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Securities and Exchange Commission

17 CFR Parts 275 and 279

Custody of Funds or Securities of Clients by Investment Advisors; Proposed Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 275 and 279

[Release No. IA–2876; File No. S7–09–09]

RIN 3235–AK32

Custody of Funds or Securities of Clients by Investment Advisers

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission is proposing amendments to the custody rule under the Investment Advisers Act of 1940 and related forms. The amendments, among other things, would require registered investment advisers that have custody of client funds or securities to undergo an annual surprise examination by an independent public accountant to verify client funds and securities. In addition, unless client accounts are maintained by an independent qualified custodian (*i.e.*, a custodian other than the adviser or a related person), the adviser or related person must obtain a written report from an independent public accountant that includes an opinion regarding the qualified custodian's controls relating to custody of client assets. Finally, the amendments would provide the Commission with better information about the custodial practices of registered investment advisers. The amendments are designed to provide additional safeguards under the Advisers Act when an adviser has custody of client funds or securities.

DATES: Comments must be received on or before July 28, 2009.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/proposed.shtml*); or
- Send an e-mail to *rule-comments@sec.gov.* Please include File Number S7–09–09 on the subject line; or
- Use the Federal eRulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

All submissions should refer to File Number S7–09–09. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/proposed.shtml*). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549 on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Vivien Liu, 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 requesting public comment on proposed amendments to rule 206(4)–2 [17 CFR 275.206(4)–2], rule 204–2 [17 CFR 275.204–2] 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

Rule 206(4)–2 regulates the custody practices of investment advisers registered under the Advisers Act.[1] Unlike banks and broker-dealers, investment advisers typically do not maintain physical custody of client funds or securities but rather may have custody because they have the authority to obtain client assets, such as by deducting advisory fees from a client account, writing checks or withdrawing funds on behalf of a client, or by acting in a capacity, such as general partner of a limited partnership, that gives an adviser or its supervised person the authority to withdraw funds or securities from the limited partnership's account. Rule 206(4)–2 requires advisers that have custody of client funds or securities to implement controls designed to protect those client assets from being lost, misused, misappropriated or subject to the advisers' financial reverses, such as insolvency. The rule contains two primary protections.

First, the rule requires advisers that have custody, with certain limited exceptions, to maintain client funds or securities with a ''qualified custodian.'' [2] 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.[3] These institutions' custodial activities are subject to extensive regulation and oversight.[4]

[1] Unless otherwise noted, when we refer to rule 206(4)–2 or any paragraph of the rule, we are referring to 17 CFR 275.206(4)–2 of the Code of Federal Regulations in which the rule is published. *See also 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''). From time to time for convenience, this release refers to rule 206(4)–2 as the ''custody rule.''

[2] Rule 206(4)–2(a)(1).

[3] Rule 206(4)–2(c)(3) (defining ''qualified custodian''). In addition, ''qualified custodian'' includes a foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps advisory clients' assets in customer accounts segregated from its proprietary assets. Foreign custody arrangements may be necessary to permit clients to trade in securities traded in foreign markets, or to accommodate clients with existing relationships with foreign institutions. When we amended the custody rule in 2003, we explained that when an adviser selects a foreign financial institution to hold clients' assets, the adviser's fiduciary obligations require it either to have a reasonable basis for believing that the foreign institution will provide a level of safety for client assets similar to that which would be provided by a ''qualified custodian'' in the United States or to fully disclose to clients any material risks attendant to maintaining the assets with the foreign custodian. *See* 2003 Adopting Release, at n. 22.

[4] *See Custody of Funds or Securities of Clients by Investment Advisers,* Investment Advisers Act Release No. 2044 (Jul. 18, 2002) [67 FR 48579 (Jul. 25, 2002)] (''2002 Proposing Release''), at n. 30 (regulatory agencies or self-regulatory organizations require these financial institutions to carry fidelity bonds to cover possible losses caused by their employees' fraudulent activities). In addition, rule 15c3–3 [17 CFR 240.15c3–3] under the Securities Exchange Act of 1934 (the ''Exchange Act''), requires a broker-dealer to segregate customer funds held by the broker-dealer for the accounts of customers and to take certain steps to protect customer assets. Under rules 17a–3 and 17a–4 under the Exchange Act [17 CFR 240.17a–3 and 17a–4] a broker-dealer must create and maintain current, specified books and records to allow the broker-dealer to easily identify what assets belong to each customer. Similarly, national banks, Federal

Second, the rule requires that an adviser with custody of client assets have a reasonable belief that the qualified custodian holding the assets provides account statements directly to clients, or investors in pooled investment vehicles, at least quarterly.[5] Clients can use the statements they receive from the qualified custodians to compare them with the statements (or other information) they receive from their advisers to determine whether account transactions, including deductions to pay advisory fees, are proper. An adviser to a pooled investment vehicle is not required to comply with the rule's account statement delivery requirement if the pooled investment vehicle is audited at least annually and distributes its audited financial statements to investors in the pool within 120 days of the end of its fiscal year.[6]

If, however, clients do not receive account statements directly from their qualified custodians, the adviser must itself deliver quarterly account statements to clients and engage an independent public accountant to verify the client assets in a surprise examination that must occur at least once during each calendar year.[7] During a surprise examination, an independent public accountant generally must (i) confirm with the custodian *all* cash and securities held by the custodian, including physical examination of securities if applicable, and will reconcile all such cash and securities to the books and records of client accounts maintained by the adviser, (ii) verify the books and records of client accounts maintained by the adviser by examining the security records and transactions since the last examination and by confirming with clients *all* funds and securities in client accounts, and (iii) confirm with clients, on a test basis, closed accounts or securities or funds that have been returned since the last examination.[8] The results of the examination must be reported by the accountant to the Commission.[9]

The surprise examination may uncover problems indicating that client assets may be at risk. Accordingly, we have designed the surprise examination requirement to provide timely information to the Commission staff in the event that the accountant uncovers a problem during the examination. Under the existing rule, the accountant must notify our Office of Compliance Inspections and Examinations within one business day of finding any material discrepancies during an examination.[10]

II. Discussion

In recent months, the Commission has brought several enforcement actions against investment advisers and broker-dealers alleging fraudulent conduct, including misappropriation or other misuse of investor assets.[11] The Commission is intensively investigating this conduct, including the role of the investment advisers, broker-dealers, and individuals that may have participated in the conduct. We continue to work with criminal authorities and other Federal and State regulators to see that the full weight of the law is brought to bear on any advisers and broker-dealers that are found to have betrayed investor trust and confidence. In addition, our staff is conducting examinations of broker-dealer and adviser custodial practices designed to evaluate whether the assets entrusted to these firms are appropriately accounted for and that the firms have in place controls reasonably designed to prevent the theft, misappropriation or other misuse of investor assets.

We also are undertaking a comprehensive review of the rules regarding the safekeeping of investor assets in order to determine changes we might make that would decrease the likelihood that client assets are misused, or would increase the likelihood that fraudulent activities are discovered earlier and client losses are thereby reduced. We are proposing today for comment several revisions to rule 206(4)–2 under the Advisers Act that are designed to improve the safekeeping of client assets.

A. Annual Surprise Examination of Client Assets

1. Application to All Advisers With Custody

The Commission proposes to require that all registered investment advisers with custody of client assets engage an independent public accountant to conduct an annual surprise examination

savings associations, and other U.S. banking institutions are subject to extensive regulation and oversight. *See* 12 U.S.C. 92a. (national banks must have authorization from the Comptroller of the Currency before establishing a trust department and taking custody of customer assets); 12 U.S.C. 1464(n) (Federal savings associations shall segregate all assets held in any fiduciary capacity and shall keep a separate set of books and records showing all transactions in the accounts); *Comptroller's Handbook,* Custody Services at 6, 15 (Jan. 2002) (a bank should have adequate systems in place to identify, measure, monitor, and control risks in the custody services area and a custodian's accounting records and internal controls should ensure that assets of each custody account are kept separate from the assets of the custodian).

[5] Rule 206(4)–2(a)(3)(i).

[6] Rule 206(4)–2(b)(3).

[7] Rule 206(4)–2(a)(3)(ii). Under the rule, an adviser is *not* required to obtain a surprise examination if the qualified custodian delivers account statements directly to the adviser's clients. An adviser to a pooled investment vehicle that is unable, or chooses not to, rely on the exception for audited financial statements and that does not have a qualified custodian send the required account statements to pool investors must provide account statements to pool investors and the adviser must obtain a surprise examination of pool assets.

[8] As stated in note 33 of the 2003 Adopting Release, the accountant must perform the examination in accordance with U.S. Generally Accepted Auditing or Attestation Standards and the standards established by the Commission, except that the accountant must verify *all* or substantiate *all* client funds and securities covered by the examination. The examination should include confirmation of all client cash and securities of which an adviser has custody, regardless of whether they are held by qualified custodians, and reconciliation of all such cash and securities to the books and records of client accounts maintained by the adviser, as well as confirmation of such information with the adviser's clients. *See Nature of Examination Required to be Made of All Funds and Securities Held in Custody of Investment Advisers and Related Accountant's Certificate,* Investment Advisers Act Release No. 201 and Accounting Series Release No. 103 (May 26, 1966) [31 FR 7821 (Jun. 2, 1966)]. Section 404.01.b. of the Commission's Codification of Financial Reporting Policies. The examination must be performed at a time chosen by the accountant without prior notice or announcement to the adviser, and the timing of the examination must be irregular from year to year, so that the adviser will be unaware of the date on which it will take place. Rule 206(4)–2(a)(3)(ii)(B).

[9] *Id.*

[10] Rule 206(4)–2(a)(3)(ii)(C). As we stated in note 34 of the 2003 Adopting Release, the independent public accountant may first take reasonable steps to establish the basis for believing a material discrepancy exists. The obligation to notify the Commission arises once the accountant has a basis for believing there is a material discrepancy. Ordinarily, an accountant should be able to determine promptly whether it has a basis for believing there is a material discrepancy.

[11] *See, e.g., SEC* v. *Donald Anthony Walker Young, et al.,* Litigation Release No. 21006 (Apr. 20, 2009) (complaint alleges registered investment adviser and its principal misappropriated in excess of $23 million, provided false account statements to investors in limited partnership, and provided false custodial statements to limited partnership's introducing broker); *SEC* v. *Isaac I. Ovid, et al.,* Litigation Release No. 20998 (Apr. 14, 2009) (complaint alleges that defendants, including registered investment adviser and manager of purported hedge funds, misappropriated in excess of $12 million); *SEC* v. *The Nutmeg Group, LLC, et al.,* Litigation Release No. 20972 (Mar. 25, 2009) (complaint alleges that registered investment adviser misappropriated in excess of $4 million of client assets, failed to maintain client assets with a qualified custodian, and failed to obtain a surprise examination); *SEC* v. *WG Trading Investors, L.P., et al.,* Litigation Release No. 20912 (Feb. 25, 2009) (complaint alleges that registered broker-dealer and affiliated registered adviser orchestrated fraudulent investment scheme, including misappropriating as much as $554 million of the $667 million invested by clients and sending clients misleading account information); *SEC* v. *Stanford International Bank, et al.,* Litigation Release No. 20901 (Feb. 17, 2009) (complaint alleges that the affiliated bank, broker-dealer, and advisers colluded with each other in carrying out an $8 billion fraud); *SEC* v. *Bernard L. Madoff, et al.,* Litigation Release No. 20889 (Feb. 9, 2009) (complaint alleges that Madoff and Bernard L. Madoff Investment Securities LLC (a registered investment adviser and registered broker-dealer) committed a $50 billion fraud).

of client assets.[12] When we adopted the custody rule in 1962, each adviser with custody of client securities or funds was required by rule 206(4)–2 to engage an independent public accountant to conduct an annual surprise examination.[13] In 2003, we amended the rule to eliminate the annual surprise examination with respect to client accounts for which the adviser has a reasonable belief that ''qualified custodians'' provide account statements directly to clients.[14] We believed that direct delivery of account statements by qualified custodians would provide clients confidence that any erroneous or unauthorized transactions would be reflected and, as a result, would be sufficient to deter advisers from fraudulent activities.[15]

We have decided to revisit the 2003 rulemaking in light of the significant enforcement actions we have recently brought alleging misappropriation of client assets.[16] We believe that a surprise examination by an independent public accountant would provide ''another set of eyes'' on client assets, and thus additional protection against their misuse. 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.[17] Therefore, we propose to require all registered investment advisers with custody of client assets to obtain an annual surprise examination regardless of whether a qualified custodian directly provides statements to clients or, in the case of a pooled investment vehicle, the pool is audited at least annually and distributes its audited financial statements to its limited partners (or other investors) within 120 days of the end of its fiscal year. We are proposing a number of additional enhancements to the rule, discussed below, including additional adviser and accountant reporting requirements and independent review of custody controls in certain circumstances, that we believe would improve the utility of the surprise examination requirement and address some of the concerns we had in 2003.

