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.[1] 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

[1] 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 adopting amendments to rule 206(4)-2.[2] The amendments are designed to provide additional safeguards under the Advisers Act when a registered adviser has custody of client funds or securities by requiring such an adviser, among other things: (i) to undergo an annual surprise examination by an independent public accountant to verify client assets; (ii) to have a reasonable basis after due inquiry, for believing that the qualified custodian maintaining client funds and securities sends account statements directly to the advisory clients; and (iii) unless client assets are maintained by an independent custodian (*i.e.*, a custodian that is not the adviser itself or a related person) to obtain or receive a report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the PCAOB.

The amendments to rule 206(4)-2 that we are adopting differ from our proposed

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[2] *See Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2968 (Dec. 30, 2009) [75 FR 1456 (Jan. 11, 2010)] (the "Adopting Release").

amendments in three respects that affect our Paperwork Reduction Act analysis.[3] First, we are providing an exception to the surprise examination requirement for advisers that have custody because they have authority to deduct advisory fees from client accounts and advisers that have custody solely because a related person holds the adviser's client assets and the related person is operationally independent of the adviser.[4] Second, advisers to pooled investment vehicles that are subject to an annual audit and that distribute audited financial statements to investors in the pools are deemed to comply with the surprise examination requirement as long as the accountant performing the annual audit is registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB").[5] Third, if an adviser sends account statements to its clients, it must not only insert a legend in the required notice to clients upon opening accounts on their behalf, but must also insert the legend in subsequent account statements sent to those clients urging the client to compare the account statements from the custodian with those from the adviser.[6]

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

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[3] The proposed changes with respect to Paperwork Reduction Act requirements are contained in Section IV of our proposing release. *Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2876 (May 20, 2009) [74 FR 25354 (May 27, 2009)] (the "Proposing Release").

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

[5] Amended rule 206(4)-2(b)(4).

[6] Amended rule 206(4)-2(a)(2).

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 PCAOB. 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.[7]

4. Efforts to Identify Duplication

The requirements of rule 206(4)-2 are not duplicated elsewhere for those investment

[7] *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).

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.

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 requested public comment on the information collection requirements under rule 206(4)-2. A number of commenters expressed concerns that the paperwork burdens associated with our proposed amendments to rule 206(4)-2 were understated.[8]

[8] *See, e.g.*, comment letter of Advisor Solution Group (July 28, 2009); comment letter of

The Commission and the staff of the Division of Investment Management also 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.

In response to information the Commission gathered from these various sources, among other considerations, the Commission has adjusted its Paperwork Reduction Act estimates as discussed below in Items 12 and 13 of this Supporting Statement.

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 current approved annual burden for rule 206(4)-2 is 415,303 hours, 21,803 of which relate to the requirement to obtain a surprise examination and the delivery of quarterly account statements by the adviser. We estimated in the Proposing Release that 9,575 advisers registered with the Commission would be subject to the surprise

examination.[9] As noted above, the amended rule we are adopting today excludes certain advisers with custody from the requirement to undergo an annual surprise examination and deems certain advisers to audited pooled investment vehicles to have complied with the

requirement.[10] Advisers that have custody for other reasons, however, such as because they or their related person serves as the qualified custodian for client assets, or because they serve as

the trustee of a client trust, must undergo an annual surprise examination.[11] As a result, we now estimate that

1,859 advisers will be subject to the surprise examination requirement under the amended rule 206(4)-2.[12]

For purposes of estimating the collection of information burden we have divided the estimated 1,859 advisers into 3 subgroups. First, we estimate that 337 advisers have custody

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The Money Management Institute (July 28, 2009); comment letter of Charles Schwab (July 28, 2009). These commenters did not provide empirical data that is relevant to our estimates of burden hours in this Paperwork Reduction Act analysis, but did provide cost estimates that we considered in Section V of the Adopting Release. The comment letters are available for public inspection and photocopying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC (File No. S7-09-09). They are also available on our website at http://www.sec.gov/comments/s7-09-09/s70909.shtml.

