand and comply with the rule as a result of the amendments, which may result in cost savings for advisers. The amendments will improve the clarity of the rule by adding several definitions, including amending the definition of "custody" to address related person custodian situations, and adding definitions of "control" and "related person."[259]

C. Costs

Surprise Examination. As noted above, the amended rule we are adopting today excludes certain advisers with custody from the requirement to undergo an annual surprise examination and deems certain others to comply with the requirement.[260] Advisers that have custody for other reasons, however, such as because they or their related person serves as the qualified custodian for client assets, or because they serve as the trustee of a client trust, must undergo an annual surprise examination.[261] As a result, we now estimate that 1,859 advisers will be subject to the surprise examination requirement under amended rule 206(4)–2.[262] Reducing that number by the 190 advisers that already undergo an annual surprise examination under the current rule,[263] we estimate that the amendments will result in approximately 1,669 additional advisers being required to obtain a surprise examination.[264]

For purposes of the PRA analysis, we estimate that the total annual collection of information burden in connection with the surprise examination, before including the hours spent on conforming written agreements with accountants to the amended rule, will be 19,950 hours.[265] Based on this estimate, we anticipate that advisers will incur an aggregate cost of approximately $1,256,850 per year for these estimated hours.[266]

Written agreement. As proposed, amended rule 206(4)–2 requires that an adviser subject to the surprise examination requirement must enter into a written agreement with the independent public accountant engaged to conduct the surprise examination and specify certain duties to be performed by the independent public accountant.[267] As stated in the Proposing Release, we believe that written agreements are commonplace and reflect industry practice when a person retains the services of a professional such as an independent public accountant, and they are typically prepared by the accountant in advance. Because the amended rule applies to investment advisers (and not accountants) we believe that the burden to add the provisions to the written agreement will be borne by the adviser. We estimate that each adviser will spend 0.25 hour to add the required provisions to the written agreement, with an aggregate of 465 hours for all advisers subject to surprise examinations.[268] Requiring certain additional items to be included in the written agreement will not significantly increase costs for advisers.[269] Moreover,

[254] The item had required an adviser to identify on Schedule D of Form ADV each related person that is an investment adviser, but made reporting of the names of related person broker-dealers optional.

[255] Section 9.C. of Schedule D of Form ADV.

[256] *Id.*

[257] Section 9.D of Schedule D of Form ADV.

[258] Amended rule 206(4)–2(b)(4)(iii).

[259] Amended rule 206(4)–2(d).

[260] Amended rule 206(4)–2(b)(3) (exception from surprise examination for advisers that have custody because they have authority to deduct fee from client accounts); amended rule 206(4)–2(b)(6) (exception from surprise examination for advisers that have custody solely because a related person holds the adviser's client assets and the related person is operationally independent of the adviser); and amended rule 206(4)–2(b)(4) (deemed compliance with the surprise examination requirement for advisers to audited pooled investment vehicles that distribute audited financial statements to pool investors if the audit was conducted by an independent public accountant registered with, and subject to regular inspection by, the PCAOB).

[261] Under amended rule 206(4)–2 an adviser has custody if its related person has custody of its client assets. Amended rule 206(4)–2(d)(2). A related person is defined as a person directly or indirectly controlling or controlled by the adviser, and any person under common control with the adviser. Amended rule 206(4)–2(d)(7).

[262] *See supra* note 173.

[263] *See supra* note 249.

[264] $1,859 - 190 = 1,669$.

[265] *See supra* note 184 accompanying text for explanation of the estimate.

[266] We expect that the function of providing lists of clients to the independent public accountant in assisting its examination, totaling 19,950 hours, would be performed by compliance clerks. Data from the *Securities Industry and Financial Markets Association's Office Salaries in the Securities Industry 2008,* modified by Commission staff to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead, suggest that cost for this position is $63 per hour. Therefore the total costs would be $1,256,850.

[267] Amended rule 206(4)–2(a)(4).

[268] $1,859 \times 0.25 = 465$.

[269] We estimate that it will take each adviser about 0.25 hour to add the required specifications. *See supra* note 186 and accompanying text. Converting the hour burden to costs, each adviser would spend $64.50. *See infra* note 271.

we do not believe that the new requirements placed on the independent public accountant by the written agreement (electronic filing of Form ADV–E and termination statement) will materially increase the accounting fees for the surprise examination discussed above.

For purposes of the PRA analysis, we estimate a total annual collection of information burden in connection with the surprise examination of 20,415 hours.[270] Based on this estimate, we anticipate that advisers will incur an aggregate cost of approximately $1,376,820 per year for the total hours their employees spend in complying with the surprise examination requirement.[271]

In the Proposing Release, we estimated that there would have been 9,575 advisers subject to the surprise examination and they would each pay, on average, an annual accounting fee of $8,100 for the surprise examination.[272] The estimated total accounting fees for all surprise examinations would therefore have been $77,557,500.[273] As explained above, the amended rule excepts from the surprise examination requirement, advisers that have custody because of deducting advisory fees, and advisers that have custody solely because a related person holds the adviser's client assets and the related person is operationally independent of the adviser, and it deems advisers to audited pooled investment vehicles to comply with the requirement under certain circumstances,[274] reducing our estimated number of advisers subject to the surprise examination requirement from 9,575 to 1,859.[275]

Several commenters believed that our cost estimates for surprise examination accounting fees were too low.[276] Some of them provided their own estimates ranging from an amount close to our estimate (for smaller advisers),[277] to over one million dollars for the largest firms.[278] We believe that the costs of the surprise examination are lower than the costs suggested by commenters because commenters' estimates were based on two critical assumptions that no longer are valid. First, these estimates were generally based on an understanding that the examination would involve verifying 100% of client assets, as is currently required under our existing guidance for accountants.[279] The revised guidance for accountants we are issuing, however, among other things, permits accountants to use sampling in the course of the surprise examination.[280] Second, many of these estimates are based on an assumption that an adviser would have custody of all of its clients' accounts based on our proposal to require the surprise examination if an adviser had custody because of the authority to deduct advisory fees directly from client accounts. The rule now provides an exception from the surprise examination when fee deduction is the reason the adviser has custody. As a result, many advisers that have custody under the amended rule will have custody with respect to a limited number of client accounts, and the scope of work for the accountant performing the surprise examination will be significantly reduced.

While, for reasons discussed above, we believe commenters' estimates of the cost of surprise examination are too high, they have caused us to reexamine our cost estimates and to determine that it would be more appropriate to categorize advisers into subcategories to estimate surprise exam costs. Instead of a single average cost, we have divided the 1,859 advisers that are subject to the surprise examination requirement into three distinct groups.[281] We now estimate that 337 advisers either serve as qualified custodian for their clients or have a related person that serves as qualified custodian.[282] These advisers would likely be subject to the surprise examination with respect to 100 percent of their clients, and as these advisers typically are large advisers with many clients, we estimate they will each spend an average of $125,000 annually.[283] We estimate that the rest of the advisers will be subject to surprise examination with respect to 5 percent of

[270] This estimated number includes the hours an adviser spends on providing client lists to the accountant performing the surprise examination and meeting the rule's requirements for the written agreement with the accountant regarding its engagement to perform the surprise examination. 15,603 hours (advisers subject to the surprise exam for 100% of clients to provide client lists) + 3,051 (advisers subject to the surprise exam for advisers with custody of a small portion of their clients to provide client lists) + 1,296 (advisers to pooled investment vehicles that are subject to the surprise examination to provide investor lists) + 465 (written agreement with accountants) = 20,415.