We request comment on our proposal to require investment advisers with custody of client assets to undergo an annual surprise examination. Would an annual surprise examination increase protections afforded to advisory clients, including pooled investment vehicles (and the investors in those vehicles)? Should we except from the surprise examination requirement advisers that have custody of client funds or securities solely as a result of their authority to withdraw advisory fees from client accounts?[18] Is this form of custody, which is common to advisers with discretionary authority, less likely to be subject to abuse? Should we instead specify requirements or restrictions regarding withdrawing fees from client accounts? If so, what should they be? Are there alternatives to the surprise examination that might provide similar protections, or are there additional requirements that we should also consider? For example, should we instead (or also) amend rule 206(4)–7, which requires advisers to adopt compliance policies and procedures administered by a chief compliance officer, to require that the chief compliance officer submit a certification to us on a periodic basis that all client assets are properly protected and accounted for on behalf of clients?[19] Should we specify certain minimum procedures that each chief compliance officer should implement to assure herself that all client assets are properly protected and accounted for? Given the variety of custodial arrangements, is it feasible for us to specify minimum requirements? Should the rule require surprise examinations to be conducted more frequently than annually or, alternatively, on a regular periodic basis, *e.g.*, semi-annually?

Many advisers have custody as a result of serving as a general partner (or in some other capacity) of a limited partnership or other form of pooled investment vehicle. The proposed rule would continue to except advisers from the requirement to have a qualified custodian send account statements with respect to a pooled investment vehicle that is audited at least annually and distributes its audited financial statements to its limited partners (or other investors) within 120 days of the end of its fiscal year.[20] It would not, however, except such advisers from the surprise examination requirement. The annual audit serves a similar purpose as the surprise examination because it involves a verification process, although it is not required to cover *all* funds or securities.[21] Should we continue to except advisers from the surprise examination requirement with respect to client assets held in pooled vehicles that are audited at least annually?

As explained above, the proposed rule would require all registered advisers that have custody of client assets, including advisers that are also registered as broker-dealers and thus are permitted to act as qualified custodians for their clients' assets, to obtain an annual surprise examination. Under the Exchange Act, a broker-dealer's financial statements must be audited annually by a registered public accounting firm.[22] This audit must include a review of the broker-dealer's procedures for safeguarding securities.[23] The scope of this review must be sufficient for the auditor to provide reasonable assurance that material inadequacies do not exist in a broker-dealer's procedures for safeguarding securities.[24] Would the surprise

[12] Proposed rule 206(4)–2(a)(4). Proposed rule 206(4)–2(c)(3) would define independent public accountant as a public accountant that meets the standards for independence described in rule 2–01(b) and (c) of Regulation S–X. As discussed further below, the annual surprise examination requirement would be *in addition* to the requirement that the adviser have a reasonable belief that qualified custodians deliver account statements directly to clients.

[13] *Adoption of Rule 206(4)–2 under the Investment Advisers Act of 1940,* Investment Advisers Act Release No. 123 (Feb. 27, 1962) [27 FR 2149 (Mar. 6, 1962)]. In 1997, we amended the rule to make it applicable only to advisers who are registered, or required to be registered, with the Commission. *Rules Implementing Amendments to the Investment Advisers Act of 1940,* Investment Advisers Act Release No. 1633 (May 15, 1997) [62 FR 28112 (May 22, 1997)] at Section II.I.5.

[14] *See* 2003 Adopting Release, at Section II.C.

[15] The custody rule provides a limited exception to the requirement of maintaining client assets with a qualified custodian with respect to mutual fund shares and certain privately offered securities. Rule 206(4)–2(b)(1) and (2). As a result, these securities may not be reflected on the qualified custodian's account statements.

[16] *See supra* note 11.

[17] The independent public accountant conducting a surprise examination would independently verify all client funds and securities of which an adviser has custody, including those maintained with a qualified custodian and those that are not maintained with a qualified custodian, such as certain privately offered securities and mutual fund shares. *See supra* note 15.

[18] Advisers registered with the Commission that have authority to deduct advisory fees from client assets have custody and are subject to rule 206(4)–2, but are not required to report that they have custody on Form ADV. *See* Item 9 of Part 1 of Form ADV (''If you are registering or registered with the SEC and you deduct your advisory fees directly from your *clients'* accounts but you do not otherwise have custody of your *clients'* funds or securities, you may answer ''no'' to Item 9A.(1) and 9A.(2).''). This would not change under the proposed rule.

[19] Rule 206(4)–7 (17 CFR 275.206(4)–7). When we adopted rule 206(4)–7 in 2003, we stated that an adviser's compliance policies and procedures adopted and implemented under the rule should address ''safeguarding of client assets from conversion or inappropriate use by advisory personnel.'' *See Compliance Programs of Investment Companies and Investment Advisers,* Investment Advisers Act Release 2204 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)], at Section II.A.1.

[20] Proposed rule 206(4)–2(b)(3).

[21] *See* AICPA Investment Company Audit and Accounting Guide, May 1, 2008.

[22] Section 17(e)(1)(A) [15 U.S.C. 78q(e)(1)(A)] of the Exchange Act.

[23] Exchange Act Rule 17a–5(g) [17 CFR 240.17a-5(g)].

[24] *Id.*

examination's ''verification'' of client assets provide additional protection for clients of advisers that are also broker-dealers? Do the custody obligations for banks present the same issues if an adviser is also a bank and maintains custody of client assets? Instead of requiring a surprise examination for advisers that also act as the qualified custodian for their clients' assets, should we instead consider a different approach, such as requiring these advisers to segregate custodial duties from advisory duties and implement additional internal controls to protect client assets?

We also request comment on whether we should revise or expand the guidance we have provided regarding the surprise examination.[25] For example, are there other procedures an accountant should perform as part of a surprise examination? Should we require an accountant to perform testing on the valuation of securities, including privately offered securities, as part of a surprise examination? Should we require an adviser to certify a listing of funds and securities and client accounts that were examined by the accountant as part of the surprise examination? Are there any procedures currently required to be performed as part of a surprise examination that are no longer necessary? If so, what procedures and why are they no longer necessary? For example, is confirming *all* client balances necessary to adequately protect investors? If not, what extent of confirmation would be appropriate? Are there any procedures currently required to be performed as part of a surprise examination that should be clarified? If so, how should they be clarified? Have investment advisers' custodial practices or operations changed such that we should revise our existing guidance on performing the surprise examination?[26] If so, what revisions should we make? If the proposed rule is adopted and a greater variety of advisers become subject to the rule's surprise examination requirement, should we provide additional guidance to assist different types of advisers and their accountants in complying with the surprise examination requirement? If so, what additional guidance should we provide?

2. Commission Reporting

We propose to amend rule 206(4)–2 to require investment advisers subject to the rule to enter into a written agreement with an independent public accountant to conduct the surprise examination requiring the accountant, among other things, to notify the Commission within one business day of finding material discrepancies, and to submit Form ADV–E to the Commission accompanied by a certificate within 120 days of the time chosen by the accountant for the surprise examination, stating that it has examined the funds and securities and describing the nature and extent of the examination.[27] The accountant's certificate describing the nature and extent of the examination assists the Commission's examination staff in identifying and assessing risks raised by the investment adviser's custodial practices and in determining the scope of the Commission staff's examination of an investment adviser. The reporting by the independent public accountant of a material discrepancy provides the Commission's examination staff with notice of a possible problem with the investment adviser's custodial practices. Should we require additional information be included in the accountant's certificate? Although we are not proposing to change the requirement, is the term ''material discrepancy,'' as used in the context of a surprise examination, widely understood by independent public accountants? If not, should we define the term or provide guidance as to the requirement? Should we require the accountant's certificate to be provided to clients or investors in pooled investment vehicles?

Currently, the custody rule requires that the accountant that performs the surprise examination file Form ADV–E with the Commission within 30 days of the completion of the examination stating that it has examined the funds and securities and describing the nature and extent of the examination. Our examination staff has found that an adviser's surprise examination may sometimes continue for an extended period of time. We propose to amend the rule to require that the accountant instead file Form ADV–E within 120 days of the time chosen by the accountant for the surprise examination. As described above, 120 days is the period of time in which a pooled investment vehicle managed by an adviser relying on the rule's annual audit exception must distribute its audited financial statements to investors in the pool.[28] Accordingly, we believe 120 days should be sufficient time for an accountant to complete a surprise examination and file Form ADV–E. Would this change create any difficulties for the accountant or the adviser to comply with the filing requirement? Is 120 days reasonable for all types of advisers? If not, what time limit should we require for the surprise examination?

In addition, we propose that the written agreement require the independent public accountant to submit Form ADV–E to the Commission within four business days of its resignation, dismissal from, or other termination, of the engagement, or upon removing itself or being removed from consideration for being reappointed, accompanied by a statement that includes (i) the date of such resignation, dismissal, removal, or other termination, 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 resignation, dismissal, removal, or other termination (''termination statement'').[29] This information would

[25] *See supra* note 8.

[26] *See Nature of Examination Required to be Made of All Funds and Securities Held in Custody of Investment Advisers and Related Accountant's Certificate, supra* note 8.

[27] Proposed rule 206(4)–2(a)(4). The written agreement would also require, in accordance with the current requirements of rule 206(4)–2, the independent public accountant to perform the surprise examination. The current rule does not specifically require that the adviser enter into a written agreement with the independent public accountant. Rule 206(4)–2(a)(3)(ii)(B) and (C). Advisers would have to keep these written agreements under rule 204–2(a)(10) [17 CFR 275.204–2(a)(10)] as they would be written agreements that an adviser enters into in its business as such. The obligation to maintain the records would 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.

[28] Rule 206(4)–2(b)(3).

[29] Proposed rule 206(4)–2(a)(4)(iii). Similarly, we require companies registered under Section 12 or 15(d) of the Exchange Act to file with us, within four business days of the dismissal or resignation of their auditors, a Form 8–K containing information relating to the circumstances under which the auditor was terminated, whether the auditor had issued any adverse reports about the company, whether there had been any disagreements between the company and the auditor and certain other information. The former auditor must respond in a publicly available document whether it agrees with the company's statement. *Form 8–K, Current Report*, Item 4.01, 17 CFR 249.308; *Changes In and Disagreements With Accountants on Accounting and Financial Disclosure*, Regulation S–K, Item 304, [17 CFR 229.304]. We also require broker-dealers registered with us to file a notice with us within 15 business days of the dismissal or resignation of their auditors. In the notice, the broker-dealer must, among other things, disclose any problem in the past two years of which, if not resolved, the former auditor would have to make reference in its report and state whether the former auditor's report of the past two years contained any adverse or qualified opinion or any disclaimer of opinion. The broker-dealer must attach to its notice the former auditor's statement as to whether it agrees with the broker-dealer's disclosure. See rule 17a–5(f)(4) under the Exchange Act. We have chosen the four business day standard to provide us with notice of potential problems with an investment adviser's custody of

Continued

permit our staff to compare information provided by the adviser with the perspective of the accountant, and to further evaluate the need for an examination of the adviser to determine whether client assets are at risk. We request comment on this proposed filing requirement. Is this the right standard for notification of potential problems or disagreements between an adviser and its independent public accountant performing the surprise examination? Is it too broad? Too narrow? Is there more information that should be required in this notification? If so, what additional information should be required? Is the required explanation of the reason for the withdrawal sufficient? Should this notification requirement provide for more detailed standards such as those included in Item 304(a)(1) of Regulation S–K with respect to a change in an issuer's independent public accountant?

We propose to have accountants file Form ADV–E with us electronically, through the Investment Adviser Registration Depository (''IARD''), which would enhance our ability to use the information by, for example, comparing information provided by advisers and their independent public accountants and thus to identify potential custodial risks. We currently are working with our contractor to develop changes to the IARD system that would permit it to accept Form ADV–E and allow us to make the filings available through our Web site.[30] We request comment on whether we should require that Form ADV–E be filed electronically, and whether we should make the accountant's termination statement publicly available.

3. Privately Offered Securities

We also propose to amend the rule to make privately offered securities that investment advisers hold on behalf of their clients subject to the surprise examination requirement.[31] Currently, privately offered securities are excluded from all aspects of the custody rule.[32] While it may not be practical to require that these securities in all cases be held by a qualified custodian,[33] we believe subjecting these securities to the surprise examination would provide greater assurance that such securities are properly safeguarded in furtherance of the purposes of the rule. We request comment on the feasibility of requiring that advisers obtain a surprise examination with respect to privately offered securities.

B. Custody by Adviser and Its Related Persons

1. Custody by Related Persons

The Commission proposes to amend rule 206(4)–2 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.[34] A ''related person'' would be a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser.[35] For purposes of this definition we would define ''control'' as the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise.[36] As a result, the protections of the rule would be afforded to clients when their funds and securities are not held with an independent custodian, but rather with the adviser itself or indirectly through a related person.[37]

Under rule 206(4)–2, an adviser has custody of client assets if it holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them.[38] In our release adopting the 2003 amendments to rule 206(4)–2, we explained that an adviser *may* have custody of client assets under circumstances in which the adviser or its personnel have access to those client assets through a related person, and cited one of our staff interpretive letters that set forth factors the staff will consider in determining whether an adviser has ''indirect'' custody of client assets.[39] The proposed amendments would simply deem advisers whose ''related persons'' hold client assets to have custody under the rule if those assets are held by the related person in connection with the advisory services provided by the adviser. We believe that the risks to advisory clients that arise as a result of a related person's ability to obtain client assets, regardless of the separation between the adviser and a related person, may be substantial enough to require the adviser to comply with the custody rule. The ''in connection with'' limitation of the proposed rule is designed to prevent an adviser from being deemed to have custody of client assets held by a related person broker-dealer (or other qualified custodian) with respect to which the adviser does not provide advice.