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

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

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

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

because (i) they serve as qualified custodians for their clients and are also broker-dealers, banks or futures commission merchants,[13] or (ii) they have a related person that serves as qualified

assets that would require a surprise examination and 10% of which is based on an estimate of the pooled investment vehicles that are subject to an annual audit). We further estimate that of the 396 advisers we estimate that are currently using related person qualified custodians, 59 (or 15%) will choose to use independent qualified custodians and, as a result, will no longer retain custody of client assets under the rule that would require these advisers to undergo the surprise examination. *See* note 282 of the Adopting Release for further explanation of this estimate. (3,689 – 38 – 703 – 1,030 – 59 = 1,859).

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

custodian for clients in connection with advisory services the adviser provides to the clients.[14] We estimate that these advisers will be subject to an annual surprise examination with respect to 100 percent of their clients (or 2,315 clients per adviser) based on the assumption that all of their clients maintain custodial accounts with the adviser or related person.[15] We estimate that each adviser will spend an average of 0.02 hours for each client to create a client contact list for the independent public accountant. The estimated total annual aggregate burden with respect to the surprise examination requirement for this group of advisers is 15,603 hours.[16]

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[14] Based on IARD data, we also estimate that 305 investment advisers have a related person bank, registered broker-dealer or futures commission merchant that is a qualified custodian for advisory client assets. 91 (advisers that are also banks or broker-dealers) + 305 (advisers using related persons as custodians) = 396. 396 – 59 (advisers that will stop using related persons as custodians) = 337 (*see supra* note Error: Reference source not found for explanation of 59 advisers removed).

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

[16] 337 advisers x 2,315 (average number of clients subject to the surprise examination requirement) x 0.02 hour = 15,603 hours. Some of these advisers will not have to obtain a surprise examination as a result of the exception to the surprise examination requirement under amended rule 206(4)-2(b)(6) for an adviser that has custody because of its related person's custody of client assets and that can overcome the presumption that it is not operationally independent of the related person custodian. *See* note 283 of the Adopting Release for further explanation of this estimate. We do not have data or another resource to provide an estimate of the number of advisers that use related person custodians that will be able to overcome the presumption. This estimated annual hour burden may, as a result, overestimate the collection of information requirement as advisers that have overcome the presumption will not have to create client contact lists.

A second group of advisers, estimated at 1,315,[17] are those that have custody because they have broad authority to access client assets held at an independent qualified custodian, such as through a power of attorney or acting as a trustee for a client's trust. Based on our staff's experience, advisers that have access to client assets through a power of attorney, acting as trustee, or similar legal authority typically do not have access to all of their client accounts, but rather only to a small percentage of their client accounts pursuant to these special arrangements. We estimate that these advisers will be subject to an annual surprise examination with respect to 5 percent of their clients (or 116 clients per adviser)[18] who have these types of arrangements with the adviser. We estimate that each adviser will spend an average of 0.02 hours for each client to create a client contact list for the independent public accountant. The estimated total annual aggregate burden with respect to the surprise examination requirement for this group of advisers is 3,051 hours.[19]

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17 This estimate is based on the total number of advisers subject to surprise examinations less those described above in the first group (custody as a result of serving as, or having related person serving as qualified custodians) and below in the third group (advisers to pooled investment vehicles) 1,859 - 337 - 207 = 1,315. *See infra* note Error: Reference source not found and accompanying text.

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

19 1,315 x 116 x 0.02 = 3,051.