[271] As we stated above, the total estimated burden hours related to the surprise examination requirement, before including the hours for written agreement with the accountant, are 19,950 hours with an estimated costs of $1,256,850. *See supra* note 184 for explanation of the estimated hours and *supra* note 266 for explanation of estimated cost. We expect that the function of adding certain duties of the accountant to the written agreement with the accountant, totaling 465 hours, would be performed by compliance managers. Data from the *Securities Industry and Financial Markets Association's Management & Professional Earnings in the Securities Industry 2008,* modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead, suggest that the cost for this position is $258 per hour. Therefore the total costs would be $1,376,820 ((19,950 × $63) + (465 × $258) = $1,376,820).

[272] *See* Proposing Release at n.102 and accompanying text.

[273] 9,575 × $8,100 = $77,557,500.

[274] *See* Section II.C.2. of this Release.

[275] *See supra* notes 170 to 173 and accompanying text.

[276] *See, e.g.,* FPA Letter (estimated costs of $15,000 to $24,000), IAA Letter (estimated costs of $20,000 to $300,000).

[277] CFP Board Letter (estimating cost of surprise examination from $5,000 to $10,000).

[278] SIFMA(PCLC) Letter (member survey indicated average cost estimate of $200,000 with one response of over $1,000,000).

[279] *See* ASR No. 103.

[280] *See* Accounting Release.

[281] The revised estimated costs are based on the experience of our staff and discussions with public accounting firms regarding the surprise examination requirement, modern accounting practices, and commenters' estimates.

[282] Based on IARD data, we estimated 396 advisers either serve as qualified custodian for their clients or have a related person that serves as qualified custodian. These advisers would likely be subject to the surprise examination with respect to 100 percent of their clients. We expect 15% of these advisers will use independent custodians instead of incurring these costs. This estimate is based on comments that we received about the high costs of the proposed requirements with respect to advisers using a related person as the qualified custodian. We believe that these advisers will do their own analysis of the benefits of continuing using their related persons as qualified custodians. Some of the advisers that maintain client assets with their related person custodians on an incidental basis may decide to use independent qualified custodians instead to avoid the costs of complying with the requirements. (396 × 85%) = 337.

[283] Several of these large advisers are advisers with thousands of client accounts, while others have significantly fewer client accounts. The largest advisers will likely incur expenses higher than $125,000. Whereas those with significantly fewer client accounts will likely incur expenses less than $125,000. Moreover, as a result of the exception to the surprise examination requirement under amended rule 206(4)–2(b)(6) for an adviser that has custody because of its related person's custody of client assets and that can overcome the presumption that it is not operationally independent of the related person custodian, some of these 337 advisers would not have to obtain the surprise examination. We do not have data or another resource to provide an estimate of the number of advisers that use related person custodians that will be able to overcome the presumption. As a result, we are unable to estimate with specificity the reduced costs due to this exception. We do estimate that of the 337 advisers subject to the surprise examination, that 259 (after the 15% reduction noted above) use related person qualified custodians. *See supra* note 175. If 75% of the 259 of these advisers could overcome the presumption, the cost estimates for the surprise examination would be overstated by $24,281,250 ((259 × .75) × $125,000), if one half of them could overcome the presumption the costs would be overstated by $16,187,500 ((259 × .5) × $125,000), or if one quarter of them could overcome the presumption the costs would be overstated by $8,093,750 ((259 × .25) × $125,000). Those advisers that overcome the presumption may, however, incur outside legal expenses to assist with the determination. We estimate that on average, such legal assistance would cost an adviser between $4,000 (for 10 hours) and $16,000 (for 40 hours), significantly less than the estimated costs for the surprise examination. The hourly cost estimate of $400 on average is based on our consultation with advisers and law advisers who regularly assist them in legal and compliance matters.

their client accounts.[284] We have divided these 1,522 advisers into two groups based on their number of clients: 262 medium-sized advisers and 1,260 small-sized advisers.[285] We estimate that medium-sized advisers will on average have accounting fees of $20,000 annually and small-sized advisers will on average have accounting fees of $10,000 annually for the surprise examination. Therefore the aggregate account fee relating to the surprise examination is estimated at $59,965,000.[286]

Internal Control Report. Under amended rule 206(4)–2, if an adviser or a related person serves as a qualified custodian for client assets in connection with advisory services the adviser provides to clients, the adviser must obtain, or receive from the related person, no less frequently than once each calendar year, a written report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the PCAOB. We estimate that approximately 337 investment advisers must obtain, or receive from a related person, an internal control report relating to custodial services.[287] One securities industry commenter noted that custodians often already provide Type II SAS 70 reports to clients who demand a rigorous evaluation of internal control as a condition of obtaining their business.[288] We estimate that 10% of the advisers that must obtain or receive an internal control report will themselves or their related person qualified custodian will already obtain an internal control report for purposes other than the custody rule.[289] In addition, a single internal control report will satisfy the rule's requirement for several related advisers if their clients use the same related person as qualified custodian. We estimate that this will reduce the number of required internal control reports by an additional 15%.[290] As a result, we estimate that independent public accountants will prepare 252 internal control reports as a result of the rule amendments. Based on discussions with accounting professionals, we understand that the cost to prepare an internal control report relating to custody will vary based on the size and services offered by the qualified custodian, but that on average an internal control report will cost approximately $250,000 per year,[291] for total costs attributable to this section of the proposed rule to be $63,000,000.[292] These advisers also will need to maintain the report as a required record. We anticipate that the cost of maintaining these records will be minimal.

Although the amended rule does not require use of an independent custodian, we encourage the use of custodians independent of the adviser to maintain client assets as a best practice whenever feasible. As a result of the amendments and our encouragement, there may be effects on competition if additional advisers (and clients) begin using independent custodians, which is a common practice of many advisers today, particularly among those that are not themselves, or affiliated with, large financial service firms.

The total cost estimate above may overestimate actual costs incurred for internal control reports because of the factors discussed below. Accountants preparing an internal control report may incorporate relevant audit work performed for other purposes, including audit work performed to meet existing regulatory requirements, which should increase efficiencies in the audit process. These efficiencies are not represented in the estimated costs as the estimates are based on a custodian entering a new engagement for an internal control report. And any report that meets the objectives of the internal control report would be acceptable under the rule. In addition to the Type II SAS 70 report, other reports a qualified custodian already obtains could satisfy the rule's requirements. For instance, a report issued in connection with an attestation conducted in accordance with AT 601 under the standard of the AICPA would be sufficient, provided that such examination meets the objectives set forth in our guidance for accountants.

One-time computer system programming costs. As stated above, the amended rule would require an adviser that has obligation under the rule to provide a notice to clients upon opening a new account on behalf of the client or changes to such account and that sends account statements to its client to include in the account statement a legend urging the clients to compare its account statement with those sent by the qualified custodian. We expect that the requirement would cause advisers that are subject to the notice requirement and that send account statement to clients to reprogram their computer system to include the legend in account statements to clients. We estimate that half of the advisers that are subject to the rule or 1,195 advisers will hire a computer programmer to modify their computer system to automatically add the legend to client account statements at an average cost of $1,000 each.[293] We believe the other half routinely use off-the-shelf software to provide client account statements and will bear little or no direct costs because we expect the software vendors will not pass the reprogramming costs on to their customers (*i.e.* the advisers) due to a very low per unit cost. Based on the above estimates, we believe that the total one-time computer system programming cost would be $1,195,000 for the advisers subject to this requirement.[294]

PCAOB registration. For an investment adviser to rely on the provision in amended rule 206(4)–2 that deems pooled investment vehicles to have satisfied the surprise examination requirement if audited financial statements are distributed to investors in the pool, the accountant that audits the pooled investment vehicle's financial statements must be registered with, and subject to regular inspection

[284] Advisers are required to undergo an annual surprise examination with respect to only those client accounts to which they have access that causes them to have custody, including through a power of attorney, acting as trustee, or similar legal authority. Based on the experience of our staff, we estimate that on average, only 5 percent of client accounts of these advisers will be subject to the surprise examination.

