

SUPPORTING STATEMENT
for the Paperwork Reduction Act Information Collection Submission
“Rule 206(4)-2”

A. JUSTIFICATION

1. Information Collection Necessity

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 an extension and a revision to the currently approved collection of information requirements.

Rule 206(4)-2 requires each registered 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.”² This requirement is necessary to safeguard the client assets over which

¹ 17 CFR 275.206(4)-2.

² Rule 206(4)-2(a)(1).

the adviser has control or access. The rule requires the adviser to promptly notify clients as to the place and manner of custody after opening an account for the client and following any changes.³ If an adviser sends account statements to its clients, it must insert a legend in the notice and in subsequent account statements sent to those clients urging them to compare the account statements from the custodian with those from the adviser.⁴ The adviser also must 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 undergo an annual surprise examination by an independent public accountant to verify client assets pursuant to a written agreement with the accountant that specifies certain duties.⁵ Unless client assets are maintained by an independent custodian (*i.e.*, a custodian that is not the adviser itself or a related person), the adviser also is required 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 Public Company Accounting Oversight Board (“PCAOB”).⁶

Advisers to limited partnerships, limited liability companies and other pooled investment vehicles are excepted from the account statement delivery requirement and are deemed to comply with the annual surprise examination requirement if the limited partnerships, limited liability companies or pooled investment vehicles are subject to annual audit by an independent public accountant registered with, and subject to regular inspection by the PCAOB, and the audited

³ Rule 206(4)-2(a)(2).

⁴ Rule 206(4)-2(a)(2).

⁵ Rule 206(4)-2(a)(3), (4).

⁶ Rule 206(4)-2(a)(6).

financial statements are distributed to investors in the pools.⁷ The rule also provides an exception to the surprise examination requirement for advisers that have custody solely 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.⁸

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. Information Collection Purpose

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.

⁷ Rule 206(4)-2(b)(4).

⁸ Rule 206(4)-2(b)(3), (b)(6).

3. Consideration Given to 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 notices 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.⁹

4. 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

⁹ 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).

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 the Agency

The Commission requested public comment on the collection of information requirements in rule 206(4)-2 before it submitted this request for extension and approval to the Office of Management and Budget. The Commission received no comments in response to its request.

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.

9. Payment or Gift

The respondents receive no payments or gifts.

10. Confidentiality

Not applicable.

11. Sensitive Questions

Not applicable.

12. Time Burden Estimate

Currently approved burdens. The current annual collection of information burden approved by OMB for rule 206(4)-2 is 67,243 hours. This burden includes 19,950 hours relating to the requirement to obtain a surprise examination, 465 hours to enter into a written agreement with an independent public accountant engaged to conduct the surprise examination, 5,104 hours to distribute audited financial statements to investors in pools managed by the adviser, and 41,724 hours to add a legend in notifications and account statements.

We now estimate the total information collection hours to be 518,275 hours.¹⁰ The cause of the change is an increase in the number of clients, private investment vehicles and investors in private investment vehicles that advisers reported on Form ADV. The Commission recently amended Form ADV to obtain additional information about advisers with custody and about the private funds that advisers manage, and that data is reflected in the revised burden.¹¹ The current burden is based on numbers estimated before advisers began reporting the new information.

Annual surprise examination. Rule 206(4)-2 requires each registered investment adviser that has custody of client funds or securities to undergo an annual surprise examination by an independent public accountant to verify client assets pursuant to a written agreement with the accountant that specifies certain duties.¹² The current approved annual burden for rule 206(4)-2 includes 19,950 hours that relate to the requirement to obtain a surprise examination. We

¹⁰ See *infra* note 36.

¹¹ See *Rules Implementing Amendments to the Investment Advisers Act of 1940*, Investment Advisers Act Release 3221 (Jun. 22, 2011); *Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release 2876 (Dec. 30, 2009).

¹² Rule 206(4)-2(a)(4).

estimated that 1,859 advisers registered with the Commission would be subject to the surprise examination. We now estimate that 1,368 advisers are subject to the surprise examination requirement under rule 206(4)-2.¹³

For purposes of estimating the collection of information burden, we have divided the estimated 1,368 advisers into three subgroups. First, we estimate that 500 advisers have custody because they serve as qualified custodians for their clients, or they have a related person that serves as qualified custodian for clients in connection with advisory services the adviser provides to the clients.¹⁴ We estimate that these advisers are subject to an annual surprise examination with respect to 100 percent of their clients (or 5,400 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

¹³ Based on data from the Investment Adviser Registration Depository (“IARD”) as of July 2, 2012 (unless indicated otherwise, all data we use in this Supporting Statement were as of July 2, 2012), 4,763 advisers 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, excluding advisers that have custody solely because they have authority to deduct fees from clients’ accounts) or answered “yes” to another question in Part 1A Item 9.C. Of these advisers, 1,368 advisers indicated in response to Item 9.C.(3) that an independent public accountant conducts an annual surprise examination of client funds and securities.