A third group of advisers, estimated at 207,[20] provide advice to pooled investment vehicles that are not undergoing an annual audit, and therefore will be subject to the surprise examination with respect to 100 percent of their pooled investment vehicle clients (which we estimate to be 5 funds and 250 investors per adviser providing advisory services exclusively to pooled investment vehicles, and 2 funds and 100 investors per adviser not providing advisory services exclusively to pooled investment vehicles).[21] We estimate that the advisers to these pooled investment vehicles will spend 1 hour for the pool and 0.02 hours for each investor in the pool to create a contact list for the independent public accountant, for an estimated total annual burden with respect to the surprise examination requirement for these advisers of 1,296 hours.[22] These estimates bring the total annual aggregate burden with respect to the surprise examination requirement for all three groups of advisers to 19,950 hours.[23] This estimate does not include the collection of information discussed below relating to the written agreement required by paragraph (a)(4) of the rule.

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

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

[22] [(78 x 5) + (78 x 250 x 0.02)] [(129 x 2) + (129 x 100 x 0.02)] = [390 + 390] + [258 + 258] = 1,296.

[23] 1,296 + 15,603 + 3,051 = 19,950. By contrast, our estimate in the Proposing Release for the surprise examination as proposed was 177,242 hours.

Written agreement with accountant. Consistent with the proposal, amended rule 206(4)-2 requires that an adviser subject to the surprise examination requirement must enter into a written agreement with the independent public accountant engaged to conduct the surprise examination and specify certain duties to be performed by the independent public accountant.[24] As stated in the Proposing Release, we believe that written agreements are commonplace and reflect industry practice when a person retains the services of a professional such as an accountant, and they are typically prepared by the independent public accountant in advance. We therefore estimate that each adviser will spend 0.25 hour to add the required provisions to the written agreement, with an aggregate of 465 hours for all advisers subject to surprise examinations.[25] Therefore the total annual burden in connection with the surprise examination is estimated at 20,415 hours under the amended rule.[26]

Audited pooled investment vehicles. The rule currently excepts, and the amended rule continues 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.[27] As explained in the Proposing

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[24] Amended rule 206(4)-2(a)(4).

[25] 1,859 x 0.25 = 465.

[26] 19,950 + 465 = 20,415.

[27] 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 x 250 x 0.5 = 393,500.

Release, we overestimated the burden for this delivery requirement in the past.[28] The collection of information burden imposed on an adviser relating to the mailing of audited financial statements to each investor in a pool that it manages should be minimal, as the financial statements could be included with account statements or other mailings. We estimate, consistent with the estimate in the Proposing Release, that the average burden for advisers to mail audited financial statements to investors in the pool is 1 minute per investor.[29] Under our revised estimate of the number of advisers to audited pooled investment vehicles,[30] we estimate that the aggregate annual hour burden in connection with the distribution of audited financial statements is 4,861 hours.[31]

The amended rule requires that an adviser to a pooled investment vehicle that is relying on the annual audit provision must have the pool audited and distribute the audited financial statements to the investors in the pool promptly after completion of the audit if the fund liquidates at a time other than its fiscal year-end. We estimate that 5 percent of pooled

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

29 Proposing Release at n. 94.

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

31 [(703 x 250 x 1)/60] + [(1,159 x 100 x 1)/60] = 2,929 + 1,932 = 4,861.

investment vehicles are liquidated annually at a time other than their fiscal year-end, which results in an additional burden of 243 hours per year.[32] As a result, the total annual hour burden in connection with the distribution of audited financial statements in connection with annual audit and liquidation audit under the amended rule is estimated to be 5,104 hours.[33]

Notice to clients. The amended rule also requires each adviser, if the adviser sends account statements in addition to those sent by the custodian, to add a legend in its notification to clients upon opening a custodial account on their behalf, and in any subsequent account statements it sends to those clients, urging them to compare the account statements from the qualified custodian to those from the adviser.[34] Although the legend requirement is new, it will be placed in a notification that is currently required to be sent to clients at specified times. We believe that the increase in this collection of information burden, if any, is negligible. We estimate that 80 percent of the 2,986 advisers would be subject to this collection of information,[35] and that each adviser will on average open a new custodial account for 5% of its clients per year, either because the adviser has new clients that request that the adviser open an account on their behalf, or because the adviser selects a new custodian and moves its existing clients' accounts to that custodian. We further estimate that the adviser will spend 10 minutes

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[32] 4,861 (total burden hours relating to distribution of audited financials) x 0.05 = 243.