[285] Based on responses to Item 5.C of Form ADV, we estimate that the average number of clients for these 1,522 advisers is 806. We determined, for purposes of this analysis, that an adviser with clients more than this average number is a medium size adviser and an adviser with clients less than this average number is a small adviser. 337 + 262 + 1,260 = 1,859.

[286] (337 × $125,000) + (262 × $20,000) + (1,260 × $10,000) = $42,125,000 + $5,240,000 + $12,600,000 = $59,965,000.

[287] *See supra* notes 276–278 for explanation of this estimate.

[288] SIFMA(AMG) Letter.

[289] Our estimate of 10% is based on our consultation with accounting firms that have experience in preparing internal control reports. 337 × 10% = 34.

[290] Our estimate of 15% is based on the IARD data. 337 × 15% = 51.

[291] *See supra* note 208 and accompanying text for explanation of this estimate.

[292] $250,000 × (337 − 34 − 51) = $250,000 × 252 = $63,000,000.

[293] As stated above, we estimated that there will be 2,389 advisers subject to this requirement. *See supra* note 196 and accompanying text. 2,389/2 = 1,195.

[294] 1,195 × $1,000 = $1,195,000. Data from the *Securities Industry and Financial Markets Association's Management & Professional Earnings in the Securities Industry 2008,* modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead, suggest that the cost for this position is $193 per hour. We further estimate that such reprogramming will take about 5 hours for each adviser. $193 × 5 hours = $965. Based on the above, we estimate that each adviser will spend approximately $1,000 as reprogramming costs.

by, the PCAOB.[295] We acknowledge that not all pooled investment vehicle audits are performed by accountants meeting the PCAOB requirement as this is a new requirement. However, our staff has reviewed several third-party databases that contain the identity of accountants that perform these audits, and substantially all the pools that identified accountants were audited by PCAOB registered and inspected firms or their affiliates.[296] Moreover, a representative of venture capital firms stated that the "vast majority" of venture capital funds are audited and, as far as it could determine, all venture capital fund audits are conducted by PCAOB registered accounting firms that are subject to PCAOB inspection.[297] As a result, we do not believe there will be a substantial dislocation of pooled investment vehicle auditors as a result of the amended rule. For those pools that will have to change accounting firms, we do not believe based on discussions with accountants that there will be additional costs to retain an accounting firm registered with, and subject to inspection by, the PCAOB, as accountants that perform these financial statement audits are likely to be with national accounting firms or accounting firms that specialize in auditing pooled investment vehicles and that charge equivalent fees to accountants registered with, and subject to inspection by, the PCAOB.[298]

Liquidation Audit. The amended rule specifically requires an adviser to a pooled investment vehicle that is relying on the annual audit provision to obtain a final audit if the pool is liquidated at a time other than the end of a fiscal year.[299] This requirement will assure that the proceeds of the liquidation are appropriately accounted for. We believe this requirement will not materially increase the costs for advisers to pooled investment vehicles because we believe most of these pooled investment vehicles are subject to contractual obligations with their investors to obtain a liquidation audit.[300] For purposes of PRA analysis, we estimate that advisers will spend 243 hours complying with the requirement[301] and thus will incur an aggregate cost of $15,309 for all advisers subject to the requirement.[302]

Qualified Custodian Account Statements. With the exception of advisers to certain pooled investment vehicles that distribute audited financial statements, the amended rule requires all registered advisers that have custody of client assets to have a reasonable belief, after due inquiry, that the qualified custodian sends account statements directly to their clients at least quarterly. We believe few advisers will have to change their practices to meet the requirement that all clients receive account statements directly from qualified custodians. Most advisers subject to the rule have qualified custodians that deliver account statements directly to clients and already conduct an inquiry of whether the qualified custodian sends account statements to clients.[303] For those advisers that previously had sent account statements directly to clients instead of having the qualified custodian send account statements to clients, the costs should not be significant because qualified custodians send account statements to clients in their normal course of business. The requirement that advisers form their reasonable belief after due inquiry similarly should not have significant costs, as we understand that today most advisers receive duplicate copies of client account statements from custodians.

Based on the above analysis, we conclude that the aggregate annual accounting fee to comply with the surprise examination requirement and the internal control report requirement under amended rule 206(4)–2 is estimated at $122,965,000. In addition, we estimate that the total hours spent by advisory employees to comply with the amendments[304] will be 29,003 at a total cost of $1,917,864[305] The total cost estimated for complying with amendments to 206(4)–2 is estimated at $126,077,864.[306]

Form ADV. We are adopting substantially as proposed several amendments to Part 1A of Form ADV that are designed to provide us with additional details regarding the custody practices of advisers registered with the Commission, and to provide additional data to assist in our risk-based examination program. For purposes of the PRA analysis, we estimated that these amendments will increase the annual information collection burden in connection with Form ADV from 22.25 hours to 22.50 hours for each adviser.[307] The total information collection burden resulting from the amendments would be 3,068 hours.[308] Based on this estimate, we anticipate that advisers will incur an aggregate cost of approximately $193,284 per year for the total hours their employees spend in connection with the amendments to Form ADV.[309]

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[295] Amended rule 206(4)–2(b)(4).

[296] These databases do not distinguish between funds managed by registered advisers from those managed by exempt advisers (who would not be subject to the rule).

[297] NVCA Letter.

[298] Two commenters expressed concerns about costs with respect to the requirement of PCAOB registration for accountants performing surprise examinations and preparing internal control reports for advisers that serve, or have related person serve, as the qualified custodian for their client assets. *See* Consortium Letter; Chamber of Commerce Letter. These comments, however, were not directed to the costs of engaging PCAOB registered accountants for audits of pooled investment vehicles, and the commenters that did recommend the PCAOB requirement did not indicate there would be increased costs for such a requirement. *See, e.g.,* CPIC Letter, MFA Letter.

[299] Amended rule 206(4)–2(b)(4)(iii).

[300] As discussed above, amended rule 206(4)–2(c) provides that an adviser's sending an account statement (paragraph (a)(5)) or distributing audited financial statements (paragraph (b)(4)) will not meet the requirements of the rule if all of the investors in a pooled investment vehicle to which the statements are sent are themselves pooled investment vehicles that are related persons of the adviser. We do not believe this requirement will impose new costs on advisers under the rule because the application of the rule as required by this new provision was incorporated into our prior cost estimates.

[301] *See supra* note 193 and accompanying text.

[302] 243 × $63 (hourly wage) = $15,309. *See supra* note 266 for explanation of advisory employee wage estimate.

[303] Filing data indicates that 190 advisers (other than those that have custody but only have pooled investment vehicle clients that are subject to an annual audit) did not have the qualified custodian send account statements directly to their clients.