¹⁴ Based on IARD data, 496 advisers indicated that an independent public accountant prepares an internal control report because the adviser or its affiliate acts as a qualified custodian (in response to Item 9.C.(4)). Similarly, 105 advisers indicated that they act as a qualified custodian (in response to Item 9.D.(1)), and 420 advisers that indicated that their related person(s) act as qualified custodian(s) (in response to Item 9.D.(2)). $105 + 420 = 525$.

¹⁵ We base our estimate on IARD data of the average number of clients of all the advisers that will be subject to the surprise examination under the rule (excluding the three largest firms).

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 54,000 hours.¹⁶

The second group of advisers, estimated at 726, 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.¹⁷ 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 270 clients per adviser) who have these types of arrangements with the adviser.¹⁸ 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 3,920 hours.¹⁹

A third group of advisers provide advice to pooled investment vehicles that are not undergoing an annual audit, and therefore would undergo the surprise examination with respect

¹⁶ 500 advisers x 5,400 (average number of clients subject to the surprise examination requirement) x 0.02 hour = 54,000 hours.

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 a related person serving as qualified custodian) less those described below in the third group (custody as a result of solely managing private funds). $1,368 - 500 - 142 = 726$.

¹⁸ Based on the IARD data, we estimate that the average number of clients of advisers subject to the surprise examination requirement is 5,400. $5,400 \times 0.05 = 270$.

¹⁹ $726 \text{ advisers} \times 270 \text{ clients} \times 0.02 \text{ hours} = 3,920 \text{ hours}$.

to those pooled investment vehicle clients. Based on current IARD data, we estimate that 100 advisers provide advice exclusively to pooled investment vehicles and undergo the surprise examination with respect to all of their pooled investment vehicle clients.²⁰ We further estimate that 42 advisers that provide advice not exclusively to pooled investment vehicles are subject to an annual surprise examination because some of the pooled investment vehicles they advise do not undergo an annual audit.²¹ We estimate that each adviser providing advisory services exclusively to pooled investment vehicles will have 12 funds and 2,900 investors, and each adviser not providing advisory services exclusively to pooled investment vehicles will have 15 funds and 49,000 investors).²² We estimate that 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 48,790 hours.²³

²⁰ Based on IARD data, we estimate that 519 advisers manage private funds and undergo a surprise examination (responses to Items 7.B. and 9.C.(3)). Of these advisers, 101 solely manage pooled investment vehicles, undergo a surprise examination, and do not undergo an annual audit of the pooled investment vehicles they manage (responses to Item 5.D.(1) and Item 9.C.).

²¹ We estimate, based on staff experience, that ten percent of the 419 advisers that provide services not exclusively to pooled investment vehicles, undergo an annual audit and obtain an annual surprise examination because some of the pooled investment vehicles they advise do not undergo an annual audit (responses to Items 7.B., 9.C.(2) and 9.C.(3)).

²² The number of funds and investors per adviser is estimated based on the information we collected from Schedule D of Form ADV filed by advisers that indicated that they undergo a surprise examination and provide advisory services to pooled investment vehicles.

²³ $[(12 \text{ funds} \times 1 \text{ hour}) + (2,900 \text{ investors} \times 0.02 \text{ hours})] \times 100 \text{ advisers}] + [(15 \text{ funds} \times 1 \text{ hour}) + (49,000 \text{ investors} \times 0.02 \text{ hours})] \times 42 \text{ advisers}] = [70 \text{ hours} \times 100 \text{ advisers}] + [995 \text{ hours} \times 42 \text{ advisers}] = 7,000 \text{ hours} + 41,790 \text{ hours} = 48,790 \text{ hours}.$

These estimates bring the total annual aggregate burden with respect to the surprise examination requirement for all three groups of advisers to 106,710 hours.²⁴ This estimate does not include the collection of information discussed below relating to the written agreement required by paragraph (a)(4) of the rule.