Should we deem an adviser to have custody if its related persons hold assets in connection with the adviser's advisory services? Are there circumstances where a related person's custody of client assets should not be imputed to the adviser? If so, should the rule contain a rebuttable presumption that an adviser has custody if any of its related persons have custody of advisory client assets?[40] What factors, if any, should we identify for advisers to consider when assessing whether the presumption can be rebutted?[41]

2. Internal Control Report and PCAOB Registration and Inspection

The Commission also proposes to amend rule 206(4)–2 to require 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

client funds or securities at an earlier time to allow our staff to take prompt action if necessary.

[30] The IARD system will not be able to accept electronic filings of Form ADV–E until it is upgraded with this function. If the proposed amendments are adopted, it is possible that accountants performing surprise examinations may have to continue paper filing of Form ADV–E for a period of time until the IARD system has been upgraded. Public access to these filings would be made available on our Web site through the Investment Adviser Public Disclosure system (IAPD).

[31] ''Privately offered securities'' are defined by rule 206(4)–2(b)(2) 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. The proposed rule would retain this definition.

[32] *Id.*

[33] Ownership of private securities is recorded only on the books of the issuer, which poses difficulties to maintain them in accounts with qualified custodians. *See* 2003 Adopting Release, at Section II.B.

[34] Proposed rule 206(4)–2(c)(2) (defining ''custody'').

[35] Proposed rule 206(4)–2(c)(6) (defining ''related person'').

[36] Proposed rule 206(4)–2(c)(1) (defining ''control''). Form ADV [17 CFR 297.1] also uses the same definition.

[37] Today, an adviser may, for example, have custody if its related person holds assets of the adviser's clients and the adviser either controls the related person's operations or has access to the client assets through the related person. *See* section 208(d) of the Advisers Act [15 U.S.C. 80b–8(d)] (an adviser may not, indirectly or through or by any other person, do any act or thing that would be unlawful for the adviser to do directly).

[38] Rule 206(4)–2(c)(1) (defining ''custody'').

[39] *See* 2003 Adopting Release at n.4 (citing *Crocker Investment Management Corp.*, SEC Staff No-Action Letter (Apr. 14, 1978)). Our staff would withdraw this no-action letter if we adopt the proposed amendment.

[40] *Cf.* Rule 206(4)–4(b) (establishing a rebuttable presumption that certain legal or disciplinary events are material and therefore must be disclosed to clients).

[41] *See, e.g., Financial and Disciplinary Information That Investment Advisers Must Disclose to Clients*, Investment Advisers Act Release No. 1083 (Sept. 25, 1987) [52 FR 36915 (Oct. 2, 1987)] (discussing factors an adviser should consider in assessing the presumption that certain disciplinary information is material and therefore should be disclosed to clients).

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 (''internal control report''), which includes an opinion from an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (''PCAOB''), with respect to the adviser's or related person's controls relating to custody of client assets.[42] The adviser would be required to maintain the internal control report in its records and make it available to the Commission or its staff upon request.[43]

We are proposing this addition to the rule because we believe maintaining client assets with the adviser or a related person instead of with an independent custodian can present higher risks to advisory clients. Indeed, several of the recent enforcement actions we have brought alleging misappropriation of client assets by investment advisers have involved advisers or related persons that maintained client assets.[44] While advisers that are themselves, or use related persons that are, qualified custodians would be required to obtain a surprise examination, the utility of the surprise examination may be limited because the independent public accountant seeking to verify client assets may have to rely on custodial reports issued by the adviser or its related person. Because of the relationship between the adviser and the custodian, we believe that there is a greater risk that the custodian could be a party to any fraud and therefore the custodian's reports could be compromised. Requiring these advisers to also obtain an internal control report would provide an additional check on the safeguards relating to client assets held by the adviser or the related person qualified custodian.

An internal control report could 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 could obtain additional comfort that confirmations received from the qualified custodian in the course of the surprise examination are reliable and, where a broker-dealer is the qualified custodian, may be able to leverage existing tests performed in compliance with broker-dealer auditing and internal control requirements. The internal control report may also reveal control problems, which could be significant.[45] Thus, the requirement to obtain an internal control report informs the surprise examination process and may itself act as a deterrent to advisers that may consider misappropriating client assets directly or through a related person in the guise of providing custodial services as a qualified custodian.

The proposed amendments would require that the internal control report include an opinion of an independent public accountant registered with, and subject to regular inspection by, the PCAOB, that is issued in accordance with the standards of the PCAOB, with respect to the description of controls placed in operation relating to custodial services, including the safeguarding of cash and securities held by either the adviser or a related person on behalf of the adviser's clients, and tests of operating effectiveness.[46] In addition, the internal control report would also contain a description of the relevant controls, the control objectives and related controls, and the independent public accountant's tests of operating effectiveness that were performed and the results of those tests.[47]

Opinions provided in reports on controls over custodial services conducted in accordance with PCAOB standards address control objectives relevant to the custodial operations, as well as the general control environment and information systems. Control objectives relevant to custodial operations might include:

- Physical securities are safeguarded from loss or misappropriation;
- Cash and security positions are reconciled accurately and on a timely basis between the custodian and depositories, and between the custodian and accounting systems;
- Client-initiated trades are properly authorized and recorded completely and accurately in the client account;
- Securities income and corporate action transactions are processed to client accounts in an accurate and timely manner;
- Net settlement procedures for delivery and receive transactions are performed accurately;
- Documentation for the opening of accounts is received and authenticated, and established completely and accurately on the applicable system; and
- Market values of securities obtained from various outside pricing sources have been recorded accurately in client accounts.

We are proposing that the independent public accountant issuing the internal control report be registered with, and subject to regular inspection by, the PCAOB, in accordance with the rules of the PCAOB.[48] We believe that registration and the periodic inspection of an independent public accountant's overall quality control system by the PCAOB will provide us greater confidence in the quality of the internal control report.

We request comment on whether we should require advisers that serve, or have related persons that serve, as qualified custodians for client funds and securities to obtain or receive an internal control report. Would this requirement provide additional protections for clients? How would the timing of the internal control report relate to the timing of the surprise examination? Does it make sense to require both an internal control report and a surprise examination? Would these requirements be duplicative? If so, in which respects? Should we require that the independent public accountant that performs the surprise examination be a different accountant than the accountant that prepares the internal control report? Should we require that the independent public accountant that prepares the internal control report be registered with the PCAOB? If so, should we require that the independent public accountant also be subject to regular inspection by the PCAOB? Would the requirement of using independent public accountants registered with, and subject to regular

[42] Proposed rule 206(4)–2(a)(6). A report on the description of controls placed in operation and tests of operating effectiveness (commonly referred to as a ''Type II SAS 70 Report'') conducted in accordance with PCAOB standards would be sufficient for purposes of satisfying the requirements of the internal control report. *See* AU 324 *Service Organizations* of the PCAOB interim standards.

[43] Proposed rule 204–2(a)(17)(iii). *See* 17 CFR 275.204–2.

[44] *See supra* note 11.

[45] In addition to the specific procedures an independent public accountant must follow during a surprise examination, the accountant should perform any additional audit procedures it deems necessary under the circumstances. *See Nature of Examination Required to be Made of All Funds and Securities Held in Custody of Investment Advisers and Related Accountant's Certificate, supra* note 8.

[46] Proposed rule 206(4)–2(a)(6).

[47] *See supra* note 42.

[48] Proposed rule 206(4)–2(a)(6). 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 proposed 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 Rule 4003 of the PCAOB's Bylaws and Rules, effective pursuant to Exchange Act Release No. 56738, File No. PCAOB–2006–03 (Nov. 2, 2007) and Exchange Act Release No. 49787, File No. PCAOB–2003–08 (Jun. 1, 2004).

inspection by, the PCAOB increase the costs to obtain these reports or make it too difficult to obtain a qualified accounting firm to provide an internal control report? Have we provided sufficient guidance for the independent public accountants that will produce these reports? Should we require that specific control objectives be addressed within the internal control report? If so, what control objectives? Would obtaining or receiving an internal control report present additional issues if an adviser, or its related person, that acts as qualified custodian for client assets is located outside of the United States? Would the requirement that the independent public accountant be registered with, and subject to regular inspection by, the PCAOB make it more difficult for such advisers or their related persons to engage an accountant to prepare the internal control report?

3. Surprise Examination and PCAOB Registration

We also are proposing to require that when an adviser or a related person serves as a qualified custodian for the adviser's clients' funds or securities, the surprise examination discussed above be performed by an independent public accountant registered with, and subject to regular inspection by, the PCAOB, in accordance with the rules of the PCAOB.[49] We are proposing this requirement because, as discussed above, we believe PCAOB registration and inspection will provide us greater confidence in the quality of the examination performed by the independent public accountant, which is even more important when an adviser or its related person, rather than an independent custodian, maintains client funds or securities.[50]

We request comment on this proposed amendment to the rule. Should we require that the independent public accountant performing the surprise examination of an adviser that serves, or whose related person serves, as a qualified custodian be registered with the PCAOB and subject to its inspection? Should we instead require all surprise examinations under the rule to be conducted by independent public accountants registered with, and subject to regular inspection by, the PCAOB? Does requiring the independent public accountant to be PCAOB-registered and inspected provide meaningful quality assurance for surprise examinations? Would the requirement of using a PCAOB-registered and inspected independent public accountant increase the costs to obtain these examinations or make it difficult to obtain a qualified accounting firm to conduct the examination? Would the requirement of using a PCAOB-registered and inspected independent public accountant disproportionally impact small accounting firms or small investment advisers?

If we require the independent public accountants that prepare the internal control report and perform the surprise examination to be registered with, and subject to regular inspection by, the PCAOB, should we also consider a similar revision to the current rule's audit exception for certain pooled investment vehicles? Specifically, should we require, as a condition of the adviser's reliance on the audit exception when the adviser or its related person serves as qualified custodian for funds or securities of the pool, that the independent public accountant that performs the audit of the pooled investment vehicle's financial statements be registered with, and subject to regular inspection by, the PCAOB? Would advisers to offshore pools find it too difficult to engage an auditor that is PCAOB-registered and inspected? Should we instead, or in addition, require the independent public accountant, as part of the surprise examination, to confirm security holdings with the highest-level unaffiliated subcustodian (*e.g.*, Depository Trust Company) in addition to confirming the security holdings with the qualified custodian, similar to the requirements for auditors performing examinations for advisers to registered investment companies that are deemed to have custody pursuant to rule 17f–2 of the Investment Company Act of 1940?[51]

4. Independent Qualified Custodians

We request comment on whether, as an alternative to our proposal to impose additional conditions on advisers that serve as, or have related persons that serve as, qualified custodians for client assets, we should simply amend rule 206(4)–2 to require that an independent qualified custodian hold client assets. The use of a custodian not affiliated with the adviser would address the conflict, and potentially greater risks to client assets, that may be presented when an adviser or its related person acts as custodian for client assets.

When we amended rule 206(4)–2 in 2003 to require that advisers with custody of client funds or securities maintain those assets with a qualified custodian, we acknowledged that the rule would permit advisers that are also qualified custodians to hold their clients' assets or to maintain them with related persons that are qualified custodians.[52] Most qualified custodians are banks and broker-dealers, which are subject to extensive regulation and oversight of their custodial practices, and we did not believe that permitting advisers to maintain securities with them presented additional custodial risk.[53]

We are interested in exploring the practical aspects of requiring, as an alternative to some or all of the amendments we are today proposing, an independent qualified custodian. For example, such a requirement could preclude a broker-dealer that is subject to rule 206(4)–2, *i.e.*, is also a registered investment adviser, from providing advisory services to a brokerage customer unless the customer held securities over which the adviser had discretionary authority in a brokerage account at another brokerage firm, or in a custodial account at a bank or other qualified custodian. While institutional investors such as mutual funds often hold securities and cash in custodial accounts,[54] would the use of custodial accounts be too costly for small advisory clients? Would they be consistent with the operation of certain types of combined advisory and brokerage accounts, such as wrap fee programs?

We request comment on the practical aspects of requiring advisers that have custody to maintain client assets with an independent qualified custodian. Would the requirement of using an independent qualified custodian result in greater costs? If yes, would the additional custodial protections for client assets afforded by an independent qualified custodian warrant the additional costs? Would the

[49] Proposed rule 206(4)–2(a)(6)(i).

[50] *Cf. SEC v. David G. Friehling, C.P.A., et al.*, Litigation Release No. 20959 (Mar. 18, 2009) (Commission charged auditors with fraud alleging, among other things, that auditors misrepresented that the financial statements of Bernard L. Madoff Investment Securities LLC (BMIS) were audited pursuant to Generally Accepted Auditing Standards, including the requirements to maintain auditor independence and perform audit procedures regarding custody of securities; did not perform a meaningful audit of the BMIS; and did not perform procedures to confirm that the securities BMIS purportedly held on behalf of its customers even existed).