[304] The total hours include time spent to produce client contact lists for the accountant performing the surprise examination, add required language in a written agreement with the accountant engaged to perform the surprise examination, prepare a required legend in notices and subsequent statements to clients urging them to compare information contained in the account statements sent by the adviser with those sent by the qualified custodian, and distribute audited financial statements, including those related to liquidation audit, to fund investors. *See* Section IV of this Release for explanation of the estimates.

[305] *See supra* notes 270 and 271 and accompanying text for explanation of these estimates. [(19,950 (employee hours for surprise examination) + 243 (employee hours for distributing audited financials related to liquidation audit) + 8,345 (employee hours for adding a legend in the notice to clients)) × $63] + (465 (employee hours for adding language in written agreements) × $258) = $1,797,894 + $119,970 = $1,917,864.

We estimated that advisory employees will spend a total of 41,724 hours to comply with the notice requirement. The estimated 8,345 hours noted above for adding the legend to the required notice represents 20% of the total hour burden relating to the notice, which is 41,724 hours. (41,724 × 0.2) = 8,345. *See supra* note 197 for explanation of the estimate.

[306] ($122,965,000 (aggregate accounting fees) + $1,917,864 (costs of hours advisory employees spent) + $1,195,000 (cost of one-time computer system programming) = $126,077,864).

[307] *See supra* note 218 and accompanying text.

[308] *See supra* note 219 and accompanying text. We received no comments on the estimate and we are keeping the estimate unchanged.

[309] We expect that the function of completing Form ADV would be performed by compliance clerks at a cost of $63 per hour. The total cost would be $193,284 (3,068 × $63 = $193,284). *See supra* note 266 for explanation of the hourly compliance clerk cost estimate.

Form ADV–E. For purposes of the PRA analysis, we estimate that the collection of information in connection with Form ADV–E will increase from the currently approved 9 hours to 112 hours based on the requirements of the amended rule. This increase results from an increase in the estimated number of advisers that will be subject to the requirement of completing Form ADV–E under the amendments to rule 206(4)–2 and the additional collections of information required by the amendments relating to completing Form ADV–E when an independent public accountant performing the surprise examination terminates its engagement. This represents an increase of 103 hours [310] with an estimated aggregated annual cost of approximately $7,056.[311]

We recognize that there also might be certain costs to investment advisers, advisory clients and others that are not easily quantifiable. For instance, some advisers may choose to only use independent qualified custodians, and as a result, they may lose advisory clients if those clients insist on maintaining their assets with a particular custodian that happens to be a related person of the adviser. Advisory clients that are unwilling to change custodians also may lose the ability to hire an adviser that is related to the custodian if the adviser will only accept clients that use independent custodians. Advisers that chose to only use independent qualified custodians might also lose efficiencies that resulted from self-custody or related person custody arrangements, which could result in increased costs to advisory clients. Additionally, to the extent that advisers discontinue existing relationships with custodians, accountants or other service providers as a result of, or as required by, the amended rule, these service providers may lose revenues and incur other costs.

Based on the above analysis, we estimate that the aggregate costs for complying with the amendments to rule 206(4)–2, rule 204–2, Form ADV, and Form ADV–E will be $126,278,204.[312] Of this amount, we estimate that $1,195,000 is one-time computer system programming costs related to account statement legends, while the remainder will be recurred on an annual basis.

VI. Final Regulatory Flexibility Analysis

The Commission has prepared the following Final Regulatory Flexibility Analysis regarding rule 206(4)–2 in accordance with section 3(a) of the Regulatory Flexibility Act.[313] We prepared an Initial Regulatory Flexibility Analysis ("IRFA") in conjunction with the Proposing Release in May 2009. A summary of that IRFA was published with the Proposing Release.[314]

A. Need for the Rule

Rule 206(4)–2, the custody rule, requires registered advisers to maintain their clients' assets with a qualified custodian, such as a broker-dealer or a bank. To enhance the protections afforded to clients' assets, we are adopting amendments to the rule to require all registered advisers that have custody of client assets, among other things: (i) To undergo an annual surprise examination by an independent public accountant to verify client assets; (ii) to have a reasonable basis, after due inquiry, for believing that the qualified custodian maintaining client funds and securities sends account statements directly to the advisory clients; and (iii) unless client assets are maintained by an independent custodian (*i.e.,* a custodian that is not the adviser itself or a related person) to obtain, or receive from a related person, a report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the PCAOB.

We have designed the amendments to enhance the protections afforded to clients when their advisers have custody of client assets. We believe that the surprise examination requirement will deter fraudulent activities by advisers. Moreover, an independent public accountant may identify misuse that clients have not, which would result in the earlier detection of fraudulent activities and reduce resulting client losses.

The amendments adopted today provide that an adviser is deemed to have custody of client assets held by related persons. Related person custody arrangements can present higher risks to advisory clients than those that maintain assets with an independent custodian. We were concerned that the surprise examination alone would not adequately address custodial risks associated with self or related person custody because the independent public accountant seeking to verify client assets would rely on custodial reports issued by the adviser or the related person. To address these risks, we are adopting a requirement that a registered adviser obtain, or receive from its related person, an annual internal control report, which would include an opinion from an independent public accountant with respect to the adviser's or related person's custody controls.

B. Significant Issues Raised by Public Comment

In the Proposing Release, we requested comment on the IRFA. We received a number of comments related to the impact of our proposal on small advisers. They argued that the proposed amendments to the rule, particularly those that would have imposed the surprise examination requirement on advisers that have custody solely because of their authority to deduct advisory fees, would be disproportionately expensive for, and would impose an undue regulatory burden on, smaller firms.[315]

We are sensitive to the burdens our rule amendments will have on small advisers. We believe that the amendments to the custody rule we are adopting today will alleviate many of the commenters' concerns regarding small advisers. In particular, as described above, we have provided an exception from the surprise examination requirement for advisers who have custody because they have authority to deduct advisory fees from client accounts. Moreover, for small advisers still subject to the surprise examination requirement, the revised guidance for accountants modernizes the procedures for surprise examinations, which may reduce the burden on small advisers.[316]

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

[310] 112 − 9 = 103. We received no comments on this estimate.

[311] We expect that the function of completing Form ADV–E would be performed by compliance clerks at a cost of $63 per hour. The total cost would therefore be $7,056 (112 × $63 = $7,056). *See supra* note 266 for explanation of the hourly compliance clerk cost estimate.

[312] $126,077,864 (total costs for complying amendments to rule 206(4)–2) + $193,284 (total costs for complying with amendments to Form ADV) + $7,056 (total costs for complying with amendments to Form ADV–E) = $126,278,204.

[313] 5 U.S.C. 605(b).

[314] *See* Proposing Release at Section VI.

[315] Mallon P.C. Letter (asserting that the requirement would cost 10 percent of smaller firms' gross income). *See also* CAS Letter; Consortium Letter; Cornell Letter; Form Letter D; FSI Letter; IAA Letter; NAPFA Letter; FPA Letter; Denk Letter. Some commenters argued that, at a minimum, it would force most small advisers to eliminate a convenient billing method chosen by many of their clients. ASG Letter; Cornell Letter; Form Letters C and D; FSI Letter; MarketCounsel Letter. Others urged us to consider that this proposal would likely drive many small advisers out of business, and would create a barrier to entry for others. Ameritrade Letter; IASBDA Letter; NAPFA Letter.

[316] *See* Accounting Release.