[33] 4,861 + 243 = 5,104.

[34] Amended rule 206(4)-2(a)(2).

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

per client drafting and sending the notice. The total hour burden relating to this requirement is estimated at 41,724 hours per year.[36]

Based on the above estimates, we anticipate that the estimated total information collection burden under amended rule 206(4)-2 would be 67,243 hours.[37] This represents a decrease of 348,060 hours from the currently approved burden,[38] primarily due to our change of methodology in estimating the collection of information with respect to distribution of audited financial statements to investors in pooled investment vehicles.[39] The total costs due to information collection hour burden is estimated at $4,326,984.[40]

13. Estimate of Total Annual Cost Burden

Currently approved 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.

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36 [(2,986 x 0.8 x 2,096 (average number of clients for the advisers with custody of client assets) x 0.05) x 10]/60 = 41,724 hours.

37 20,415 (surprise examination) + 5,104 (distribution of audited financial statements) +

38 415,303 – 67,243 = 348,060 hours.

39 *See supra* note Error: Reference source not found and accompanying text.

40 [465 (hours spent on written agreement) x $258 (average hour rate for compliance managers)] + [66,778 (hours spent on complying with other provisions of the rule) x $63 (average rate for compliance clerks)] = $119,970 + $4,207,014 = $4,326,984. *See* Adopting Release at n.266 for explanation of estimated hour rate for compliance clerks and at n.271 for explanation of estimated hour rate of compliance managers.

New annual aggregate cost. Based on the amendments we are adopting today, we estimate a total annual aggregate accounting fee of $122,965,000.[41] The increase in estimated aggregated cost is attributable to an increase in the number of advisers that will be subject to the surprise examination, an increase in the estimated cost for the surprise examination, and the estimated cost for an adviser to obtain, or to receive from its related persons, an internal control report when the adviser or related person serves as qualified custodian for the adviser's clients' assets.

In the Proposing Release, we estimated that advisers subject to the surprise examination would on average pay an accounting fee of $8,100 annually.[42] Many commenters asserted that this estimate was too low.[43] In revising our estimates, we have considered the commenters' estimates,[44] engaged in further discussions with industry participants and accounting firms, including accounting firms that are registered with, and subject to regular inspection by, the PCAOB, and considered the cost implications for the surprise examination of certain aspects of

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41 *See infra* note Error: Reference source not found and accompanying text

42 *See* Proposing Release at n.102 and accompanying text.

43 *See, e.g.,* comment letter of Financial Planning Association (July 28, 2009) (estimated costs of $15,000 to $24,000); comment letter from Investment Adviser Association (July 24, 2009) (estimated costs of $20,000 to $300,000); comment letter of Certified Financial Planner Board of Standards, Inc. (July 28, 2009) (estimating cost of surprise examination from $5,000 to $10,000). comment letter of SIFMA Private Client Legal Committee (July 28, 2009) ("SIFMA(PCLC) Letter") (member survey indicated average cost estimate of $200,000 with one response of over $1,000,000).

44 We note that commenters based their cost estimates for surprise examinations on the current guidance for accountants, which requires verification of 100% of client assets. We believe that these estimates would have been significantly lower if they had reflected the modernized procedures for the surprise examination described in the guidance for accountants issued in a companion release. *See* FR Investment Advisers Act Release 2969 (Dec. 30, 2009).

our guidance for accountants that we are issuing today.[45] We now estimate that of the 1,859 advisers subject to the surprise examination requirement, 337 advisers will be subject to the surprise examination with respect to 100 percent of their clients and will each spend an average of $125,000 annually,[46] 262 medium sized advisers will be subject to the surprise examination requirement with respect to 5% of their clients and will each spend an average of $20,000 annually, and 1,260 small sized advisers will be subject to the surprise examination requirement with respect to 5% of their clients and will each spend an average of $10,000 annually, with an aggregate annual accounting fee of $59,965,000 for all advisers subject to the surprise examination.[47]