[51] *See* American Institute of Certified Public Accountants, *Audit and Accounting Guide: Investment Companies § 2.160 Footnote 47 (May 1, 2008),* which requires confirmation of security holdings with the highest-level of unaffiliated subcustodian in connection with examinations performed pursuant to rule 17f–2 of the Investment Company Act of 1940 [17 CFR 270.17f–2].

[52] *See* 2003 Adopting Release at Section II.B.

[53] *See* 2002 Proposing Release at Section II.

[54] According to Lipper's LANA Database, more than 95 percent of registered open-end investment company assets are held in custody at a bank or trust company (based on Dec. 31, 2008 data).

requirement result in greater burdens on advisory clients of firms that are registered both as investment advisers and broker-dealers or cause them to lose access to services or other efficiencies they currently receive? Is there any reason why the custodial protections afforded by the banking laws and our rules under the Exchange Act (and the rules of the self-regulatory organizations) are sufficient to protect bank and brokerage customers, but may not be sufficient to protect custodial accounts of advisory clients?

C. Delivery of Account Statements and Notice to Clients

The Commission proposes to amend rule 206(4)–2 to require registered advisers with custody of client funds or securities to have a reasonable basis for believing that the qualified custodian sends an account statement, at least quarterly, to each client for which the qualified custodian maintains funds or securities.[55] The amendment would eliminate the alternative, currently provided in the rule, under which an adviser can send reports to clients if it undergoes a surprise examination by an independent public accountant at least annually.[56] We permitted the latter alternative delivery option because some advisers did not wish to disclose the names of their clients to custodians to prevent a potential competitor from having access to their lists of clients, or to protect the privacy of some well-known clients.[57]

We are proposing to eliminate the alternative delivery option and require all advisers with custody of client assets to have a reasonable belief that the qualified custodian delivers account statements to advisory clients or their representatives (and not through the investment adviser).[58] We believe that direct delivery will provide greater assurance of the integrity of those account statements, which we now believe, in light of recent frauds, is of substantially greater value than the concerns that led us in 2003 to accommodate those advisers that wished not to share client names with custodians.[59] The confidentiality concern, we believe, could also be addressed in custodial contracts or agreements outside of the contract that would restrict the custodian's use of the information.[60]

We are also proposing to amend rule 206(4)–2 to state that advisers relying on the qualified custodian to send account statements directly to clients must form their reasonable belief that such account statements are sent after ''due inquiry.'' Because the effectiveness of the rule depends significantly on direct delivery of account statements by the qualified custodian, we are making it explicit that the adviser is obligated under the rule to conduct some inquiry to form a reasonable belief.[61]

We request comment on these proposed changes to the rule. Should we eliminate the alternative delivery option in rule 206(4)–2? We understand that most advisers do not currently take advantage of the alternative delivery option, and that this proposal will not have a significant effect on a substantial number of advisers or clients.[62] We request comment on our understanding. Are there securities for which a qualified custodian would not send account statements? If so, is this due to legal, tax, or practical limitations? Are there other alternatives that would provide greater assurance of the integrity of client account statements? Should we include the due inquiry requirement in the rule? Should we instead specify particular steps an adviser must take to seek to determine that the qualified custodian sends account statements directly to clients?

We also propose to revise the content of the notice advisers are currently required to send to clients upon opening a custodial account on their behalf. Specifically, we propose to require advisers to include a statement in the notice urging clients to compare the account statements they receive from the custodian with those they receive from the adviser.[63] Client review of periodic account statements from the qualified custodian can enable clients to discover improper account transactions or other fraudulent activity. Raising client awareness of this safeguard at account opening could enhance its effectiveness. We request comment on this notice requirement. Advisers are not required by the Advisers Act or rules to send their own account statements to clients. Should we require advisers that have custody and elect to send account statements to include a legend urging clients to compare the information the adviser sends to clients with the information reflected in the qualified custodian's account statements? Should we require all advisers that have custody to deliver account statements and include such a legend? If so, should we provide specific language for the legend? Are there other disclosure requirements we should consider?

D. Liquidation Audit

We are proposing an amendment to clarify the provision of the rule that exempts advisers from the account statement provisions with respect to those limited partnerships or other pooled investment vehicles that are subject to an annual audit and that distribute financial statements to investors. The proposed amendment would clarify the availability of the annual audit exception to pooled

[55] Proposed rule 206(4)–2(a)(3). An adviser to a limited partnership or other pooled investment vehicle that is subject to an annual audit and that distributes its financial statements to investors would remain excepted from the account statement delivery requirement with respect to assets held by the pool. Proposed rule 206(4)–2(b)(3).

[56] Rule 206(4)–2(a)(3)(ii).

[57] *See* 2002 Proposing Release at Section II.C. *See also* 2003 Adopting Release at Section II.C. (recognizing that certain advisers had presented reasons for allowing a direct delivery exception, and citing Section II.C. of the 2002 Proposing Release).

[58] An ''independent representative'' is a person that (i) acts as agent for an advisory client and by law or contract is obligated to act in the best interest of the advisory client; (ii) does not control, is not controlled by, and is not under common control with the adviser; and (iii) does not have, and has not had within the past two years a material business relationship with the adviser. Rule 206(4)–2(c)(2) [unchanged as proposed rule 206(4)–2(c)(4)].

[59] *See* Section II.C. of the 2003 Adopting Release. 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.

[60] We also note that with respect to individual clients who obtain custodial services for their personal, family or household purposes, a U.S. qualified custodian would 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). Under these privacy rules, a qualified custodian would be prohibited from sharing the advisory client's personal information with nonaffiliated third parties (other than under an exception) unless the custodian first provides the client with a notice explaining its information sharing practices and the opportunity to opt out of the information sharing and the client does not opt out. *See, e.g.*, 17 CFR 248.10(a)(1).

[61] There are a number of ways advisers could satisfy the ''due inquiry'' requirement. For example, in the 2003 Adopting Release, we explained that an adviser could form this reasonable belief if the qualified custodian provides the adviser with a copy of the account statement that was delivered to the client. *See* the 2003 Adopting Release at n. 29. The receipt of these statements would satisfy the ''due inquiry'' requirement. As another example, an adviser could satisfy the due inquiry requirement if the qualified custodian confirms in writing, including sending a fax or an e-mail to the adviser, that it has sent account statements to the adviser's clients; such confirmation would need to cover each quarter during which the qualified custodian is expected to send account statements to the clients.

[62] Based on the number of Form ADV–Es filed with us during 2008, we estimate 190 advisers relied on the exception.

[63] Proposed rule 206(4)–2(a)(2).

investment vehicles that liquidate and make final distributions other than at year end.[64] This amendment is designed to assure that the proceeds of the liquidation are appropriately accounted for so that investors can take timely steps to protect their rights. Do commenters agree with us that this clarification would provide additional protection to the investors in the pool? Are there alternatives to a liquidation audit that we should consider that would also protect pool investors?

E. Amendments to Form ADV

We are proposing several amendments to Part 1A and Schedule D of Form ADV. The amendments are designed to provide more complete information about the custody practices of advisers registered with the Commission, and to provide us with additional data to improve our ability to identify compliance risks.

Item 7. Item 7 of Part 1A requires advisers to report certain financial industry affiliations, including whether the adviser has a related person that is an investment adviser or a broker-dealer. The item *requires* an adviser to identify on Schedule D of Form ADV each related person that is an investment adviser, and *permits* advisers to report the names of related person broker-dealers. We propose to modify Item 7 to require an 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.[65]

Item 9. Item 9 of Part 1A requires advisers to report to us whether they or a related person have custody of client funds or securities. We propose to amend the item to require advisers that have custody (or whose related persons have custody) of client funds or securities to provide additional information about their custodial practices under rule 206(4)–2.

Specifically, we propose to amend Item 9 of Part 1A to require an adviser to report the amount in U.S. dollars of client assets and number of clients of which it or its related person has custody,[66] and whether it or its related person serves as qualified custodian with respect to the adviser's clients' funds or securities.[67] We would also add a new subsection that would require an adviser with custody to report (i) whether a qualified custodian sends quarterly account statements to investors in pooled investment vehicles the adviser manages, (ii) whether the financial statements of the pooled investment vehicles the adviser manages are audited, (iii) whether the adviser's clients' funds or securities are subject to a surprise examination, and (iv) whether an independent public accountant registered with, and subject to regular inspection by, the PCAOB prepares an internal control report with respect to the adviser or its related persons' custodial services when acting as a qualified custodian for advisory client funds or securities.[68] We also propose to amend Item 9 to require advisers that are subject to the surprise examination to report the month in which the last examination commenced.[69] Last, we propose to amend Form ADV: General Instruction number 4 to make conforming changes to reflect that certain of the proposed questions are only required to be updated in an adviser's annual amendment. The information we propose to collect would improve our ability to monitor compliance with the custody rule.

We also propose to amend Schedule D of Form ADV by adding items to require additional details relevant to an adviser's response to the proposed amendments to Item 9 discussed above. With respect to accountants, these amendments would require advisers to: (i) Identify the accountants that perform audits or surprise examinations and that prepare internal control reports; (ii) provide information about the accountants, including address and PCAOB registration and inspection status; (iii) indicate the type of engagement (audit, surprise examination, internal control report); and (iv) indicate whether the accountant's report was unqualified.[70] With respect to qualified custodians, these amendments would require advisers to identify any related person that serves as a qualified custodian for its clients by reporting the related person's name and address, and indicate whether the related person qualified custodian is a bank, futures commission merchant or foreign financial institution.[71] This information would allow our staff to better monitor compliance with the requirements of rule 206(4)–2, and, together with other data reported on Form ADV, would allow our staff to better assess the compliance risks of an adviser.[72]

We request comment on the amended items. We understand that the additional information we would require is readily available to investment advisers and should not be burdensome to provide. Is our understanding correct? Are the new questions clear? If not, what changes should we make to make them clearer? We do not believe that the information we propose to require is proprietary information the disclosure of which would have adverse consequences to the adviser or its clients. Are we correct in this belief?

F. Amendments to Form ADV–E

We are proposing three amendments to the instructions to Form ADV–E. First, we propose to amend the instructions to require that the form and the accountant's examination certificate that accompanies it be filed electronically with the Commission.[73] Second, we propose to amend the instructions to reflect the proposed requirement that Form ADV–E and the examination certificate must be filed within 120 days of the time chosen by the accountant for the surprise examination.[74] Third, we propose to add an instruction that would implement the proposed rule change regarding the accountant's obligation under the written agreement with the adviser to file Form ADV–E accompanied by the termination statement, described above, within four business days of the accountant's resignation, dismissal, or removal. We request comment on these proposed

[64] Proposed rule 206(4)–2(b)(3)(ii).

[65] Proposed Section 7.A. of Schedule D of Form ADV.

[66] Proposed Item 9.A.(2) and B(2) of Part 1A of Form ADV. This information would only be required to be updated when the adviser prepares its annual updating amendment.

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

[68] Proposed Item 9.C. of Part 1A of Form ADV.

[69] Proposed Item 9.E. of Part 1A of Form ADV. This information would only be required to be updated when the adviser prepares its annual updating amendment.

[70] Proposed Section 9.C. of Schedule D of Form ADV.

[71] Proposed Section 9.D. of Schedule D of Form ADV. Proposed Item 7 of Form ADV and Section 7.A. of Schedule D of Form ADV would require advisers to report the same information for an affiliated broker-dealer that is a qualified custodian for the adviser. *See supra* note 65 and accompanying text.

[72] These proposed 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.*

[73] Currently accountants submit Form ADV–E and the attached examination certificates to the Commission by mail. Electronic filing of Form ADV–E would be through the IARD system and would begin only when the system is upgraded for this function.

[74] Proposed rule 206(4)–2(a)(4).

amendments. Are there additional changes to Form ADV–E that we should consider?

G. Required Records

We also are proposing to amend rule 204–2 to require the adviser to maintain a copy of the internal control report that an adviser would be required to obtain or receive from its related person, pursuant to proposed rule 206(4)–2(a)(6) for five years from the end of the fiscal year in which the internal control report is finalized. Requiring an adviser to retain a copy of the internal control report would provide our examiners with important information about the safeguards in place at an adviser or related person that maintains client assets. Information from these reports would also assist our staff in assessing custody-related risks at a particular adviser. We request comment on this proposal. Is there any additional documentation relating to the internal control report that should be maintained under rule 204–2?

III. General Request for Comment

The Commission requests comment on the rule amendments proposed in this Release, suggestions for additional changes to the existing rules and comment on other matters that might have an effect on the proposals contained in this Release. Commenters should provide empirical data to support their views.

IV. Paperwork Reduction Act

The proposed amendments contain several ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995,[75] and the Commission has submitted the amendments to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The titles for the collections of information are ''Rule 206(4)–2, Custody of Funds or Securities of Clients by Investment Advisers,'' ''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. The rule and the forms contain currently approved collection of information numbers under OMB control numbers 3235–0241, 3235–0049, and 3235–0361, respectively. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

[75] 44 U.S.C. 3501 to 3520.

