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**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 U.S.C. 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.<sup>1</sup> 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 a revision to the currently approved collection of information requirements under the above mentioned OMB control number.

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

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<sup>1</sup> 17 CFR 275.206(4)-2.

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 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.

The Commission is proposing amendments to rule 206(4)-2,<sup>2</sup> which, among other things, would require all 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 regardless of whether a qualified custodian directly provides statements to clients or, in the case of a pooled investment vehicle, whether 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. 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 internal control report from an independent public accountant that includes an opinion regarding the qualified custodian's controls relating to custody of client assets.

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<sup>2</sup> See Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2876 (May 20, 2009) [74 FR 25354 (May 27, 2009)].

The Commission is also proposing to require all registered advisers with custody of client funds or securities to have a reasonable basis after due inquiry 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. The amendment would eliminate the alternative, currently provided in the rule, under which an adviser can send its account statements to clients if it undergoes a surprise examination by an independent public accountant at least annually.

The proposed amended rule would also require investment advisers with custody of client funds and securities to enter into a written agreement with an independent public accountant to conduct the surprise examination. In addition, the Commission is proposing to revise the content of the notice advisers are currently required to send to clients upon opening a custodial account on their behalf and 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.

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) annual surprise examinations conducted by independent public accountants, (2) mailing of audited financial statements to investors in a fund, (3) mailing of notice to clients about new custodial accounts, and (4) internal control reports by independent public accountants registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board. 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>3</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.

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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).

**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.

**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**

In its release proposing amendments to rule 206(4)-2, the Commission requests public comment on the information collection requirements under rule 206(4)-2. 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. Payment or Gift to Respondents**

Not applicable.

**10. Assurance of Confidentiality**

Not applicable.

**11. Sensitive Questions**

Not applicable.

## **12. Estimate of Hour Burden**

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,<sup>4</sup> 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.<sup>5</sup>

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.

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<sup>4</sup> 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.

<sup>5</sup> Based on information filed through the Investment Adviser Registration Depository ("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 respect to a client that is a registered investment company.

First, we estimate that 7,126 of the 9,575 advisers do not have pooled investment vehicles as their clients.<sup>6</sup> Based on our records and staff 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).<sup>7</sup> A second group of advisers that have custody, totaling 372, are also broker-dealers, banks or futures commission merchants,<sup>8</sup> or have a related person that serves as a qualified custodian for advisory clients' funds or securities.<sup>9</sup> We estimate that these advisers would be subject to an annual surprise examination with respect to 100 percent of

<sup>6</sup> 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 Error: Reference source not found), 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 Error: Reference source not found and Error: Reference source not found and accompanying text.

<sup>7</sup> 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.

<sup>8</sup> 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.

<sup>9</sup> 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.



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,<sup>10</sup> 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)<sup>11</sup> and 100 percent of their pooled investment vehicle clients (or 2 funds with 100 investors per adviser).<sup>12</sup> A fourth group of advisers, totaling 796,<sup>13</sup> 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).<sup>14</sup> 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

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<sup>10</sup> 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.

<sup>11</sup> See supra note Error: Reference source not found.

<sup>12</sup> We estimate that each of these advisers would advise, on average, 2 pooled investment vehicles with 50 investors in each of the pools.

<sup>13</sup> 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.

<sup>14</sup> 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.

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.<sup>15</sup> This does not include 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.<sup>16</sup> Therefore the total annual burden in connection with the surprise examination would be 179,636 hours under the proposed amendments.<sup>17</sup>

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

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<sup>15</sup>  $(7,126 \times 928 \times 0.02) + (372 \times 1092 \times 0.02) + [(1,281 \times 928 \times 0.02) + (1,281 \times 100 \times 0.02) + (1,281 \times 2 \times 1)] + [(796 \times 250 \times 0.02) + (796 \times 5 \times 1)] = 177,242.$

<sup>16</sup>  $9,575 \times 0.25 = 2,394.$

<sup>17</sup>  $177,242 + 2,394 = 179,636.$

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.<sup>18</sup> 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.<sup>19</sup> Of these 2,112 advisers, we estimate that 796 advisers would each on average provide advice to five pooled investment vehicles that have a total of 250 investors.<sup>20</sup> 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,<sup>21</sup> 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.<sup>22</sup>

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<sup>18</sup> 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.  $3,148 \times 250 \times 0.5 = 393,500$ .