Written agreement with accountant. 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.²⁵ We estimate that each adviser will spend 0.25 hour to add the required provisions to the written agreement, with an aggregate of approximately 342 hours for all advisers that undergo surprise examinations.²⁶ Therefore the total annual burden in connection with the surprise examination is estimated at 107,052 hours under the rule.²⁷

Audited pooled investment vehicles. The rule excepts 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.²⁸ The rule also requires that an adviser to a pooled investment vehicle that is relying on the annual audit provision must have the pool

²⁴ 54,000 hours + 3,920 hours + 48,790 hours = 106,710 hours.

²⁵ Rule 206(4)-2(a)(4).

²⁶ 1,368 advisers required to obtain a surprise examination x 0.25 = 342.

²⁷ 106,710 exam hours + 342 written agreement hours = 107,052 hours.

²⁸ Rule 206(4)-2(b)(4).

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.²⁹

The currently approved annual burden in connection with the required distribution of audited financial statements is 5,104 hours. We estimate that the average burden for advisers to mail audited financial statements to investors in the pool is 1 minute per investor. Under our revised estimate of the number of advisers to audited pooled investment vehicles, the number of pooled investment vehicles and the number of investors, we estimate that the aggregate annual hour burden in connection with the distribution of annual audited financial statements is 340,470 hours.³⁰ We estimate that 5 percent of pooled investment vehicles are liquidated annually at a time other than their fiscal year-end, which results in an additional burden of 17,024 hours per year.³¹ As a result, the total annual hour burden to distribute audited financial statements in connection with the annual audit and liquidation audit requirements under the rule is estimated to be 357,494 hours.³²

²⁹ *Id.*

³⁰ Based on IARD data, we estimate that 3,461 advisers have custody of client assets and provide advisory services to pooled investment vehicles. Of these advisers, we estimate that 3,319 advisers will have their pooled investment vehicles audited and distribute audited financial statements to investors in the pool. [3,461 advisers to pooled investment vehicles – 142 advisers that undergo a surprise examination = 3,319 advisers that undergo an audit] We estimate that the 3,319 advisers provide advice to 22,731 pooled investment vehicles that have a total of 20,027,646 investors. $20,027,646 \text{ investors} \times 0.017 \text{ hour} = 340,470 \text{ total burden hours to distribute annual audited financials.}$

³¹ $340,470 \text{ (total burden hours relating to distribution of annual audited financials)} \times 0.05 = 17,024 \text{ hours.}$

³² $340,470 \text{ (total burden hours relating to distribution of annual audited financials)} + 17,024 \text{ (total burden hours relating to distribution of liquidation audited financials)} = 357,494 \text{ hours.}$

Notice to clients. The 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.³³ The legend is placed in a notification that is otherwise required to be sent to clients at specified times, so the collection of information burden is negligible. We estimate that 2,625 advisers will be subject to this collection of information,³⁴ and that each adviser will on average open a new custodial account for 5% of its clients per year, either because the adviser has new clients that request that the adviser open an account on their behalf, or because the adviser selects a new custodian and moves its existing clients' accounts to that custodian. We further estimate that the adviser will spend 10 minutes per client drafting and sending the notice. The total hour burden relating to this requirement is estimated at 53,729 hours per year.³⁵

³³ Rule 206(4)-2(a)(2).

³⁴ Based on IARD data, 4,763 advisers reported that they have custody (this excludes advisers having custody solely because of deducting fees, which we understand do not typically open custodial accounts on behalf of their clients). Of those advisers, 1,544 are advisers exclusively to audited pooled investment vehicles. Since we estimate that 96% of advisers to audited pooled investment vehicles obtain an annual audit (see *supra* note 30), the notice requirement does not apply to 1,482 advisers, leaving 3,281 advisers that may be subject to this information collection. [4,763 advisers with custody – (1,544 advisers to pooled investment vehicles x 0.96) = 4,763 – 1,482 = 3,281 advisers] Based on our staff's observation, we estimate that clients of 80% of these advisers will receive account statements from their advisers in addition to the account statements from the qualified custodian. $0.8 \times 3,281 = 2,625$.

³⁵ $[2,625 \times 2,408$ (average number of clients for the advisers with custody of client assets) $\times 0.05] \times 0.17$ hours = 53,729 hours.