The collections of information under rule 206(4)–2 are necessary to ensure that clients' funds and securities in the custody of advisers are safeguarded, and information contained in the collections is used by staff of the Commission in its enforcement, regulatory, and examination programs. The respondents are investment advisers registered with us that have custody of clients' funds or securities. The collections of information under Form ADV are necessary for use by staff of the Commission in its examination and oversight program, 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. 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. With the exception of an accountant's notification of any material discrepancies identified in a surprise examination, responses provided to the Commission are not kept confidential.

A. Rule 206(4)–2

Currently approved burdens. The current annual collection of information burden approved by OMB for rule 206(4)–2 is 415,303 hours. Rule 206(4)–2 currently requires each registered investment adviser that has custody of client funds or securities to maintain those client assets with a qualified custodian. The rule also requires that an adviser with custody of client assets send quarterly account statements to its clients and undergo an annual surprise examination unless the adviser has a reasonable belief that the qualified custodian sends account statements directly to its clients at least quarterly. In the case of an adviser to a pooled investment vehicle, the adviser does not have to obtain an annual surprise examination and deliver account statements to investors if the pooled investment vehicle is audited at least annually by an independent public accountant and distributes its audited financials to investors in the pool within 120 days of the end of the pool's fiscal year.

The current approved annual burden relating to the requirement to obtain a surprise examination and the delivery of quarterly account statements by the adviser is 21,803 hours. We estimated that 204 advisers were subject to the two requirements. We estimated that each adviser had 670 clients on average and that 193 of the 204 advisers were subject to the two requirements only with respect to 1 percent of their clients and the remainder (11 advisers) were subject to the two requirements with respect to 100 percent of their clients. We further estimated that each adviser would spend 2.5 hours per client in connection with delivering quarterly account statements to clients and undergoing an annual surprise examination pursuant to the rule.

Annual surprise examination. The proposed amendments would eliminate the option for an adviser that has custody of client assets to choose not to have a qualified custodian deliver quarterly account statements directly to clients if the adviser arranges for an annual surprise examination verifying client assets. The proposed rule also would reinstate the requirement for an annual surprise examination for (i) advisers with custody that currently rely on qualified custodians to send account statements directly to advisory clients, (ii) advisers that custody client assets themselves as qualified custodians or advisers with client assets held at a qualified custodian that is a related person,[76] and (iii) advisers to audited pooled investment vehicles. Thus the proposed rule would require all advisers that have custody of client funds or securities to be subject to an annual surprise examination. The proposed amendments are designed to enhance protections afforded to advisory clients by the custody rule. We estimate that 9,575 out of the 11,272 advisers registered with the Commission fall into this category.[77]

[76] The proposed amended rule would deem an adviser to have custody if its related persons have custody of its client assets in connection with the adviser's advisory services. Proposed rule 206(4)–2(c)(2). A related person would be defined as a person directly or indirectly controlling or controlled by the adviser, and any person under common control with the adviser. Proposed rule 206(4)–2(c)(6). The proposed amended rule would require that the surprise examination be performed by an independent public accountant registered with, and subject to regular inspection by, the PCAOB when an adviser or a related person serves as a qualified custodian for the adviser's clients.

[77] Based on information filed through the IARD as of February 2009. The 9,575 advisers include both advisers that have custody of their client assets and advisers whose related persons have custody of the adviser's client assets (including advisers that answered ''yes'' to Item 9.A. or B. of Part 1A of Form ADV). The number also includes those advisers that have discretionary authority over client accounts, which we understand predominantly reflects arrangements with clients to withdraw fees from client accounts. The 9,575 advisers, however, do not include 42 advisers that provide advisory services exclusively to registered investment companies (advisers that checked only (4) under Item 5.D). Under rule 206(4)–2(b)(4) and proposed rule 206(4)–2(b)(4), advisers are not, and would not be, subject to the custody rule with

Continued

We have categorized the estimated 9,575 advisers that report that they have custody of client assets into 4 subgroups for purposes of estimating the collection of information burden. First, we estimate that 7,126 of the 9,575 advisers do not have pooled investment vehicles as their clients.[78] Based on our records and staff's examination experiences, we estimate that these advisers would be subject to surprise examinations with respect to 85 percent of their client accounts (or 928 clients per adviser).[79] A second group of advisers that have custody, totaling 372, are also broker-dealers, banks or futures commission merchants,[80] or have a related person that serves as a qualified custodian for advisory clients' funds or securities.[81] We estimate that these advisers would be subject to an annual surprise examination with respect to 100 percent of their clients (or 1,092 clients per adviser) based on the assumption that all of their clients maintain custodial accounts with the adviser or related person. A third group of advisers, totaling 1,281,[82] advise both pooled investment vehicles and other clients, and would be subject to the surprise examination with respect to 85 percent of their non-pooled investment vehicle clients (or 928 clients per adviser)[83] and 100 percent of their pooled investment vehicle clients (or 2 funds with 100 investors per adviser).[84] A fourth group of advisers, totaling 796,[85] provide advice exclusively to pooled investment vehicles and would be subject to the surprise examination with respect to 100 percent of their pooled investment vehicle clients (or 5 funds and 250 investors per adviser).[86] We estimate that each adviser would spend an average of 0.02 hours for each client that is not a pooled investment vehicle to create a client contact list for the independent public accountant. We further estimate that the advisers to pooled investment vehicles would 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. These estimates would bring the total annual aggregate burden in connection with the surprise examination to 177,242 hours.[87] This does not nclude the collection of information discussed below, relating to the written agreement required by paragraph (a)(4) of the custody rule, as proposed to be amended.

Written agreement with accountant. Requiring the agreement with the independent public accountant that performs the surprise examination to be in writing and to specify certain duties to be performed by the accountant should not significantly increase the paperwork burden on advisers. 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 accountant in advance. We therefore estimate that each adviser would spend 0.25 hour to add the required provisions to the written agreement, with an aggregate of 2,394 hours for all advisers subject to surprise examinations.[88] Therefore the total annual burden in connection with the surprise examination would be 179,636 hours under the proposed amendments.[89]

Exception for audited pooled investment vehicles. The rule currently excepts, and the proposed rule would continue to except, 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.[90] According to data we obtained from the IARD, 2,112 advisers with custody of client assets provided advice to pooled investment vehicles as of February 2009.[91] Of these 2,112 advisers, we estimate that 796 advisers would each on average provide advice to five pooled

respect to a client that is a registered investment company.

[78] Based on the number of advisers that answered ''yes'' to Item 9.A. or B. of Part 1A of Form ADV (having custody) and checked ''none'' under Item 5.D.(6) (clients that are pooled investment vehicles) as of February 2009, excluding 42 advisers that provide advisory services only to registered investment companies (see supra note 77), and those advisers that are also registered broker-dealers, banks or futures commission merchants or have a related person broker-dealer, bank or futures commission merchant that serves as qualified custodian, which are accounted for separately in the second group. *See infra* notes 80 and 81 and accompanying text.

[79] Based on data collected from the IARD (Item 5.F.(2)(d) and (e) of Form ADV), we estimate that on average 85 percent of the client accounts managed by these advisers are discretionary accounts and the remaining 15 percent are non-discretionary accounts. We believe that advisers have custody due to withdrawal of fees only with respect to the discretionary accounts that they manage.

We estimate that each adviser has, on average, 1,092 clients. This average is based on advisers' responses to Item 5.C. of Part 1A of Form ADV as of November 2008, excluding the two advisers that reported the largest number of clients. Those advisers account for over 51 percent of all advisory clients of SEC registrants and not excluding them would raise the average client count to 2,265 clients. These two firms provide advisory services primarily over the Internet and we believe that it is appropriate to exclude these firms from our calculations.

[80] There are 139 of these investment advisers based on the number of advisers that answered ''yes'' to Item 9.A. of Part 1A of Form ADV (having custody) and checked Item 6.A.(1), (3), or (6) (indicating that the adviser is also a broker-dealer, futures commission merchant, commodity pool operator, commodity trading advisor, or bank). We eliminated advisers that are commodity pool operators or commodity trading advisors, by a firm by firm search of the National Futures Association registration database.

[81] We estimate that there are 233 of these investment advisers based on a percentage of the number of advisers that answered ''yes'' to Item 9.B. of Part 1A of Form ADV (related person custody) and checked Item 7.A.(4) or (5) (indicating that the adviser has a related person bank or futures commission merchant), and answered ''yes'' to Item 9.C. of Part 1A of Form ADV that the related person that has custody is a registered broker-dealer.

[82] Based on the number of advisers that answered ''yes'' to Item 9.A. or B. of Part 1A of Form ADV (having custody) and checked Item 5 D.(6) (indicating that they have pooled investment vehicles as clients) as of February 2009, excluding those that checked only (6) under Item 5 D. and those advisers that are also broker-dealers, banks, or futures commission merchants and custody client assets or have a related person broker-dealer, bank or futures commission merchant that serves as qualified custodian, which are accounted for separately in the second group.

[83] *See supra* note 79.

[84] We estimate that each of these advisers would advise, on average, 2 pooled investment vehicles with 50 investors in each of the pools.

[85] Based on the number of advisers that answered ''yes'' to Item 9 A. or B. of Part 1A of (having custody) and checked Item 5 D.(6) only (indicating that all their clients are pooled investment vehicles) as of February 2009 less those advisers that are also broker-dealers, banks, or futures commission merchants and custody client assets or have a related person broker-dealer, bank or futures commission merchant that serves as qualified custodian, which are accounted for separately in the second group.

[86] 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 (checked only (6) under Item 5 D.) as of February 2009. We found that 77 percent of these advisers had clients in the range of 1–10. We picked the middle point of the range for our estimate. The estimate of 250 investors per adviser is based on the calculation we submitted for the currently approved hour burden.

[87] $(7{,}126 \times 928 \times 0.02) + (372 \times 1092 \times 0.02) + [(1{,}281 \times 928 \times 0.02) + (1{,}281 \times 100 \times 0.02) + (1{,}281 \times 2 \times 1)] + [(796 \times 250 \times 0.02) + (796 \times 5 \times 1)] = 177{,}242$.

[88] $9{,}575 \times 0.25 = 2{,}394$.

[89] $177{,}242 + 2{,}394 = 179{,}636$.

[90] 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. $3{,}148 \times 250 \times 0.5 = 393{,}500$.

[91] Based on the number of advisers that answered ''yes'' to Item 9 A. or B. of Part 1A of Form ADV (having custody) and checked Item 5 D.(6) (indicating that they have clients that are pooled investment vehicles) as of February 2009.

investment vehicles that have a total of 250 investors.[92] We further estimate that the remaining advisers, 1,316 advisers, would on average each provide advice to two pooled investment vehicles that have a total of 100 investors. The hour burden imposed on the adviser relating to the mailing of the audited financial statements with respect to each investor in the pool should be minimal, and could be included with account statements or other mailings. We overestimated the burden for this delivery requirement in the past,[93] and are now revising it to an estimated 1 minute per investor for mailing audited financial statements. The aggregate annual hour burden in connection with the distribution of audited financial statements would therefore be 5,510 hours.[94]

Under the proposed amendments, the rule would clarify that an adviser to a pooled investment vehicle that is relying on the annual audit exception 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. Based on an assumption that 5 percent of pooled investment vehicles are liquidated annually at a time other than their fiscal year-end, this amendment would impose an additional burden of 276 hours per year.[95] As a result, the total annual hour burden in connection with the distribution of audited financial statements under the proposed amendments would be 5,786 hours.[96] This represents a decrease of 387,714 hours in our estimated burden.[97] This decrease in burden is primarily due to the reduction in the estimated hour burden regarding the delivery of audited financial statements to each investor and the reduction of the total number of the advisers subject to the requirement from an estimated 3,148 to 2,112.[98]

Notice to clients. Under the proposed amendments, the rule would also require each adviser to add a statement in its notification to clients upon opening a custodial account on their behalf, urging them to compare the account statements from the qualified custodian to those from the adviser if the adviser sends statements to clients. Although the statement requirement is new, it would 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, would be negligible. We estimate that 3,617 advisers would be subject to this collection of information,[99] and that each adviser would 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 would spend 10 minutes per client drafting and sending the notice. The total hour burden relating to this requirement would be 33,156 hours per year.[100] Based on the analysis above, we estimate that the total hour collection of information burden for advisers subject to rule 206(4)–2, as proposed to be amended, would be 216,184 hours per year.[101]

Annual aggregate cost. The currently approved collection of information for the custody rule includes an aggregate cost estimate of $281,000. We estimated that the accounting fees for 11 advisers that are subject to the surprise examination with respect to 100 percent of their clients would be $8,000 each annually, on average, and 193 advisers would be subject to the surprise examination with respect to only to 1 percent of their clients and therefore have accounting fees of $1,000 annually, on average. Based on the proposed rule changes we now estimate total annual aggregate costs of $170,557,500. The increase in estimated aggregated costs is attributable to an increase in the number of advisers that would be subject to the surprise examination and the requirement that an adviser obtain, or receive from related persons, an internal control report with respect to the description of controls placed in operation relating to custodial services when the adviser or related person serves as qualified custodian for the adviser's clients' funds or securities.