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.[317]

The Commission estimates that as of November 2, 2009 approximately 73 SEC-registered investment advisers that have custody of client assets were small entities that will be subject to the surprise examination requirement under amended rule 206(4)–2(a)(4), and that no more than eight small entity advisers that have custody of client assets will be subject to the requirement of obtaining or receiving an internal control report under amended rule 206(4)–2(a)(6).[318]

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

The rule amendments impose certain reporting, recordkeeping and compliance requirements on advisers, including small advisers. The rule requires advisers that are subject to the surprise examination to complete Form ADV–E and to maintain internal control reports in certain instances. In addition, under the amendments, each adviser that is required to undergo an annual surprise examination must enter into a written agreement with the independent public accountant that performs the surprise examination that specifies certain duties the accountant must perform as part of the surprise examination engagement. Investment advisers, under the proposed rule amendments, must maintain a copy of an internal control report that an adviser is required to obtain, or receive from its related person, for five years from the end of the fiscal year in which the internal control report is finalized.

We estimate that a total of 1,859 advisers will be subject to the surprise examination requirement, of which 337 advisers will be subject to the surprise examination with respect to 100 percent of their clients and will each spend an average of $125,000 annually,[319] and 1,522 will be subject to the surprise examination with respect to 5 percent of their clients. Of the 1,522 advisers, 262 medium-sized advisers will each spend an average of $20,000 annually,[320] and 1,260 small-sized advisers will each spend an average of $10,000 annually.[321] The advisers subject to the surprise examination that fall into the definition of "small entities" under section 3(a) of the Regulatory Flexibility Act are among the smallest within the small-sized advisers group, with an average of fewer than 6 clients whose accounts would be subject to the surprise examination requirement.[322] As a result, the accounting fees for the surprise examination conducted on the client accounts at these advisers may be lower than our estimated average cost of $10,000.[323] As a result, the potential impact of the amendments on these small entities due to the surprise examination requirement should not be substantial.

We also estimate that, on average, an internal control report will cost approximately $250,000 per year, but would vary based on the size and services offered by the qualified custodian. As stated above, we estimate that no more than eight small entity advisers will be subject to the internal control report requirement, half of which will obtain the report and the other half will receive the report from a related person. We believe that the cost of an internal control report for the four small entity advisers that must obtain one will be lower than the estimated $250,000 because of the small scale of their businesses. Alternatively, these advisers may simply advise their clients to select independent qualified custodians so that they will not be subject to the requirement of obtaining an internal control report.

E. Agency Action To Minimize Effect on Small Entities

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

Regarding the first and fourth alternatives, we do not believe that differing compliance or reporting requirements or an exemption from coverage of the rule amendments, or any part thereof, for small entities, would be appropriate or consistent with investor protection. Because 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 under the amendments.

Regarding the second alternative, the amendments clarify when an investment adviser, including a small adviser, has custody. In addition, we are providing updated guidance for accountants that modernize the procedures for the surprise examination and should provide clarification to investment advisers, including small entities, and accountants on certain issues regarding the surprise examination. We also have endeavored to consolidate and simplify the rule, by adding new definitions to the rule.

Regarding the third alternative, we do not consider using performance rather than design standards to be consistent with our statutory mandate of investor protection with respect to custody of client assets by investment advisers.

VII. Effects on Competition, Efficiency and Capital Formation

We are adopting amendments to rule 204–2, Part 1A of Form ADV and Form ADV–E, in part, pursuant to our authority under Section 204. Section 204 requires the Commission, when engaging in rulemaking pursuant to that authority, to consider whether the rule is "necessary or appropriate in the public interest or for the protection of investors."[324] Section 202(c)(1) of the Advisers Act requires the Commission, when engaging in rulemaking that

[317] 17 CFR 275.0–7(a).

[318] Based on IARD data.

[319] *See supra* note 206 and accompanying text for explanation of the estimate.

[320] These advisers report a larger number of clients than the average number of clients for the subset of advisers that are subject to the surprise examination for only a portion (estimated at 5%) of their clients.

[321] These advisers report a smaller number of clients than the average number of clients for the subset of advisers that are subject to the surprise examination for only a portion (estimated at 5%) of their clients.

[322] Based on IARD data, we estimate that more than half (43) of the 73 small advisers will be subject to the surprise examination with respect to no more than 6 clients.

[323] For the four small entity advisers that may be subject to the surprise examination with respect to 100% of their clients, we believe the cost will be significantly less than the $125,000 annual fee estimated for the 337 advisers. Based on IARD data, we estimate that the average number of clients for these advisers would be 120 rather than the 2,315 we estimate for other advisers that are in the same group. *See supra* note 176 and accompanying text for explanation of our estimate of average number of clients for the 337 advisers.

[324] 15 U.S.C. 80b–4(a).

requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[325] In the Proposing Release, we solicited comment on whether, if adopted, the proposed rule and form amendments would promote efficiency, competition and capital formation. We further encouraged commenters to provide empirical data to support their views on any burdens on efficiency, competition or capital formation that might result from adoption of the proposed amendments. We did not receive any empirical data in this regard concerning the proposed amendments. We received some general comments asserting that the proposed amendments to require a surprise examination for advisers with custody of client assets as a result of deducting advisory fees from client accounts would have a significant adverse impact on competition.[326]

We believe the amendments we are adopting today to rule 204–2, Part 1A of Form ADV and Form ADV–E in connection with amendments to rule 206(4)–2, which are substantively similar to those we proposed, will promote efficiency and competition, but have little or no effect on capital formation.

The amendments to Part 1A of Form ADV are designed to provide us with additional details concerning the custody practices of advisers registered with the Commission, and to provide additional data to assist in our risk-based examination program. Under the amendments to Form ADV–E, the form and attached accountant's certificate will be filed electronically on the IARD system. In addition, the rule requires the accountant performing an annual surprise examination to, upon the accountant's termination or dismissal, or removal from consideration for reappointment, file Form ADV–E within 4 business days accompanied by a statement explaining any problems relating to examination scope or procedure that contributed to the resignation, dismissal, removal, or other termination. Both Part 1A of Form ADV and Form ADV–E will be available to the public on the Commission's web site.

Public availability of more detailed disclosure of advisers' custodial practices will permit investors to use this information together with other information they obtain from Form ADV in making more informed decisions about whether to hire or retain a particular adviser. A more informed investing public will create a more efficient marketplace and strengthen competition among advisers. Moreover, the electronic filing requirements are expected to expedite and simplify the process of filing Form ADV–E and attached accountant's certificate with the Commission, thus further improving efficiency. We believe, however, that the amendments are unrelated to, and will have little or no effect on, capital formation.

We are amending rule 204–2 to require (i) that, if an independent custodian does not maintain client assets but the adviser or a related person instead serves as a qualified custodian for client funds or securities under the rule in connection with advisory services the adviser provides to clients, the adviser must maintain a copy of any internal control report obtained or received pursuant to amended rule 206(4)–2(a)(6), and (ii) the memorandum describing the basis upon which the adviser determined that the presumption that a related person is not operationally independent was overcome, pursuant to amended rule 206(4)–2(d)(5) for five years from the end of the fiscal year in which, as applicable, the internal control report or memorandum is finalized.[327] The amendment is designed to provide our examiners important information about the safeguards in place and assess custody-related risks at an adviser or a related person that maintains client assets. We believe that these amendments will not materially increase the compliance burden on advisers under rule 204–2 and thus will not affect competition, efficiency and capital formation.