Based on the above estimates, we anticipate that the estimated total information collection burden under rule 206(4)-2 would be 518,275 hours.³⁶ This represents an increase from the currently approved burden, primarily due to an increase in the number of clients, funds and investors for advisers with custody based on new data from amended Form ADV.³⁷ The total costs due to this information collection hour burden is estimated at \$31,171,398.³⁸

13. Total Annual Cost Burden

The currently approved collection of information for the custody rule includes an aggregate accounting fee estimate of \$122,965,000. We now estimate a total annual aggregate accounting fee of \$152,905,000.³⁹ The increase in estimated aggregated cost is attributable to an increase in the estimated number of investment advisers subject to a surprise examination with respect to all of their clients, based on new data from amended Form ADV.⁴⁰

³⁶ 107,052 (surprise examination) + 357,494 (distribution of audited financial statements) + 53,729 (notice to clients) = 518,275.

³⁷ See *supra* note 11 and accompanying text.

³⁸ [342 (hours spent on written agreement) x \$279 (average hour rate for compliance managers)] + [517,933 (hours spent on complying with other provisions of the rule) x \$60 (average rate for compliance clerks)] = \$95,418 + \$31,075,980 = \$31,171,398. Data from the *Securities Industry and Financial Markets Association's Office Salaries in the Securities Industry 2011*, 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 a compliance clerk is \$60 per hour, and data from the *Securities Industry and Financial Markets Association's Management & Professional Earnings in the Securities Industry 2011*, 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 ("SIFMA Management & Professional Earnings"), suggest that the cost for a compliance manager position is \$279 per hour.

³⁹ See *infra* note 46 and accompanying text.

⁴⁰ See *supra* note 11 and accompanying text.

We estimate that of the 1,368 advisers subject to the surprise examination requirement, approximately 351 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,⁴¹ 136 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 881 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,⁴² with an aggregate annual accounting fee of \$55,405,000 for all advisers subject to the surprise examination.⁴³

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 estimate that, on average, an internal control report would cost approximately \$250,000 per year for each adviser subject to the requirement. We estimate that under rule 206(4)-2, 390 advisers will be subject to

⁴¹ We estimate, based on IARD data, there are 351 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 (they indicated on Form ADV, Part 1A, Items 9.C.(3) and 9.C.(4) that they are subject to examination and have internal control reports because the adviser or its related person is a qualified custodian).

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

⁴² Based on responses to Item 5.C. of Form ADV, we estimate that the average number of clients for the 1,017 advisers that indicated they do not have internal control reports is 794. We determined, for purposes of this analysis, that an adviser with clients more than this average number is a medium size adviser (136) and an adviser with clients less than this average number is a small adviser (881).

⁴³ $(351 \times \$125,000) + (136 \text{ (medium advisers)} \times \$20,000) + (881 \text{ (small advisers)} \times \$10,000) = \$43,875,000 + \$2,720,000 + \$8,810,000 = \$55,405,000.$

the requirement of obtaining or receiving an internal control report.⁴⁴ Therefore the total cost attributable to this requirement will be \$97,500,000.⁴⁵ The total estimated accounting fee under the rule 206(4)-2 is therefore estimated at \$152,905,000.⁴⁶

14. Federal Government Cost

There are no additional costs to the federal government.

15. Changes in Burden

The current annual time burden approved by OMB for rule 206(4)-2 is 67,243 hours. We now estimate that the total information collection hours is 518,275 hours. The cause of such increase is an increase in the number of clients, private investment vehicles, and investors in private investment vehicles that advisers reported on Form ADV. The currently approved annual burden under rule 206(4)-2 includes an aggregate cost estimate of \$124,160,000. We now estimate that the annual cost burden under the rule would increase to \$152,905,000, which is primarily caused by an increase in the estimated number of investment advisers subject to a surprise examination with respect to all of their clients, based on data from Form ADV.

⁴⁴ We estimate that 500 advisers obtain an internal control report (*see supra* note 14 for this estimate). Of the 351 advisers that will be subject to both the surprise examination and internal control report requirement (*see supra* note 41 for this estimate), 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%. $500 - (351 \times 10\%) - (500 \times 15\%) = 500 - 35 - 75 = 390$.

⁴⁵ $\$250,000 \times 390 = \$97,500,000$.

⁴⁶ $\$55,405,000$ (accounting fee for surprise examination) + $\$97,500,000$ (accounting fee for

16. Information Collection Planned for Statistical Purposes

The Commission does not intend to publish or disclose specific trading data or information for statistical use.

17. Approval to Omit OMB Expiration Date

The Commission is not seeking approval to omit the expiration date for OMB approval.

18. Exception to Certification Statement

Not applicable.

B. COLLECTION OF INFORMATION EMPLOYING STATISTICAL METHODS

The collection of information does not employ statistical methods.

internal control report) = \$152,905,000.