Based on the subcategories of advisers with custody as described above, we now estimate that all 9,575 advisers that would be subject to the surprise examination requirement and pay an accounting fee, on average, of $8,100.[102] The estimated total accounting fees for all surprise examinations would therefore be $77,557,500.[103] This would represent an increase of $77,276,500 in the cost estimate,[104] primarily resulting from an increase in the number of advisers that would be subject to the surprise examination.

If an adviser or a related person serves as a qualified custodian for client funds or securities under the proposed 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 a written internal control report that provides an opinion from an independent public accountant with respect to the adviser's or related person's controls relating to custody of client assets. We are proposing that the independent public accountant issuing the internal control report be registered with, and subject to regular inspection by, the PCAOB. We estimate that approximately 372 investment advisers would have to obtain, or receive from a related person, an internal control report relating to custodial services, and would have to maintain the report as a required record.[105] We anticipate the cost of maintaining these records will be minimal. Based on discussions with accounting professionals, we understand that the cost to prepare an internal control report relating to custody would vary based on the size and services offered by the qualified custodian, but that on average an internal control report would cost approximately $250,000 per year,[106] for

[92] *See supra* note 90.

[93] We previously estimated that an adviser would spend 0.5 hour 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.

[94] [(796 × 250 × 1 minute) + (1,316 × 100 × 1 minute)]/60 = 5,510 hours.

[95] 5,510 × 0.05 = 276.

[96] 5,510 + 276 = 5,786.

[97] 393,500 − 5,786 = 387,714.

[98] *See supra* note 90.

[99] We assume that advisers have custody solely because of deducting fees do not typically open custodial accounts on behalf of their clients. Excluding those advisers we have 3,617 advisers that may be subject to this information collection (advisers that answered ''yes'' to Item 9A. or B. of Part 1A. of Form ADV).

[100] [3,617 × (1,092 × 0.05) × 10 minutes]/60 = (3,617 × 55 (rounded up from 54.60) × 10 minutes)/60 = 33,156 hours.

[101] 177,242 + 5,786 + 33,156 = 216,184.

[102] We believe that the average accounting fee for advisers with 85 percent of client accounts subject to the surprise examination would not be materially different from that for advisers with 100 percent of client accounts subject to the surprise examination. We consulted with a few accounting firms before reaching these estimates, which include the costs of the surprise examination and any filing and reporting obligations the accountant has with respect to the surprise examination. The estimates are consistent with the estimates we made in 2002 and 2003 when last revising rule 206(4)–2. *See* the 2002 Proposing Release, at nn.72 and 73, and Section VI.A of the 2003 Adopting Release. The revised estimate reflects requirements under the proposed rule.

[103] $8,100 × 9,575 = $77,557,500.

[104] $77,557,500 − $281,000 = $77,276,500.

[105] *See infra* note 163 for explanation of our estimate.

[106] We consulted accounting firms that issue these reports to prepare this estimate.

total costs attributable to this element of the proposed rule to be 93,000,000.[107]

B. Form ADV

The currently approved collection of information for all advisers completing and amending Form ADV is 109,678 hours. Based on the proposed amendments, we estimate an increase to this collection of information, to 132,599 hours.[108] The increased burden would result from the shortening of the amortization period currently in use for the approved collection of information, increases to our estimates of the number of advisers and advisory clients, and the proposed amendments to Part 1A and Schedule D of Form ADV.

We are proposing 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. The proposed amendments would revise Item 7 of Form ADV, under which advisers report certain financial industry affiliates, to require an adviser to report all related persons who are broker-dealers and to identify which, if any, serve as qualified custodians with respect to the advisers' client assets.[109] We also propose to amend 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 proposed rule 206(4)–2. In addition, the proposed amendments to Schedule D of Form ADV would require an adviser, depending on the adviser's response to Item 9, to provide additional details including information about the accountants that perform annual audits or surprise examinations or that prepare internal control reports,[110] whether a report prepared by an independent public accountant contains an unqualified opinion,[111] and information about any related person that serves as a qualified custodian for the adviser's clients.[112]

Investment advisers should already have the information that we would require them to report on Form ADV, so the increased collection of information burden should not be significant. We estimate that these amendments would increase the average collection of information burden for the initial application and annual amendment of Form ADV from the currently approved 22.25 hours per adviser to 22.50 hours per adviser. We also estimate that there would be 12,272 advisers subject to this information collection.[113] The total annual burden for initial filing and annual amendments would therefore be 276,120.[114] For the currently approved hour burden, the Commission staff chose a fifteen-year amortization, however, for purposes of our proposal, we are amortizing the estimated burden over a shorter period of time—three years.[115] Therefore the annual burden, after amortizing it over the three year period, would be 92,040 hours or 7.5 hours per adviser.[116]

In addition to the burden associated with the initial filing and annual amendments to Form ADV, we estimated for the currently approved collection of information that, on average, each adviser filing Form ADV through the IARD system would likely amend its form 1.5 times during the year.[117] We estimated that the collection of information burden for such amendments would be 0.75 hours per amendment. We believe our proposal would not increase the hour burden per adviser in connection with such amendments. The total hour burden in connection with such amendments would therefore be 13,806 hours.[118] Adding the annual burden of 26,753 hours associated with the requirement of delivering to clients the advisers' code of ethics upon clients' request,[119] the total annual hour burden for Form ADV under the proposed amendments would be 132,599 hours.[120] This represents an increase of 22,921 hours from the currently approved annual hour burden, primarily due to the shortening of the amortization period from 15 year to three years, the increase in our estimates of the numbers of advisers and advisory clients, and the proposed amendments to Part 1A of Form ADV.[121]

C. Form ADV–E

The currently approved collection of information for Form ADV–E is 12 hours. We estimate that this collection of information would increase to 575 hours based on the proposed rule amendments. This increase results primarily from an increase in the estimated number of advisers that would be subject to the requirement of completing Form ADV–E under the proposed amendments to rule 206(4)–2 and the additional collections of information proposed by the amendments to the rule.

For the currently approved annual hour burden for Form ADV–E, we estimated that there would be 231 advisers 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.[122] We now estimate that there would be 9,575 advisers 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 would thus be increased to 479 hours.[123]

In addition, under the proposed amendments, rule 206(4)–2 would require an adviser subject to the surprise examination to enter into a written agreement with the independent public accountant that specifies the

[107] $250,000 × 372 = $93,000,000. *See infra* notes 165–166 and accompanying text for additional discussion on this estimate.

[108] This number also includes a burden of 26,753 hours associated with the requirement of delivering to clients copies of the adviser's code of ethics upon clients' request. The currently approved hour burden associated with this requirement is 78,973 hours, based on the estimates that there were 11,787 advisers subject to this burden (10,787 currently registered advisers + 1,000 new advisers). We estimated that each adviser had 670 clients and that 10 percent of those clients would request the adviser's code of ethics. We further estimated that satisfying each delivery request would impose a burden of 0.10 hour. (10,787 + 1,000) × (670 × 0.10) x 0.10 = 78,973.

We now estimate that 12,272 advisers (11,272 currently registered advisers + 1,000 new advisers) are subject to this burden and that each adviser has 1,092 clients. *See supra* note 79 for calculation of average client number. We further estimate that 10 percent of the clients would request their adviser's code of ethics and that satisfying each delivery request would impose a burden of 0.02 hour. The total burden under the new estimates would be 26,753 hours. (11,272 currently registered advisers + 1,000 new advisers) × (1,092 clients × 0.10) × 0.02 hours = 12,272 × 109 × 0.02 = 26,753 hours.

[109] Proposed Section 7 A. of Schedule D of Form ADV.

[110] Proposed Section 9 C. of Schedule D of Form ADV.

[111] *Id.*

[112] Proposed Section 9 D. of Schedule D of Form ADV.

[113] Based on the information collected from the IARD as of February 2009, 11,272 advisers were registered with us. In addition, based on historical data of the IARD, we estimate that there are approximately 1,000 new applicants for registration with the Commission each year. 11,272 + 1,000 = 12,272.

[114] 22.5 × 12,272 = 276,120.

[115] Every three years, we must submit for approval by the OMB collections of information imposed by our rules and thus the three-year period reflects the effective period of OMB's approval of this collection of information.

[116] 276,120 / 3 = 92,040; 92,040 / 12,272 = 7.5.

[117] In addition to the required annual update of their Form ADV, advisers must amend their Form ADV by filing additional amendments promptly if information they provided in response to certain items of Form ADV becomes inaccurate in any way. *See* General Instructions to Form ADV.

[118] 12,272 × 1.5 × 0.75 = 13,806.

[119] *See supra* note 108.

[120] 92,040 + 13,806 + 26,753 = 132,599 hours.

[121] 132,599 − 109,678 = 22,921 hours.

[122] 231 × 0.05 = 11.55 hours.

[123] 9,575 × 0.05 = 479.

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, 1,915 advisers would, under our proposal, be required each year to complete Form ADV–E with respect to an accountant's termination.[124] The total annual hour burden in connection with this proposal would be 96 hours,[125] and the total annual hour burden for advisers to complete Form ADV–E in connection with the surprise examination and the termination statement would be 575 hours.[126]

D. Request for Comment

We request comment whether these estimates are reasonable. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to:

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

Persons wishing to submit comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 3208, Washington, DC 20503, and also should send a copy to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090 with reference to File No. S7–09–09. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives the comment within 30 days after publication of this release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7–09–09, and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street, NE., Washington, DC 20549–0213.

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.[127] Advisers may comply with the current custody rule by either having the qualified custodian send account statements directly to their clients at least quarterly or by sending their own quarterly account statements to their clients and undergoing an annual surprise examination.[128]

The rule, as proposed to be amended, would retain the requirement that advisers maintain clients' assets with a qualified custodian, but would require all registered advisers that have custody of client assets to have a reasonable belief after due inquiry that the qualified custodian sends an account statement directly to each client or its representative for which the qualified custodian maintains assets.[129] The proposed rule would also require all advisers that have custody of client assets to undergo an annual surprise examination.[130] In addition, we propose to amend the rule to provide that an adviser has custody if any of its related persons has custody of the adviser's client assets in connection with the adviser's advisory services.[131] In situations where an adviser or a related person serves as a qualified custodian for client funds or securities under the proposed 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 a written internal control report that provides an opinion from an independent public accountant with respect to the adviser's or related person's controls relating to custody of client assets.[132] We are proposing that the independent public accountant issuing the internal control report be registered with, and subject to regular inspection by, the PCAOB.[133] We also are proposing to require that when an adviser or a related person serves as a qualified custodian for the adviser's clients' funds or securities, the surprise examination would have to be performed by an independent public accountant registered with, and subject to regular inspection by, the PCAOB.[134]

These proposed amendments are designed to improve the safekeeping of advisory client assets. We have identified, below, certain costs and benefits that may result from the proposed rule amendments. We request comment on the costs and benefits of the proposed rule amendments, and encourage commenters to identify, discuss, analyze, and supply relevant data regarding these or any additional costs and benefits.

B. Benefits

Improved protection for advisory clients. We have designed the proposed amended rule to provide greater protection for advisory clients' assets. The potential benefits to investors, however, are difficult to quantify. The proposed rule would require all registered advisers with custody of client assets to undergo an annual surprise examination by an independent public accountant that would provide ''another set of eyes'' on client assets, and thus additional protection against their misuse. In addition, the independent public accountant may identify mishandling of client assets, which may result in the earlier detection of fraudulent activities and reduce resulting client losses. We estimate that the rule, if amended to make this change, would require 9,575 advisers to obtain an annual surprise examination with respect to 8,214,462 clients' accounts.[135]

[124] 9,57 5/5 = 1,915.

[125] 1,915 × 0.05 = 96.

[126] 479 + 96 = 575.

[127] Under rule 206(4)–2(c)(3), a qualified custodian means a bank, a savings association, a registered broker-dealer, a registered futures commission merchant, and in certain instances a foreign custodial institution.

[128] Rule 206(4)–2(a)(3)(i) and (ii). In the case of a pooled investment vehicle, the account statements and surprise examination requirements can be satisfied if the pooled investment vehicle is audited at least annually and distributes its audited financial statements to the investors in the pool within 120 days of the end of the pool's fiscal year. Rule 206(4)–2(a)(3)(iii) and (b)(3).

[129] Proposed rule 206(4)–2(a)(3). We would retain the exemption from the account statement delivery requirement, described above in *supra* note 128 for an adviser to a pooled investment vehicle.

[130] Proposed rule 206(4)–2(a)(4).

[131] Proposed rule 206(4)–2(c)(2). Currently, an adviser may, depending on the circumstances, be deemed to have custody of client assets held by an affiliate. *See supra* note 76 and accompanying text.

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

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

[134] Proposed Rule 206(4)–2(a)(6)(i).