We understand that the cost to prepare an internal control report relating to custody will vary based on the size and services offered by the qualified custodian. We estimated in the Proposing Release that, on average, an internal control report would cost approximately

45 *Id.*

46 We estimate, based on IARD data, that there will be 396 advisers that do not currently use an independent qualified custodian and will be subject to the surprise examination with respect to 100% of their clients. We expect 15% of these advisers will choose to use independent custodians instead of incurring these costs to comply with the rule. (396 x 85%) = 337.

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

47 (337 x $125,000) + (262 x $20,000) + (1,260 x $10,000) = $ 42,125,000 + $5,240,000 + $12,600,000 = $59,965,000. *See* notes 282 – 286 and accompanying text of the Adopting Release for further explanation of the estimated amounts. We also note that we may have overestimated the costs for the surprise examination for advisers that have custody because a related person has custody of client assets in connection with advisory services. As we have indicated, as a result of the exception to the surprise examination requirement under amended rule 206(4)-2(b)(6) for an adviser that has custody because of its related person's custody of client assets and that can overcome the presumption that it is not operationally independent of the related person custodian, some of the 337 advisers may not have to obtain a surprise examination. Those advisers that overcome the presumption may, however, incur outside legal expenses to assist with that determination. *See* note 283 of the Adopting Release for further explanation.

$250,000 per year for each adviser subject to the requirement.[48] We estimate that under amended rule 206(4)-2, 252 advisers will be subject to the requirement of obtaining or receiving an internal control report.[49] Therefore the total cost attributable to this requirement will be $63,000,000.[50] The total estimated accounting fee under the amended rule 206(4)-2 is therefore estimated at $122,965,000.[51]

One-time computer system programming costs. As stated above, the amended rule would

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48 One commenter, the Chamber of Commerce, generally stated that the Commission's estimate of $250,000 was too low, but did not provide alternative data. *See* comment letter of Center for Capital Markets Competitiveness, Chamber of Commerce (July 28, 2009)("Chamber of Commerce Letter"). Another commenter, Securities Industry and Financial Markets Association, however, concurred with our cost estimate of $250,000. *See* SIFMA(PCLC) Letter. A third commenter, Managed Funds Association, estimated that the internal control report of a hedge fund adviser would cost approximately $500,000 and over $1 million in some cases. *See* comment letter of Managed Fund Association (July 28, 2009) ("MFA Letter"). We understand that advisers to pooled investment vehicles typically do not maintain client assets as qualified custodians and, as a result few advisers to pooled investment vehicles would have to obtain an internal control report. Rather, it is more likely that the internal control report would be for a related person broker-dealer, which costs we believe are accurately reflected in the comment letter sent by the Securities Industry and Financial Markets Association. *See* SIFMA(PCLC) Letter. After further consultation with several accounting firms that have experience in preparing Type II SAS 70 reports (a type of report we have indicated could satisfy the internal control report requirement), including accounting firms that are registered with the PCAOB, we believe our estimate of $250,000 is reasonable. Moreover, we are not requiring that a specific type of internal control report be provided under the rule as long as the objectives noted above are addressed. This flexibility should permit accountants of qualified custodians to leverage audit work they have performed to satisfy existing regulatory requirements to which these custodians are subject, which may reduce the costs for advisers to comply with the internal control report requirement.

49 Of the 337 advisers (*see supra* note Error: Reference source not found for this estimate) that will be subject to both the surprise examination and internal control report requirement, we further estimate, based on consultation with several accounting firms, that 10% of these advisers already obtain an internal control report for purposes other than the custody rule. In addition, we believe that some related persons may serve as the qualified custodian for more than one affiliated adviser. We estimate that this will reduce the number of required internal control reports by an additional 15%. *See* notes 289 and 290 and accompanying text of the Adopting Release for further explanation of this estimate. 337 – (337 x 10%) – (337 x 15%) = 337 – 34 – 51 = 252.