<sup>19</sup> 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.

<sup>20</sup> See supra note Error: Reference source not found.

<sup>21</sup> 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.

<sup>22</sup>  $[(796 \times 250 \times 1 \text{ minute}) + (1,316 \times 100 \times 1 \text{ minute})]/60 = 5,510 \text{ hours}$ .

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.<sup>23</sup> 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.<sup>24</sup> This represents a decrease of 387,714 hours in our estimated burden.<sup>25</sup> 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.<sup>26</sup>

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

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<sup>23</sup>  $5,510 \times 0.05 = 276$ .

<sup>24</sup>  $5,510 + 276 = 5,786$ .

<sup>25</sup>  $393,500 - 5,786 = 387,714$ .

<sup>26</sup> See supra note Error: Reference source not found.

information,<sup>27</sup> 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.<sup>28</sup> 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 218,578 hours per year.<sup>29</sup>

We expect that 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 at \$258 per hour,<sup>30</sup> and other functions performed to comply with the rule, totaling 216,184 hours, would be performed by compliance clerks at \$63 per hour.<sup>31</sup> Therefore, the total

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<sup>27</sup> 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).

<sup>28</sup>  $[3,617 \times (1,092 \times 0.05) \times 10 \text{ minutes}]/60 = (3,617 \times 55 \text{ (rounded up from 54.60)} \times 10 \text{ minutes})/60 = 33,156 \text{ hours.}$

<sup>29</sup>  $179,636 + 5,786 + 33,156 = 218,578.$

<sup>30</sup> 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.

<sup>31</sup> 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.

costs of hour burden under the proposed amended rule 206(4)-2 would be \$14,237,244.<sup>32</sup>

### 13. Estimate of Total Annual Cost Burden

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.<sup>33</sup> The estimated total accounting fees for all surprise

<sup>32</sup>  $(2,394 \times \$258) + (216,184 \times \$63) = \$14,237,244$

<sup>33</sup> 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 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)] at nn.72 and 73, and Section VI.A of Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2176 (Sept. 25, 2003) [68 FR 56692

examinations would therefore be \$77,557,500.<sup>34</sup> This would represent an increase of \$77,276,500 in the cost estimate,<sup>35</sup> 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.<sup>36</sup> 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

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(Oct. 1, 2003)]. The revised estimate reflects requirements under the proposed rule.

<sup>34</sup>  $\$8,100 \times 9,575 = \$77,557,500.$

<sup>35</sup>  $\$77,557,500 - \$281,000 = \$77,276,500.$

<sup>36</sup> 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 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.

offered by the qualified custodian, but that on average an internal control report would cost approximately \$250,000 per year,<sup>37</sup> for total costs attributable to this element of the proposed rule to be \$93,000,000.<sup>38</sup> The total costs attributable to the proposed amended rule would be \$170,557,500.<sup>39</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 415,303 hours. We now request that the total information collection hours be decreased to 218,578 hours. The cause of such decrease is mainly due to the adjustment in our estimates of annual burden relating to the required distribution of audited financial statements. We previously estimated that an adviser would spend 0.5 hour per investor sending investors audited financial statements with an aggregated annual burden of 393,500 hours.<sup>40</sup> 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. We are now revising it to an estimated 1 minute per investor for mailing audited financial statements and the aggregate annual hour burden would therefore be 5,510 hours.<sup>41</sup> But for this change in estimated annual hour burden relating to distribution of audited financial statements, the proposed amendments would have increased the

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<sup>37</sup> We consulted accounting firms that issue these reports to prepare this estimate.

<sup>38</sup>  $\$250,000 \times 372 = \$93,000,000$ .

<sup>39</sup>  $\$77,557,500 + \$93,000,000 = \$170,557,500$ .

<sup>40</sup> See supra note Error: Reference source not found and accompanying text.

<sup>41</sup> See supra note Error: Reference source not found and accompanying text.



information collection burden by 191,265 hours.

The currently approved annual burden under rule 206(4)-2 includes an aggregate cost estimate of \$281,000. We now estimate that the annual cost burden under the rule would increase to \$170,557,500. Two changes cause such increase: (1) the increase of the number of advisers that are subject to the surprise examination from previously estimated 204 advisers to now estimated 9,575 advisers; and (2) the requirement of advisers that do not custody their client assets with independent custodians obtain or receive an internal control report from an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board.

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

Not applicable.

**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.