[135] For purposes of Paperwork Reduction Act analysis, we estimate that there would be 9,575 advisers subject to the surprise examination with respect to 8,214,462 advisory clients' accounts: (i)

Continued

These benefits would also extend to investors in pooled investment vehicles managed by a registered adviser, because the amended rule would require the adviser to obtain an annual surprise examination with respect to those assets. The annual surprise examination would be in addition to any annual audit of the pool (required if the qualified custodian is not sending account statements directly to investors), which is performed at the end of each fiscal year. The surprise examination requirement therefore would provide an additional deterrent to fraudulent activity by advisers that are relying on the audit exception. Based on IARD data, we estimate that 327,100 investors would benefit from the additional protection afforded by the proposal.[136]

Amending the rule to state that advisers have custody if their ''related persons'' hold client assets in connection with advisory services provided by the adviser, would extend the protections of the custody rule to these clients. This amendment to the rule would result in client assets held by the adviser or its related persons becoming subject to a surprise examination performed by an independent public accountant registered with, and subject to regular inspection by, the PCAOB and other requirements of the rule, which may deter fraudulent activity perpetrated by an adviser through its related persons, and provide an independent check on the adviser's ability to convert client assets to its own use.

The proposed rule would require an adviser to obtain, or receive from a related person, no less frequently than once each calendar year a written internal control report from an independent public accountant registered with, and subject to regular inspection by, the PCAOB with respect to controls relating to custody when the adviser or a related person serves as a qualified custodian for client funds or securities in connection with advisory services the adviser provides to clients. This requirement would provide important safeguards to advisory clients in these higher risk situations. Requiring these advisers to also obtain an internal control report would provide an additional check on the safeguards relating to client assets held at a related person qualified custodian. An internal control report could 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 could obtain additional comfort that confirmations received from the qualified custodian in the course of the surprise examination are reliable and, where a broker-dealer is the qualified custodian, may be able to leverage existing tests performed in compliance with broker-dealer auditing and internal control requirements. The internal control report may also reveal control problems, which could be significant.[137] Thus, the requirement to obtain an internal control report informs the surprise examination process and may itself act as a deterrent to advisers that may consider misappropriating client assets directly or through a related person in the guise of providing custodial services as a qualified custodian. We also propose to require advisers to maintain the internal control report as a required record to provide our staff access to the accountant's report. Based on IARD data, we estimate clients of 372 advisers would benefit from the protections provided by the internal control report requirement.[138]

The proposed amendments would 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 would be 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 would, under the proposed amendments, receive account statements directly from qualified custodians.[139] This change would provide clients confidence that any erroneous or unauthorized transactions would be reflected and, as a result, deter advisers from fraudulent activities. Based on IARD data, we estimate that 176,320 clients would benefit from this proposal and would receive account statements directly from qualified custodians.[140]

As proposed to be amended, the rule would require each adviser that is required to undergo an annual surprise examination to enter into a written agreement with an independent public accountant to perform the surprise examination. The written agreement would 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 of engagement, file Form ADV–E within 4 business days accompanied by a statement explaining the reasons for such termination if related to examination scope or procedure. These filings and reports would provide our staff additional information to prioritize examinations and would assist in establishing advisers' risk profiles. As proposed, the rule would result in the electronic filing of Form ADV–E and the accountant statement on the Internet-based IARD system. Clients would benefit from electronic filing of the Form ADV–E because it would allow them to easily access important information about the surprise examinations performed on their advisers. We estimate that 8,214,462 advisory clients and 327,100

928 clients for each of the 7,126 advisers that would have non-pool clients only, (ii) 1,092 clients for each of the 372 advisers that are themselves qualified custodians, (iii) 930 clients (928 individual clients and 2 fund clients) for each of the 1,281 advisers that provide advice to both individual clients and pooled investment vehicles; and (iv) 5 fund clients for each of the 796 advisers that provide advice to pooled investment vehicles only. *See supra* notes 77–86 and accompanying text.

[136] As stated above in supra notes 77–86 and accompanying text, for purposes of the Paperwork Reduction Act analysis, we estimated that 1,281 advisers that provide advice to both individual clients and pooled investment vehicles would each be subject to the surprise examination with respect to two pooled investment vehicles with 50 investors in each pool and 796 advisers that provide advice exclusively to pooled investment vehicles would be subject to the surprise examination with respect to five pooled investment vehicles with 50 investors in each pool. [(1,281 × 100) + (796 × 250) = 327,100].

[137] In addition to the specific procedures an independent public accountant must follow during a surprise examination, the accountant should perform any additional audit procedures deemed necessary under the circumstances. *See Nature of Examination Required to be Made of All Funds and Securities Held in Custody of Investment Advisers and Related Accountant's Certificate, supra* note 8.

[138] We estimate that 139 investment advisers that are also banks, registered broker-dealers or futures commission merchants would custody client assets as a qualified custodian under the rule. Based on IARD data, we also estimate that 233 investment advisers have a related person bank, registered broker-dealer or futures commission merchant that is a qualified custodian for advisory client assets. 139 + 233 = 372.

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

[140] We estimate that approximately 190 advisers would be subject to the surprise examination with respect to 928 clients each under the current custody rule. The proposed elimination of the option for advisers to send account statements would result in approximately 176,320 clients receiving account statements directly from the qualified custodian. (190 × 928 = 176,320).

investors in pooled investment vehicles would benefit from the proposed change.[141] Furthermore, the availability to the general public of Form ADV–E information on the Commission's Web site may result in additional benefits, including to potential clients deciding which investment adviser to select.

We are proposing to require advisers to include a statement in the notice that they are currently required to send to their clients upon opening a custodial account on their clients' behalf.[142] The statement would 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 could enhance the rule's effectiveness. We estimate that 198,935 clients would receive notices containing this additional information.[143]

Finally, we propose to amend Form ADV in connection with the amendments to the custody rule. We would modify Item 7 of Part 1A under which advisers report certain financial industry affiliates, to require an adviser to report all related persons that are broker-dealers and to identify which, if any, serve as qualified custodians with respect to the adviser's client assets.[144] We also would amend 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 proposed amendments to Schedule D of Form ADV would require an adviser, depending on the adviser's response to Item 9, to provide additional details including information about the accountants that perform annual audits, surprise examinations or that prepare internal control reports,[145] whether a report prepared by an accountant contains an unqualified opinion,[146] and about any related person that serves as a qualified custodian for the adviser's clients.[147] These disclosures would provide our staff more information to determine advisers' risk profiles and prepare for examinations. Moreover, this information would be filed electronically under the proposed amended rule and would be available to the public on the Commission's Web site. Clients would therefore benefit by obtaining more information about their advisers' custodial practices.

Improved clarity of the rule. We anticipate that investment advisers would find it easier to understand and comply with the rule as a result of the proposed amendments, which may result in cost savings for advisers. The proposed amendments would 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.'' [148]

C. Costs

Surprise Examination. As discussed above, the proposed amended rule would require all advisers with custody of client assets to undergo an annual surprise examination. This amendment would result in a new requirement to obtain a surprise examination for (i) advisers with custody that rely on qualified custodians to send account statements directly to advisory clients, (ii) advisers that custody client assets themselves as qualified custodians or advisers with client assets held at a qualified custodian that is a related person,[149] and (iii) advisers to pooled investment vehicles that are subject to an annual audit and deliver the audited financial statements to investors in the pool.[150] Based on the data we collected from Form ADV as of February 2009, we estimate that the proposed amended rule would subject 9,575 advisers to an annual surprise examination.[151] Reducing that number by the 190 advisers that already undergo an annual surprise examination under the current rule,[152] we estimate that the proposed amendments would result in approximately 9,385 additional advisers being required to obtain a surprise examination.[153] For purposes of the Paperwork Reduction Act analysis, we estimate a total annual collection of information burden in connection with the surprise examination of 179,636 hours.[154] Based on this estimate we anticipate that advisers would incur an aggregate cost of approximately $11,783,898 per year for the total hours their employees spend in complying with the surprise examination requirement.[155]

In addition, advisers subject to the surprise examination requirement would incur accounting fees to comply with the requirement. We previously estimated that there were 204 advisers subject to the surprise examination requirement under the current custody rule.[156] Of the 204 advisers, 11 advisers were subject to the surprise examination with respect to 100 percent of their clients and spent $8,000 each annually,

[141] *See supra* notes 135 and 136 and accompanying text for further information.

[142] Rule 206(4)–2(a)(2).

[143] We estimated that approximately 3,617 advisers open accounts on behalf of their clients and each year on average open accounts for about 5% of their 1,092 clients who are either new clients or whose accounts have been transferred to new qualified custodians. (3,617 × (1,092 × 0.05) = 3,617 × 55 (rounded up from 54.60) = 198,935).

[144] Proposed Section 7.A. of Schedule D of Form ADV.

[145] Proposed Section 9.C. of Schedule D of Form ADV.

[146] *Id.*

[147] Proposed Section 9.D of Schedule D of Form ADV.

[148] Rule 206(4)–2(c).

[149] Under the current custody rule, depending on circumstances, an adviser may or may not have custody if a related person has custody of its clients' assets. *See supra* note 76.

[150] We also have proposed to amend the rule to make privately offered securities that investment advisers hold on behalf of their clients subject to the surprise examination requirement. It is unlikely that an adviser would be subject to the surprise examination requirement *solely* based on this rule change, but rather the amendment would subject these positions to the surprise examination requirement.

[151] Based on responses to Item 9.A. or Item 9.B. and Item 5 of Part 1A, Form ADV as of February 2009. We reduced this number by the 42 advisers that provide advisory services exclusively to registered investment companies (advisers that checked only (4) under Item 5 D.). Under rule 206(4)–2(b)(4) and proposed rule 206(4)–2(b)(5), advisers are not subject to the custody rule with respect to the account of a registered investment company.

[152] *See supra* note 139 and 140.

[153] 9,575 − 190 = 9,385.

[154] *See supra* note 89 and accompanying text for further information. We estimate that of the 179,636 hours, 177,242 would be spent on providing clients lists and other information to the independent public accountant performing the examination and 2,394 hours would be spent on adding to the written agreement with the accountant the specified duties the rule would require the accountant perform.

[155] We expect that the function of providing lists of clients and other information to the independent public accountant in assisting its examination, totaling 177,242 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. We expect that the function of adding certain duties of the accountant to the written agreement with the accountant, totaling 2,394 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 $11,783,898 ((177,242 × $63) + (2,394 × $258)).

[156] We did the estimate in connection with our 2007 application for hour burden approval from the OMB under the Paperwork Reduction Act with respect to information collection required by the current custody rule.

on average, and 193 advisers were subject to the surprise examination with respect to only 1 percent of their clients and spent $1,000 each annually, on average. The total estimated accounting fees were therefore $281,000.[157]

We now estimate that there would be 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.[158] The estimated total accounting fees for all surprise examinations would therefore be $77,557,500.[159] This represents an increase of $77,276,500 in estimated costs attributable to this rulemaking, resulting primarily from the increase in the estimated number of advisers that would be subject to the surprise examination.[160]

Under the proposed amended rule 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, specifying certain duties that the accountant would perform under the rule.[161] We believe that the requirement of a written agreement reflects current industry practice and that advisers therefore would have a written agreement with their accountants regardless of whether it is required by the custody rule. Requiring certain additional items to be included in the written agreement would not significantly increase costs for advisers.[162] Moreover, 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) would materially increase the accounting fees for the surprise examination discussed above.

Internal Control Report. As discussed above, in situations where an adviser or a related person serves as a qualified custodian for client funds or securities under the proposed 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 a written internal control report that provides an opinion from an independent public accountant with respect to the adviser's or related person's controls relating to custody of client assets. We are proposing that the independent public accountant issuing the internal control report be registered with, and subject to regular inspection by, the PCAOB. We estimate that approximately 372 investment advisers would have to obtain, or receive from a related person, an internal control report relating to custodial services, and would have to maintain the report as a required record.[163] We anticipate the cost of maintaining these records will be minimal. Based on discussions with accounting professionals, we understand that the cost to prepare an internal control report relating to custody would vary based on the size and services offered by the qualified custodian, but that on average an internal control report would cost approximately $250,000 per year, for total costs attributable to this section of the proposed rule to be $93,000,000.[164]

Our estimated cost of implementing the internal control report requirement is based on information available to us. We believe, however, that actual costs may be lower than estimated because (i) some qualified custodians already obtain an internal control report on their custody practices,[165] (ii) advisers that have more than one related person qualified custodian may concentrate these custody arrangements with a single related person qualified custodian, and (iii) that to the extent advisers have accommodated certain client arrangements that result in a related person maintaining client funds or securities on an infrequent basis, they may discontinue these accommodations.[166]

Liquidation Audit. The proposed amended rule would specifically require an adviser to a pooled investment vehicle that is relying on the annual audit exception to obtain a final audit if the pool is liquidated at a time other than the end of a fiscal year.[167] This clarification would assure that the proceeds of the liquidation are appropriately accounted for. We believe this clarification would 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.

Due Inquiry. The proposed rule would require 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, with the exception for certain pooled investment vehicles, described above. 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, so we believe few advisers would have to change their practices.[168] 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.

Form ADV. As discussed above, we are proposing 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 Paperwork Reduction Act analysis, we estimate that these amendments would increase the annual information collection burden in connection with Form ADV from 22.25 hours to 22.50 hours for each adviser.[169] The total

[157] (11 × $8,000) + (193 × $1,000) = $281,000.