[325] 15 U.S.C. 80b–2(c). We are adopting amendments to rule 206(4)–2 pursuant to our authority set forth in Sections 206(4) and 211(a) of the Advisers Act, neither of which requires us to consider the factors indentified in Section 202(c). Analysis of the effects of these amendments is contained in Sections IV, V, and VI above.

[326] *See, e.g.,* ASG Letter; Ameritrade Letter. The amended rule excludes from the surprise examination requirement advisers that have custody of client assets because of deducting advisory fees from client accounts. *See* amended rule 206(4)–2(b)(3).

[327] Rule 206(4)–2 requires that if an independent custodian does not maintain client assets but the adviser or a related person instead serves as a qualified custodian for client funds or securities under the rule in connection with advisory services the adviser provides to clients, the adviser must obtain, or receive from the related person, no less frequently than once each calendar year an internal control report, which includes an opinion from an independent public accountant with respect to the adviser's or related person's controls relating to custody of client assets. *See* amended rule 206(4)–2(a)(6)(ii).

VIII. Statutory Authority

We are adopting amendments to rule 206(4)–2 (17 CFR 275.206(4)–2) pursuant to our authority set forth in sections 206(4) and 211(a) of the Advisers Act (15 U.S.C. 80b–6(4) and 80b–11(a)). We are adopting amendments to rule 204–2 pursuant to the authority set forth in sections 204 and 211 of the Advisers Act (15 U.S.C. 80b–4 and 80b–11). We are adopting amendments to Part 1 of Form ADV (17 CFR 279.1) pursuant to our 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)). We are adopting amendment to Form ADV–E (17 CFR 279.8) pursuant to our authority set forth in sections 204, 206(4), and 211(a) of the Advisers Act (15 U.S.C. 80b–4, 80b–6(4), and 80b–11(a)).

List of Subjects in 17 CFR Parts 275 and 279

Reporting and recordkeeping requirements, Securities.

Text of Rule and Form Amendments

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

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

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

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

* * * * *

■ 2. Section 275.204–2 is amended by:

■ a. Removing "in effect, and" at the end of paragraph (a)(17)(i) and adding in its place "in effect;" ;

■ b. Removing the period at the end of paragraph (a)(17)(ii) and adding in its place a semicolon;

■ c. Adding paragraph (a)(17)(iii); and

■ d. Adding paragraph (b)(5).

The addition reads as follows:

§ 275.204–2 Books and records to be maintained by investment advisers.

(a) * * *

(17) * * *

(iii) A copy of any internal control report obtained or received pursuant to § 275. 206(4)–2(a)(6)(ii).

(b) * * *

(5) A memorandum describing the basis upon which you have determined that the presumption that any related person is not operationally independent

under § 275.206(4)–2(d)(5) has been overcome.

* * * * *

■ 3. 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. If you send account statements to a client to which you are required to provide this notice, include in the notification provided to that client and in any subsequent account statement you send that client a statement urging the client to compare the account statements from the custodian with those from the adviser.

(3) *Account statements to clients.* You have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement, at least quarterly, to each of your clients for which it maintains funds or securities, identifying the amount of funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period.

(4) *Independent verification.* The client funds and securities of which you have custody are verified by actual examination at least once during each calendar year, except as provided below, by an independent public accountant, pursuant to a written agreement between you and the accountant, at a time that is chosen by the accountant without prior notice or announcement to you and that is irregular from year to year. The written agreement must provide for the first examination to occur within six months of becoming subject to this paragraph, except that, if you maintain client funds or securities pursuant to this section as a qualified custodian, the agreement must provide for the first examination to occur no later than six months after obtaining the internal control report. The written agreement must require the accountant to:

(i) File a certificate on Form ADV–E (17 CFR 279.8) with the Commission within 120 days of the time chosen by the accountant in paragraph (a)(4) of this section, stating that it has examined the funds and securities and describing the nature and extent of the examination;

(ii) Upon finding any material discrepancies during the course of the examination, notify the Commission within one business day of the finding, by means of a facsimile transmission or electronic mail, followed by first class mail, directed to the attention of the Director of the Office of Compliance Inspections and Examinations; and

(iii) Upon resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed, file within four business days Form ADV–E accompanied by a statement that includes:

(A) The date of such resignation, dismissal, removal, or other termination, and the name, address, and contact information of the accountant; and

(B) An explanation of any problems relating to examination scope or procedure that contributed to such resignation, dismissal, removal, or other termination.

(5) *Special rule for limited partnerships and limited liability companies.* If you or a related person is 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 paragraph (a)(3) of this section must be sent to each limited partner (or member or other beneficial owner).

(6) *Investment advisers acting as qualified custodians.* If you maintain, or if you have custody because a related person maintains, client funds or securities pursuant to this section as a qualified custodian in connection with advisory services you provide to clients:

(i) The independent public accountant you retain to perform the independent verification required by paragraph (a)(4) of this section must be registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the Public Company Accounting Oversight Board in accordance with its rules; and

(ii) You must obtain, or receive from your related person, within six months of becoming subject to this paragraph and thereafter no less frequently than once each calendar year a written internal control report prepared by an independent public accountant:

(A) The internal control report must include an opinion of an independent public accountant as to whether controls have been placed in operation as of a specific date, and are suitably designed and are operating effectively to meet control objectives relating to custodial services, including the safeguarding of funds and securities held by either you or a related person on behalf of your advisory clients, during the year;

(B) The independent public accountant must verify that the funds and securities are reconciled to a custodian other than you or your related person; and

(C) The independent public accountant must be registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the Public Company Accounting Oversight Board in accordance with its rules.

(7) *Independent representatives.* A client may designate an independent representative to receive, on his behalf, notices and account statements as required under paragraphs (a)(2) and (a)(3) of this section.

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

(2) *Certain privately offered securities.* (i) You are not required to comply with paragraph (a)(1) of this section with respect to securities that are:

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

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

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

(ii) Notwithstanding paragraph (b)(2)(i) of this section, the provisions of this paragraph (b)(2) are available with

respect to securities held for the account of a limited partnership (or a limited liability company, or other type of pooled investment vehicle) only if the limited partnership is audited, and the audited financial statements are distributed, as described in paragraph (b)(4) of this section.

(3) *Fee deduction.* Notwithstanding paragraph (a)(4) of this section, you are not required to obtain an independent verification of client funds and securities maintained by a qualified custodian if:

(i) you have custody of the funds and securities solely as a consequence of your authority to make withdrawals from client accounts to pay your advisory fee; and

(ii) if the qualified custodian is a related person, you can rely on paragraph (b)(6) of this section.

(4) *Limited partnerships subject to annual audit.* You are not required to comply with paragraphs (a)(2) and (a)(3) of this section and you shall be deemed to have complied with paragraph (a)(4) of this section with respect to the account of a limited partnership (or limited liability company, or another type of pooled investment vehicle) that is subject to audit (as defined in rule 1–02(d) of Regulation S–X (17 CFR 210.1–02(d))):

(i) At least annually and distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or members or other beneficial owners) within 120 days of the end of its fiscal year;

(ii) By an independent public accountant that is registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the Public Company Accounting Oversight Board in accordance with its rules; and

(iii) Upon liquidation and distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or members or other beneficial owners) promptly after the completion of such audit.

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

(6) *Certain Related Persons.* Notwithstanding paragraph (a)(4) of this section, you are not required to obtain an independent verification of client funds and securities if:

(i) you have custody under this rule solely because a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services you provide to clients; and

(ii) your related person is operationally independent of you.