50 $250,000 x 252 = $63,000,000. *See supra* note Error: Reference source not found and notes 275 to 292 and accompanying text of the Adopting Release for explanation of our estimate of costs of the internal control report.

require an adviser that has an obligation under the rule to provide a notice to clients upon opening a new account on behalf of the client or changes to such account and that sends account statements to its client to include in the account statement a legend urging the client to compare its account statement with those sent by the qualified custodian. We expect that the requirement would cause advisers that are subject to the notice requirement and that send account statements to clients to reprogram their computer system to include the legend in account statements to clients. We estimate that half of the advisers that are subject to the rule or 1,195 advisers will hire a computer programmer to modify their computer system to automatically add the legend to client account statements at an average cost of $1,000 each.[52] We believe the other half routinely use off-the-shelf software to provide client account statements and will bear little or no direct costs because we expect the software vendors will not pass the reprogramming costs on to their customers (*i.e.* the advisers) due to a very low per unit cost. Based on the above estimates, we believe that the total one-time computer system programming cost would be $1,195,000 for the advisers subject to this requirement.[53]

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

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51 $59,965,000 (accounting fee for surprise examination) + $63,000,000 (accounting fee for internal control report) = $122,965,000.

52 As stated above, we estimated that there will be 2,389 advisers subject to this requirement. *See supra* note Error: Reference source not found and accompanying text. 2,389/2 = 1,195.

53 1,195 x $1,000 = $1,195,000. *See* note 294 of the Adopting Release for an explanation of the estimate.

subject to regular inspection by, the PCAOB.[54] We acknowledge that not all pooled investment vehicle audits are performed by accountants meeting the PCAOB requirement as this is a new requirement. However, our staff has reviewed several third-party databases that contain the identity of accountants that perform these audits, and substantially all the pools that identified accountants were audited by PCAOB registered and inspected firms or their affiliates.[55] Moreover, a representative of venture capital firms stated that the "vast majority" of venture capital funds are audited and, as far as it could determine, all venture capital fund audits are conducted by PCAOB registered accounting firms that are subject to PCAOB inspection.[56] As a result, we do not believe there will be a substantial dislocation of pooled investment vehicle auditors as a result of the amended rule. For those pools that will have to change accounting firms, we do not believe based on discussions with accountants that there will be additional costs to retain an accounting firm registered with, and subject to inspection by, the PCAOB, as

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54 Amended rule 206(4)-2(b)(4).

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

56 Comment letter of National Venture Capital Association (July 28, 2009).

accountants that perform these financial statement audits are likely to be with national accounting firms or accounting firms that specialize in auditing pooled investment vehicles and that charge equivalent fees to accountants registered with, and subject to inspection by, the PCAOB.[57]

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 67,243 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. 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 4,861 hours. This adjustment results in a decrease of 388,639 hours in total estimated hours for distribution of audited financial statements. But for this change in estimated

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[57] Two commenters expressed concerns about costs with respect to the requirement of PCAOB registration for accountants performing surprise examinations and preparing internal control reports for advisers that serve, or have related person serve, as the qualified custodian for their client assets. *See* comment letter of The Consortium (July 18, 2009); Chamber of Commerce Letter. These comments, however, were not directed to the costs of engaging PCAOB registered accountants for audits of pooled investment vehicles, and the commenters that did recommend the PCAOB requirement did not indicate there would be increased costs for such a requirement. *See, e.g.*, comment letter of Coalition of Private Investment Companies (July 31, 2009); MFA Letter.

annual hour burden relating to distribution of audited financial statements, the proposed amendments would have increased the information collection burden by 40,579 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 $124,160,000. 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 1,859 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.