

1  
**SUPPORTING STATEMENT**  
**Rule 206(4)-2**

**A. JUSTIFICATION**

**1. Necessity for the Information Collection**

Section 206(4) of the Investment Advisers Act of 1940 (“Advisers Act”) [15 USC 80b-6(4)] prohibits any investment adviser from engaging in any act, practice or course of business which is fraudulent, deceptive or manipulative and gives the Commission the power, by rules and regulations, to define and prescribe means reasonably designed to prevent such acts, practices and courses of business.

Rule 206(4)-2 under the Advisers Act requires advisers to protect the assets that their clients have entrusted to their custody. The rule contains several “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995 [44 U.S.C. 3510 to 3520]. The title for the collection of information is “Rule 206(4)-2 under the Investment Advisers Act of 1940 -- Custody of Funds or Securities of Clients by Investment Advisers.” The collection of information is currently approved under OMB control number 3235-0241. The Commission is submitting this Paperwork Reduction Act Submission for an extension and a revision to the currently approved collection of information.

Rule 206(4)-2 requires each investment adviser that has custody of client funds or securities to maintain those client funds or securities with a broker-dealer, bank or other “qualified custodian.” This requirement is necessary to safeguard the client assets over which the adviser has control or access. The rule also requires the adviser to promptly notify the clients as to the place and manner of custody, to send quarterly account statements to each client whose assets are in the adviser’s custody, and to have an independent public accountant conduct

an annual surprise examination of the custodied assets. However, if the qualified custodian sends monthly account statements directly to an adviser's clients, the adviser is relieved from sending its own account statements and undergoing an annual surprise examination. Account statements are necessary to enable clients to review the activity in their accounts and to question any discrepancies or irregularities. The rule exempts advisers from the rule with respect to clients that are registered investment companies. The rule also exempts advisers to limited partnerships and limited liability companies from the account statement delivery and annual surprise examination requirements if the limited partnerships or limited liability companies they advise are subject to annual audit by an independent public accountant.

These collection of information requirements are found at 17 CFR 275.206(4)-2 and are mandatory. As discussed, advisory clients use this information to confirm proper handling of their accounts. The Commission's staff uses the information obtained through the collection in its enforcement, regulatory and examination programs. The respondents to this information collection are those investment advisers that are registered with the Commission and have custody of client funds or securities.

## **2. Purpose of the Information Collection**

As discussed above, the Commission uses the information required by rule 206(4)-2 in connection with its investment adviser enforcement, regulatory, and examination programs. Advisory clients use the information required by rule 206(4)-2 to monitor their adviser's handling of their accounts. Without the information collected under the rule, the Commission would be less efficient and effective in its programs and advisory clients would not have information they need to monitor the adviser's handling of their accounts.

### **3. Role of Improved Information Technology**

The collection of information requirements under rule 206(4)-2 take the form of (1) mailing of account statements to advisory clients from either the adviser, (2) annual surprise examinations conducted by independent public accountants, and (3) mailing of audited financial statements to investors in a fund. Accordingly, the Commission's use of computer technology may have little effect. The Commission currently permits advisers to provide to clients the information required by rule 206(4)-2 electronically.<sup>1</sup>

### **4. Efforts to Identify Duplication**

The requirements of rule 206(4)-2 are not duplicated elsewhere for those investment advisers that must comply with the rule.

### **5. Effect on Small Entities**

The requirements of rule 206(4)-2 apply equally to all investment advisers that are registered with the Commission and have custody of funds or securities of their clients, including those advisers that are small entities. It would defeat the purpose of the rule to exempt small entities from these requirements.

### **6. Consequences of Less Frequent Collection**

If the information required by rule 206(4)-2 is either not collected or is collected less frequently, both the Commission's ability to protect investors and the ability of clients to monitor the handling of their accounts would be reduced.

---

<sup>1</sup> See Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information; Additional Examples Under the Securities Act of 1933, Securities Exchange Act of 1934, and Investment Company Act of 1940, Investment Advisers Act Release 1562, (May 9, 1996).