[158] *See supra* note 102 and accompanying text.

[159] 9,575 × $8,100 = $77,557,500.

[160] $77,557,500 − $281,000 = $77,276,500.

[161] Proposed rule 206(4)–2(a)(4).

[162] We estimate that it would take each adviser about 0.25 hour to add the required specifications. *See supra* note 88 and accompanying text. Converting the hour burden to costs, each adviser would spend $64.50. *See supra* note 155.

[163] Some advisers may have client assets that are in custody with more than one related person qualified custodian, but a related person qualified custodian also may provide custody services to more than one related person investment adviser. For purposes of this analysis we assume that these alternatives offset one another since those advisers that have more than one related person that is a qualified custodian is likely part of a large financial service provider and the custodian is more likely to be providing custody services to more than one adviser. The same internal control report would satisfy the rule's obligations for related person advisers that use a common related qualified custodian.

[164] $250,000 × 372 = $93,000,000.

[165] For instance, it is our understanding after discussions with several large accounting firms that mutual fund custodians obtain internal control reports to assist funds in meeting their obligations under the Investment Company Act compliance program rule (rule 38a– 1) [17 CFR 270.38a–1].

[166] For instance, an advisory client may be referred to the adviser by a related person broker-dealer that would continue to maintain custody of the client assets even though the adviser is managing the assets.

[167] Proposed rule 206(4)–2(b)(3)(ii).

[168] 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; *see supra* notes 139 and 140.

[169] *See supra* notes 113–121 and accompanying text.

information collection burden resulting from the proposed amendments would be 3,068 hours.[170] Based on this estimate we anticipate that advisers would incur an aggregate cost of approximately $193,284 per year for the total hours their employees spend in connection with the proposed provisions of Form ADV.[171]

Form ADV–E. For purposes of the Paperwork Reduction Act analysis, we estimate that the collection of information in connection with Form ADV–E would increase from the currently approved 12 hours to 575 hours based on the proposed rule amendments. This increase results from an increase in the estimated number of advisers that would be subject to the requirement of completing Form ADV–E under the proposed amendments to rule 206(4)–2 and the additional collections of information proposed by the amendments relating to filing Form ADV–E when an independent public accountant performing the surprise examination terminates its engagement. This represents an increase of 563 hours[172] with an estimated aggregated annual cost of approximately $35,469.[173]

D. Request for Comment

- The Commission requests comments on all aspects of the cost-benefit analysis, including the accuracy of the potential costs and benefits identified and assessed in this release, as well as any other costs or benefits that may result from the proposals.
- We encourage commenters to identify, discuss, analyze, and supply relevant data regarding these or additional costs and benefits.

VI. Initial Regulatory Flexibility Analysis

The Commission has prepared the following Initial Regulatory Flexibility Analysis (''IRFA'') regarding proposed rule 206(4)–2 in accordance with section 3(a) of the Regulatory Flexibility Act.[174]

A. Reasons for Proposed Action

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. Advisers may comply with the current custody rule either by having a reasonable belief that the qualified custodian sends periodic account statements directly to the advisory clients or by the adviser sending its own quarterly account statements to its clients and undergoes an annual surprise examination.[175] An adviser to a pooled investment vehicle may comply with the rule by having the pool audited annually by an independent public accountant and distributing the audited financials to the investors in the pool within 120 days of the end of the pool's fiscal year.[176]

To enhance the protections afforded to clients' assets, we are proposing to require *all* registered advisers that have custody of client assets to have a reasonable belief that the qualified custodian that holds advisory client assets sends account statements directly to advisory clients at least quarterly.[177] Under the proposed amendments, the rule would require all advisers having custody of client assets to undergo an annual surprise examination.[178] In addition, the rule would explicitly state that an adviser has custody if any of its related persons has custody of the adviser's client assets in connection with the adviser's advisory services.[179] The rule would also require the adviser and the accountant, under the terms of its agreement with the adviser, to report information to the Commission that would assist the Commission in protecting advisory client assets. Together, these revisions to the rule are designed to strengthen the controls relating to advisers' custody of client assets and deter advisers from fraudulent activities.

B. Objectives and Legal Basis

We have designed the proposed amendments to enhance the protections afforded to clients when their advisers have custody of client assets. The surprise examination requirement of the rule may 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 proposed amendments would eliminate the exemption from the requirement of an annual surprise examination provided under the current rule for advisers to audited pooled investment vehicles. Annual surprise examinations of pooled investment vehicles would provide the investors in the pool additional protection. Unlike an annual audit of the pool, which is performed at the end of each fiscal year, the accountant could choose to conduct the surprise examination at any time during the year. The possibility of an unscheduled examination at any time would act as an additional deterrent to fraudulent activity by advisers, and would provide an independent check on the safety of pooled investment vehicle assets.

The proposed amendments would provide that an adviser is deemed to have custody of client assets held by related persons. These amendments would result in the rule being easier to understand for advisers. Similarly, the proposed amendments would add to the rule definitions of ''control'' and ''related person'' to assist advisers in understanding the rule.

The Commission is proposing to amend rule 206(4)–2 pursuant to the authority set forth in sections 206(4) and 211(a) of the Advisers Act [15 U.S.C. 80b–6(4) and 80b–11(a)]; to amend 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]; to amend Form ADV pursuant to the authority set forth in sections 203(c)(1), 204, and 211(a) of the Advisers Act [15 U.S.C. 80b–3(c)(1), 80b–4 and 80b–11(a)]; and to amend Form ADV–E 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)]. Section 206(4) gives us authority to issue rules designed to prevent fraudulent, deceptive, or manipulative acts or practices. Section 211 gives us authority to classify, by rule, persons and matters within our jurisdiction and to prescribe different requirements for different classes of persons, as necessary or appropriate to the exercise of our authority under the Act. Section 203(c)(1) gives us authority to prescribe registration forms, by rule, to collect information and documents, as necessary or appropriate in the public interest or for the protection of investors. Section 204 gives us authority to prescribe, by rule, such records and reports that an adviser must make, keep

[170] As stated above we estimate that there would be 12,272 advisers subject to the Form ADV filing requirement. *See supra* note 113 ((22.50 – 22.25) × 12,272 = 3,068).

[171] 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 155 for explanation of the hourly compliance clerk cost estimate.

[172] 575 − 12 = 563.

[173] 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 $35,469. *See supra* note 155 for explanation of the hourly compliance clerk cost estimate.

[174] 5 U.S.C. 603(a).

[175] Rule 206(4)–2(a)(3)(i) and (ii).

[176] Rule 206(4)–2(a)(3)(iii) and (b)(3).

[177] Proposed rules 206(4)–2(a)(3) and (b)(3). As described above, the rules would continue to contain a limited exception to this requirement for audited pooled investment vehicles.

[178] Proposed rule 206(4)–2(a)(4).

[179] Proposed rule 206(4)–2(c)(2). Under the current custody rule, an adviser may or may not have custody if a related person has custody of its clients' assets.

for prescribed periods, or disseminate, as necessary or appropriate in the public interest or for the protection of investors.

C. Small Entities Subject to Rule

Under Commission rules, for the purposes of the Advisers Act and the Regulatory Flexibility Act, an investment adviser generally is a small entity if it: (i) Has assets under management having a total value of less than $25 million; (ii) did not have total assets of $5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had $5 million or more on the last day of its most recent fiscal year.[180]

The Commission estimates that as of February 2009 approximately 177 SEC-registered investment advisers that have custody of client assets were small entities, and that no more than 8 of these advisers or their related persons would serve as a qualified custodian for client funds or securities under the proposed rule in connection with advisory services the advisers provides to their clients.[181]

D. Reporting, Recordkeeping, and Other Compliance Requirements

The proposed rule amendments would impose certain reporting, recordkeeping and compliance requirements on advisers, including small advisers. The rule would require 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 proposed 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 would specify certain duties the accountant would have to perform as part of the surprise examination engagement. Investment advisers, under the proposed rule amendments, would have to maintain a copy of an internal control report that an adviser would be 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 estimated that the average annual accounting fee for such surprise examination would be $8,100 for each of the advisers subject to the surprise examination.[182] This is based on our estimate that each adviser, on average, would be subject to the surprise examination with respect to 928 client accounts. Most small advisers that would be subject to the surprise examination have less than 6 accounts that would be included in the surprise examination.[183] Thus the accounting fees for surprise examination conducted on small advisers would likely be much lower than our estimated average cost. As a result, the potential impact of the amendments on small entities due to the proposed surprise examination requirement should not be significant.

We also estimated that on average an internal control report would 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 advisers would have to obtain these reports, half of which would have to obtain the report and the other half would have to receive the report from a related person.

E. Duplicative, Overlapping, or Conflicting Federal Rules

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

F. Significant Alternatives

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the proposed rule 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 proposed amendments.

Regarding the second alternative, the proposed amendments would clarify when an investment adviser, including a small adviser, has custody. 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.

G. Solicitation of Comments

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

- The number of small entities that would be affected by the proposed rule; and
- whether the effect of the proposed rule on small entities would be economically significant.

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

VII. Effects on Competition, Efficiency and Capital Formation

Section 202(c)(1) of the Advisers Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[184] Today the Commission is proposing amendments to rule 204–2, Part 1A of Form ADV and Form ADV–E in connection with proposing amendments to rule 206(4)–2, the rule governing registered investment adviser custodial practices.[185]

The proposed 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-

[180] 17 CFR 275.0–7(a).

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

[182] *See supra* note 102.

[183] Based on data collected from the IARD as of February 2009, more than half of the 177 small advisers would be subject to the surprise examination with respect to no more than 6 accounts.

[184] 15 U.S.C. 80b–2(c).

[185] We are proposing amendments to rule 206(4)–2 pursuant to our authority set forth in sections 206(4) and 211(a) of the Advisers Act. Analysis of the effects of these proposed amendments is contained in sections IV, V, and VI above.

based examination program. Under the proposed amendments to Form ADV–E, the form and attached accountant's certificate would be filed electronically on the IARD system. In addition, the rule would require the accountant performing an annual surprise examination to, upon termination of its engagement, file a Form ADV–E and a termination statement to explain the reasons for such termination. Both Part 1A of Form ADV and Form ADV–E would 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 proposed amendments are unrelated to, and will have little or no effect on, capital formation.

We are proposing to amend rule 204–2 to require 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 rule 206(4)–2(a)(6) for five years from the end of the fiscal year in which the internal control report is finalized.[186] The proposed amendment is designed to provide our examiners important information about the safeguards in place at an adviser or a related person that maintains client assets. We believe that the proposed amendment would not materially increase the compliance burden on advisers under rule 204–2 and thus would not affect competition, efficiency and capital formation.

The Commission requests comment whether the above proposals, if adopted, would promote efficiency, competition, and capital formation. Commenters are requested to provide empirical data to support their views.

VIII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or ''SBREFA,''[187] the Commission must advise OMB whether a proposed regulation constitutes a ''major'' rule. Under SBREFA, a rule is considered ''major'' where, if adopted, it results in or is likely to result in: (1) An annual effect on the economy of $100 million or more; (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effects on competition, investment or innovation.

We request comment on the potential impact of the proposed rule amendments on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

IX. Statutory Authority

We are proposing 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 proposing 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 proposing 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 proposing amendments 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 Proposed Rule and Form Amendments

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

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

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

Authority: 15 U.S.C. 80b–2(a)(11)(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; and

c. Adding paragraph (a)(17)(iii).

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).

* * * * *

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. Include in the notification a statement urging the client to compare the account statements he or she shall receive from the custodian with those from the adviser.

[186] Proposed rule 206(4)–2 would require 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* proposed rule 206(4)–2(a)(6)(ii).

[187] Public Law No. 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

(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 for which you have custody are verified by actual examination at least once during each calendar year 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 also 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 or 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 a member registered with, and that is subject to regular inspection as of the commencement of the professional engagement period by, the Public Company Accounting Oversight Board in accordance with its rules; and

(ii) You must obtain, or receive from your related person, 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, issued in accordance with the standards of the Public Company Accounting Oversight Board, with respect to the description of controls placed in operation 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, and tests of operating effectiveness; and

(B) The independent public accountant must be a member registered with, and that is subject to regular inspection as of the commencement of the professional engagement period 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 books of the issuer or its transfer agent in the name of the client; and

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

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

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

(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; and

(ii) 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.

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

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

(1) *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 (''LLC'') if the person:

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

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

(C) Is an elected manager of the LLC; 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) *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.

(6) *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 Sections 7.A., 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.

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.

* * * * *

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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 deduct your advisory fees directly from your clients' accounts but you do not otherwise have custody of your clients' funds or securities.

(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) _____

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?	☐	☐

(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.

The instruction to Item 9.A.(1)(a) and (b) above regarding fee deductions does not apply to this Item 9.C.

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 responded "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 ☐

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

* * * * *

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, 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.

* * * * *

By the Commission.

Dated: May 20, 2009.

Elizabeth M. Murphy,

Secretary.

[FR Doc. E9–12182 Filed 5–26–09; 8:45 am]

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