(c) *Delivery to Related Person.* Sending an account statement under paragraph (a)(5) of this section or distributing audited financial statements under paragraph (b)(4) of this section shall not satisfy the requirements of this section if such account statements or financial statements are sent solely to limited partners (or members or other beneficial owners) that themselves are limited partnerships (or limited liability companies, or another type of pooled investment vehicle) and are your related persons.

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

(1) *Control* means the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise. Control includes:

(i) Each of your firm's officers, partners, or directors exercising executive responsibility (or persons having similar status or functions) is presumed to control your firm;

(ii) A person is presumed to control a corporation if the person:

(A) Directly or indirectly has the right to vote 25 percent or more of a class of the corporation's voting securities; or

(B) Has the power to sell or direct the sale of 25 percent or more of a class of the corporation's voting securities;

(iii) A person is presumed to control a partnership if the person has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital of the partnership;

(iv) A person is presumed to control a limited liability company if the person:

(A) Directly or indirectly has the right to vote 25 percent or more of a class of the interests of the limited liability company;

(B) Has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital of the limited liability company; or

(C) Is an elected manager of the limited liability company; or

(v) A person is presumed to control a trust if the person is a trustee or managing agent of the trust.

(2) *Custody* means holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. You have custody if a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services you provide to clients. Custody includes:

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

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

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

(3) *Independent public accountant* means a public accountant that meets the standards of independence described in rule 2–01(b) and (c) of Regulation S–X (17 CFR 210.2–01(b) and (c)).

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

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

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

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

(5) *Operationally independent:* for purposes of paragraph (b)(6) of this section, a related person is presumed not to be operationally independent unless each of the following conditions is met and no other circumstances can reasonably be expected to compromise the operational independence of the related person: (i) Client assets in the custody of the related person are not subject to claims of the adviser's creditors; (ii) advisory personnel do not have custody or possession of, or direct or indirect access to client assets of which the related person has custody, or the power to control the disposition of

such client assets to third parties for the benefit of the adviser or its related persons, or otherwise have the opportunity to misappropriate such client assets; (iii) advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision; and (iv) advisory personnel do not hold any position with the related person or share premises with the related person.

(6) *Qualified custodian* means:

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

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

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

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

(7) *Related person* means any person, directly or indirectly, controlling or controlled by you, and any person that is under common control with you.

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

■ 4. 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.*

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

■ a. In the General Instructions, revising the first bullet and last paragraph of instruction 4;

■ b. In Part 1A, revising the last paragraph of Item 7.A. and revising Item 9; and

■ c. In Schedule D, revising Section 7.A., and adding Sections 9.C. and 9.D.

The revisions read as follows:

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

BILLING CODE 8011–01–P

Form ADV

* * * * *

Form ADV: General Instructions

* * * * *

4. * * *

- information you provided in response to Items 1, 3, 9 (except 9.A.(2), 9.B.(2), and 9.(E)), or 11 of Part 1A or Items 1, 2.A. through 2.F., or 2.I. of Part 1B becomes inaccurate in any way;

* * * * *

If you are submitting an other-than-annual amendment, you are not required to update your responses to Items 2, 5, 6, 7, 9.A.(2), 9.B.(2), 9.E., or 12 of Part 1A or Items 2.H. or 2.J. of Part 1B even if your responses to those items have become inaccurate. If you are amending Part II, do not file the amendment with the SEC.

* * * * *

Part 1A

* * * * *

Item 7 Financial Industry Affiliates

* * * * *

A. * * *

If you checked Items 7.A.(1) or (3), you must list on Section 7.A. of Schedule D all your *related persons* that are investment advisers, broker-dealers, municipal securities dealers, or government securities broker or dealers.

* * * * *

Item 9 Custody

In this Item, we ask you whether you or a *related person* has *custody* of *client* assets and about your custodial practices.

A. (1) Do you have *custody* of any advisory *clients'*:

		Yes	No
(a)	cash or bank accounts?	□	□
(b)	securities?	□	□

If you are registering or registered with the SEC, answer "No" to Item 9.A.(1)(a) and (b) if you have custody solely because (i) you deduct your advisory fees directly from your clients' accounts, or (ii) a related person maintains client funds or securities as a qualified custodian but you have overcome the presumption that you are not operationally independent (pursuant to Advisers Act rule 206(4)(2)-(d)(5)) from the related person.

(2) If you checked "yes" to Item 9.A.(1)(a) or (b), what is the amount of *client* funds and securities and total number of *clients* for which you have *custody*:

U.S. Dollar Amount — Total Number of *Clients*

(a) $_____ (b) _____

If your related person serves as qualified custodian of client assets, do not include the amount of those assets and the number of those clients in your response to Item 9.A.(2). Instead, include that information in your response to Item 9.B.(2).

B. (1) Do any of your *related persons* have *custody* of any of your advisory *clients'*:

		Yes	No
(a)	cash or bank accounts?	□	□
(b)	securities?	□	□

You are required to answer this item regardless of how you answered Item 9.A.(1)(a) or (b).

(2) If you checked "yes" to Item 9.B.(1)(a) or (b), what is the amount of *client* funds and securities and total number of *clients* for which your *related persons* have *custody*:

U.S. Dollar Amount — Total Number of *Clients*

(a) $_____ (b) _____

C. If you or your *related persons* have *custody* of *client* funds or securities, check all the following that apply:

☐ (1) A qualified custodian(s) sends account statements at least quarterly to the investors in the pooled investment vehicle(s) you manage.

☐ (2) An independent public accountant audits annually the pooled investment vehicle(s) that you manage and the audited financial statements are distributed to the investors in the pools.

☐ (3) An independent public accountant conducts an annual surprise examination of *client* funds and securities.

☐ (4) An independent public accountant prepares an internal control report with respect to custodial services when you or your *related persons* are qualified custodians for *client* funds and securities.

If you checked Item 9.C.(2), C.(3) or C.(4), list in Section 9.C. of Schedule D the accountants that are engaged to perform the audit or examination or prepare an internal control report.

D. Do you or your *related persons* act as qualified custodians for your *clients* in connection with advisory services you provide to *clients*?

		Yes	No
(1)	you act as a qualified custodian	☐	☐
(2)	your related persons act as qualified custodians	☐	☐

If you checked "yes" to Item 9.D.(2), list in Section 9.D. of Schedule D all your related persons that act as qualified custodians for your clients in connection with advisory services you provide to clients (you do not have to list broker-dealers already identified as qualified custodians in Section 7.A. of Schedule D).

E. If you are filing your annual updating amendment and you were subject to a surprise examination by an independent public accountant during your last fiscal year, provide the date (MM/YYYY) the examination commenced: _____

* * * * *

Schedule D

* * * * *

SECTION 7.A. Affiliated Investment Advisers and Broker-Dealers

You must complete the following information for each *related person* investment adviser and broker-dealer. You must complete a separate Schedule D Page 3 for each listed *related person*.