**7. Inconsistencies with Guidelines in 5 CFR 1320.5(d)(2)**

Investment advisers registered with the Commission may be required to maintain and preserve certain information required under rule 206(4)-2 for more than three years. The long-term retention of these records is necessary for the Commission's inspection program to ascertain compliance with the Investment Advisers Act.

**8. Consultation Outside Agency**

The Commission and the staff of the Division of Investment Management participate in an ongoing dialogue with representatives of the investment adviser industry through public conferences, meetings and informal exchanges. These various forums provide the Commission and the staff with a means of ascertaining and acting upon paperwork burdens confronting the industry.

**9. Gift or Gift to Respondents**

Not applicable.

**10. Assurance of Confidentiality**

Not applicable.

**11. Sensitive Questions**

Not applicable.

**12. Estimate of Hour Burden**


The current annual burden approved by OMB for rule 206(4)-2 is 398,738 hours for the 1,686 advisers that the Commission estimated in 2004 were subject to the information collection burden under the rule. We now request that the total information collection hours be increased

to 415,303 hours. The cause of such increase is the increase in the estimated number of respondents.<sup>2</sup>

As discussed above, rule 206(4)-2 requires each investment adviser that has custody of client funds or securities to maintain those client funds or securities with a broker-dealer, bank or other “qualified custodian.” The rule also requires an adviser to send quarterly account statements to each client whose assets are in the adviser’s custody, and to have an independent public accountant conduct an annual surprise examination of the custodied assets. An adviser is exempted from the account statement delivery and annual surprise examination requirements if the qualified custodian sends account statements directly to the adviser’s clients. According to data collected from the EDGAR system,<sup>3</sup> 204 investment advisers were subject to the account statement delivery and surprise examination requirements and had the independent public accountant file a certificate on Form ADV-E with the Commission after the completion of the examination during 2006. We estimate that these advisers would have an average of 670 clients each. We further estimate that (i) 95 percent (193) of the 204 advisers would be eligible for exemption from the account statement delivery and annual surprise examination requirements with respect to 99 percent of their clients, and (ii) 5 percent (11) of the 204 advisers would be

---

<sup>2</sup> We now estimate that 3,352 respondents would be subject to the information collection burden under the rule.

<sup>3</sup> EDGAR (Electronic Data Gathering and Retrieval). The Commission uses EDGAR to make public company documents such as 10-Ks, 10-Qs, quarterly reports, and other SEC filings, available to the public. 

subject to the account statement delivery and surprise examination requirements with respect to all their clients. The aggregate annual burden would be 21,803 hours for this group of advisers.<sup>4</sup>

Rule 206(4)-2 also exempts advisers to limited partnerships and limited liability companies from the account statement delivery and surprise examination requirements if the limited partnership or limited liability company is audited annually by an independent public accountant and the audited financial statements are distributed to the investors in the limited partnership.<sup>5</sup> According to the data we collected from the IARD,<sup>6</sup> there were 3148 advisers to limited partnerships and limited liability companies as of March 2007. We assume that these advisers would be exempted by the rule from the information collection burden as described in the previous paragraphs. They would be, however, subject to the audited financial statement delivery requirement. We estimate that these advisers would have, on average, 250 investors in the funds they advise and thus the annual audited financial statement delivery requirement would impose an aggregate of 393,500 burden hours on these advisers.<sup>7</sup>

---

<sup>4</sup> The 193 advisers facing this burden with respect to 1% of their clients would spend 2.5 hour per client for 7 clients annually with a total burden of 3,378 hours ( $193 \times 7 \times 2.5 = 3,378$ ). We estimated that such respondents would spend 2.5 hours annually for each client based on the assumption that they responded, on average, 5 times annually (4 times to prepare quarterly account statements and 1 time to respond to the annual surprise examination requirement) with respect to each of the 7 clients at an average of 0.5 hour per response, thus spending an estimated 2.5 hours per client annually. The remaining 11 advisers facing this burden with respect to all of their clients would each spend 2.5 hour per client for 670 clients annually with a total burden of 18,425 hours ( $11 \times 670 \times 2.5 = 18,425$ ).

<sup>5</sup> We understand that advisers to pooled investment vehicles are subject to contractual obligations to retain an accountant to audit the funds they advise. The Commission adopted this alternative compliance approach under the rule to align regulatory requirements with industry practice.

<sup>6</sup> IARD (Investment Adviser Registration Depository). Investment advisers use the IARD to file their initial registration applications and annual amendments of Form ADV electronically.

<sup>7</sup> We estimate that the 3148 advisers would each spend 0.5 hour per investor annually for delivering audited financial statements to their 250 investors ( $3148 \times 250 \times 0.5 = 393,500$ ).

Based on the above analysis, we estimate that the total burden hours faced by the advisers subject to rule 206(4)-2 would be 415,303 hours.<sup>8</sup>

### **13. Estimate of Total Annual Cost Burden**

The currently approved annual burden under rule 206(4)-2 includes an aggregate cost estimate of \$963,000. We now estimate that the annual cost burden under the rule would decrease to \$281,000. The cause for such decrease is the decrease in the estimated number of respondents that would be subject to annual cost burden under the rule.<sup>9</sup>

As discussed earlier, we now estimate that 204 advisers would be subject to the surprise examination requirement under rule 206(4)-2. Of the 204 advisers, 11 advisers would be subject to the surprise examination requirement with respect to all of their clients and 193 advisers would be subject to the requirement with respect to 1 percent of their clients. We further estimate that accounting fees for the 193 advisers who would be subject to the examination requirement for 1 percent of their clients would be \$1,000 per adviser and the accounting fees for the 11 advisers who would be subject to the examination requirement for all of their clients would be \$8,000. Therefore, the aggregate cost estimates for accounting fees for the annual

surprise examinations would be \$88,000 for the 11 advisers<sup>10</sup> and \$193,000 for the 193

---

<sup>8</sup> 21,803 hours for advisers that would be subject to account statement delivery and surprise examination requirements and 393,500 hours for advisers to limited partnerships and limited liability companies (21,803 + 393,500 = 415,303).

<sup>9</sup> We estimated in 2004 that the total respondents subject to the cost burden (in this case annual surprise examination by an independent public accountant) would be 711 respondents. We now estimate that there would be 204 respondents in total who would be subject to the annual surprise examination.

advisers,<sup>11</sup> such that the aggregate cost estimate under the rule would decrease to \$281,000.<sup>12</sup>

#### **14. Estimate of Cost to the Federal Government**

There are no additional costs to the federal government.

#### **15. Explanation of Changes in Burden**

The current annual burden approved by OMB for rule 206(4)-2 is 398,738 hours. We now request that the total information collection hours be increased to 415,303 hours. The cause of such increase is the increase in the estimated number of respondents. The Commission estimated in 2004 that 1,686 advisers were subject to the information collection burden under the rule. We now estimate that 3,352 respondents would be subject to the information collection burden under the rule.

The currently approved annual burden under rule 206(4)-2 includes an aggregate cost estimate of \$963,000. We now estimate that the annual cost burden under the rule would decrease to \$281,000. The cause for such decrease is the decrease in the estimated number of respondents that would be subject to annual cost burden under the rule. We estimated in 2004 that the total respondents subject to the cost burden (in this case annual surprise examination by an independent public accountant) would be 711 respondents. We now estimate that there would be 204 respondents in total who would be subject to the annual surprise examination.

#### **16. Information Collection Planned for Statistical Purposes**

Not applicable.

---

<sup>10</sup> 11 advisers x \$8,000 accounting fees = \$88,000.

<sup>11</sup> 193 advisers x \$1,000 accounting fees = \$193,000.

<sup>12</sup> \$88,000 + \$193,000 = \$281,000.



**17. Approval to not Display Expiration Date**

Not applicable.

**18. Exception to Certification Statement**

Not applicable.

**B. COLLECTION OF INFORMATION EMPLOYING STATISTICAL METHODS**

Not applicable.