Check only one box: ☐ Add ☐ Delete ☐ Amend

Legal Name of *Related Person*:

_____

Primary Business Name of *Related Person*:

_____

Related person is (check only one box): ☐ Investment Adviser ☐ Broker-Dealer ☐ Dual (Investment Adviser and Broker-Dealer)

If the *related person* is a broker-dealer, is it a qualified custodian for your *clients* in connection with advisory services you provide to *clients*? Yes ☐ No ☐

If you are registering or registered with the SEC and you have answered "yes," have you overcome the presumption that you are not operationally independent (pursuant to Advisers Act rule 206(4)(2)-(d)(5)) from the *related person* broker-dealer, and thus are not required to obtain a surprise examination for your *clients'* funds or securities that are maintained at the *related person*?
Yes ☐ No ☐

Related Person Adviser's SEC File Number (if any) 801-_____
Related Person's CRD Number (if any): _____

* * * * *

SECTION 9.C. Independent Public Accountant

You must complete the following information for each independent public accountant engaged to perform a surprise examination, perform an audit of a pooled investment vehicle that you manage, or prepare an internal control report. You must complete a separate Schedule D Page 4 for each independent public accountant.

Check only one box: ☐ Add ☐ Delete ☐ Amend

(1) Name of the independent public accountant:

_____

(2) The location of the independent public accountant's office responsible for the services provided:

_____
(number and street)

_____
(city) (state/country) (zip+4/postal code)

(3) Is the independent public accountant registered with the Public Company Accounting Oversight Board? Yes ☐ No ☐

(4) If yes to (3) above, is the independent public accountant subject to regular inspection by the Public Company Accounting Oversight Board in accordance with its rules? Yes ☐ No ☐

(5) The independent public accountant is engaged to:

A. ☐ audit a pooled investment vehicle
B. ☐ perform a surprise examination of *client* assets
C. ☐ prepare an internal control report

(6) Does the report prepared by the independent public accountant that audited the pooled investment vehicle or that examined internal controls contain an unqualified opinion?
Yes ☐ No ☐

SECTION 9.D. *Related Person* Qualified Custodian

You must complete the following information for each of your *related persons* that acts as a qualified custodian for your *clients* in connection with advisory services you provide to *clients* (you do not have to list broker-dealers already identified as qualified custodians in Section 7.A. of Schedule D). You must complete a separate Schedule D Page 5 for each listed *related person*.

Check only one box: ☐ Add ☐ Delete ☐ Amend

Legal Name of *Related Person*:

_____

Primary Business Name of *Related Person*:

_____

The location of the *related person*'s office responsible for custody of your *clients*' assets:

_____
(number and street)

_____
(city) (state/country) (zip+4/postal code)

Related Person is (check only one box):

☐ U.S. Bank or Savings Association
☐ Futures Commission Merchant
☐ Foreign Financial Institution

If you are registering or registered with the SEC, have you overcome the presumption that you are not operationally independent (pursuant to Advisers Act rule 206(4)(2)-(d)(5)) from the *related person* qualified custodian, and thus are not required to obtain a surprise examination for your *clients'* funds or securities that are maintained at the *related person*? Yes ☐ No ☐

* * * * *

BILLING CODE 8011-01-C

■ 6. Form ADV–E (referenced in § 279.8) is amended by revising the instructions to the Form.

The revisions read as follows:

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

Form ADV–E

* * * * *

Instructions

This Form must be completed by investment advisers that have custody of client funds or securities and that are subject to an annual surprise examination. This Form may *not* be used to amend any information included in an investment adviser's registration statement (*e.g.*, business address).

Investment Adviser

1. All items must be completed by the investment adviser.

2. Give this Form to the independent public accountant that, in compliance with rule 206(4)–2 under the Investment Advisers Act of 1940 (the "Act") or applicable state law, examines client funds and securities in the custody of the investment adviser within 120 days of the time chosen by the accountant for the surprise examination and upon such accountant's resignation or dismissal from, or other termination of, the engagement, or if the accountant removes itself or is removed from consideration for being reappointed.

Accountant

3. The independent public accountant performing the surprise examination must submit (i) this Form and a certificate of accounting required by rule 206(4)–2 under the Act or applicable state law within 120 days of the time chosen by the accountant for the surprise examination, and (ii) this Form and a statement, within four business days of its resignation or dismissal from, or other termination of, the engagement, or removing itself or being removed from consideration for being reappointed, that includes (A) the date of such resignation, dismissal, removal, or other termination, and the name, address, and contact information of the accountant, and (B) an explanation of any problems relating to examination scope or procedure that contributed to such resignation, dismissal, removal, or other termination:

(a) By mail, until the Investment Adviser Registration Depository ("IARD") accepts electronic filing of the Form, to the Securities and Exchange Commission or appropriate state securities administrators. File the original and one copy with the Securities and Exchange Commission's principal office in Washington, DC at the address on the top of this Form, and one copy with the regional office for the region in which the investment adviser's principal business operations are conducted, or one copy with the appropriate state administrator(s), if applicable; or

(b) By electronic filing of the certificate of accounting and statement regarding resignation, dismissal, other termination, or removal from consideration for reappointment on the IARD, when the IARD accepts electronic filing of the Form.

* * * * *

Dated: December 30, 2009.

By the Commission.

Florence E. Harmon,

Deputy Secretary.

[FR Doc. 2010–18 Filed 1–8–10; 8:45 am]

BILLING CODE 8011–01–P

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 276

[Release Nos. IA–2969; FR–81]

Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)–2 Under the Investment Advisers Act of 1940

AGENCY: Securities and Exchange Commission.

ACTION: Interpretation.

SUMMARY: The Securities and Exchange Commission (the "Commission") is publishing interpretive guidance for independent public accountants in connection with the adoption of amendments to Rule 206(4)–2 under the Investment Advisers Act of 1940 (the "Custody Rule"). This guidance provides direction with respect to the independent verification and internal control report as required under the amended Custody Rule.

DATES: Effective Date March 12, 2010.

FOR FURTHER INFORMATION CONTACT: General questions about this release should be referred to Bryan J. Morris, Assistant Chief Accountant, Jaime L. Eichen, Assistant Chief Accountant, or Richard F. Sennett, Chief Accountant at (202) 551–6918 or *IMOCA@sec.gov*, Office of the Chief Accountant, Division of Investment Management, U.S. Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–8626. Questions about Rule 206(4)–2 should be directed to staff of the Office of Investment Adviser Regulation, Division of Investment Management, U.S. Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–8549 at (202) 551–6787 or *IArules@sec.gov*.

SUPPLEMENTARY INFORMATION:

I. Background

Rule 206(4)–2(a) under the Investment Advisers Act of 1940 (the "Act") provides, among other things, that it is a fraudulent, deceptive or manipulative act, practice, or course of business within the meaning of Section 206(4) of the Act for any investment adviser registered (or required to be registered) under Section 203 of the Act (herein "investment adviser") to have custody of client funds or securities unless:

(1) A qualified custodian maintains those funds and securities in a separate account for each client under that client's name; or in accounts that contain only clients' funds and securities, under the investment adviser's name as agent or trustee for the clients;

(2) Clients are notified promptly in writing of the qualified custodian's name, address, and the manner in which the funds or securities are maintained, when an account is opened by an investment adviser on a client's behalf and following any changes to this information; and

(3) The investment adviser has a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement, at least quarterly, to each of its clients for which it maintains funds or securities, identifying the amount of funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period.

Rule 206(4)–2(a) generally requires that client funds and securities of which an investment adviser has custody under the rule be verified by actual examination at least once during each calendar year by an independent public accountant [1] ("accountant"), pursuant to a written agreement, between the investment adviser and the accountant, at a time that is chosen by the accountant without prior notice or announcement to the investment

[1] If the investment adviser itself or a related person maintains clients' funds and securities as qualified custodian, the independent public accountant must be registered with, and subject to inspection by, the Public Company Accounting Oversight Board ("PCAOB"). *See* Rule 206(4)–2(a)(6)(i).