

institutions that customarily hold financial assets for their customers, provided that the foreign financial institution keeps advisory clients' assets in customer accounts segregated from its proprietary assets.²²

Many advisers registered with us are themselves qualified custodians under the amended rule.²³ These advisers may maintain their own clients' funds and securities, subject to the account statement requirements described below and the custody rules imposed by the regulators of the advisers' custodial functions. Advisers may also maintain client assets with affiliates that are qualified custodians.

The amended rule contains special provisions for two types of securities: mutual fund shares and private issues. Commenters noted that, at times, a client or adviser may purchase shares of a mutual fund directly from the fund's transfer agent rather than through another intermediary such as a broker-dealer. In these cases, the mutual fund's transfer agent maintains the securities for the client on the mutual fund's books. The adviser, however, may also have custody because, for example, the adviser has check-writing or fee-deduction authority over the assets.²⁴ The amended rule allows an adviser to use the mutual fund transfer agent in lieu of a qualified custodian with respect to those shares.²⁵

²² Amended rule 206(4)-2(c)(3)(iv). We proposed to include foreign financial institutions only for securities whose primary trading market was in the country where the custodian was located. Some commenters urged that we permit foreign custodians to be used more broadly, arguing that some advisers, and some clients, especially those residing overseas, may at times have reason to use a foreign firm as a custodian or may have existing relationships with foreign institutions. We are modifying the rule from the proposal to avoid disrupting these existing practices. Where an adviser selects a foreign financial institution to hold clients' assets, we believe the adviser's fiduciary obligations require it either to have a reasonable basis for believing that the foreign institution will provide a level of safety for client assets similar to that which would be provided by a "qualified custodian" in the United States or to fully disclose to clients any material risks attendant to maintaining the assets with the foreign custodian.

²³ For example, Form ADVs submitted by SEC-registered advisers indicate that as of May 16, 2002, 647 advisers were broker-dealers registered with us under section 15 of the Exchange Act (15 U.S.C. 78o) and 77 advisers were banks (or separately identifiable departments or divisions of banks).

²⁴ Commenters were concerned that without an exception, an advisory client or adviser would have to use a qualified custodian in addition to the mutual fund transfer agent.

²⁵ See amended rule 206(4)-2(b)(1). The fund transfer agent must fulfill all aspects of the role of a qualified custodian under the rule, including sending statements directly to the client, or the adviser will be subject to annual surprise examinations. See discussions in Section II.C. of this Release.

Commenters also pointed out that, on occasion, a client may purchase privately-offered securities and that maintaining certain of these assets in accounts with qualified custodians poses difficulties because the client's ownership of the security is recorded only on the books of the issuer. The client may receive copies of subscription or partnership agreements that are not maintained with a custodian.²⁶ The amendments except advisers from the rule with respect to privately-offered uncertificated securities in their clients' accounts, if ownership of the securities is recorded only on the books of the issuer or its transfer agent, in the name of the client, and transfer of ownership is subject to prior consent of the issuer or holders of the issuer's outstanding securities.²⁷ These impediments to transferability provide some external safeguards against the kinds of abuse the rule seeks to prevent. These safeguards, however, may be ineffective in the case of limited partnerships (or other pooled investment vehicles). Because the private securities are held in the name of the limited partnership and the adviser acts for the partnership, the adviser has apparent authority to arrange transfers that would be recognized by the issuer of the securities. Accordingly, an adviser may use the exception for private securities with respect to the account of a limited partnership only if the limited partnership is audited annually, and the audited financial statements are distributed, as described in amended rule 206(4)-2(b)(3).²⁸

²⁶ Commenters specifically mentioned clients' investments in limited partnerships, where clients receive only a copy of the partnership agreement as evidence of their investment. Commenters also mentioned assignment agreements for debt or equity interests in a private company, or other types of customized agreements. See our staff's summary of comments posted on our web site at www.sec.gov/rules/extra/s72802csumm.htm.

²⁷ For example, in many privately-offered limited partnerships transfer of a limited partnership interest must be approved by a majority or some other percentage of the other limited partners. The rule does not require a specific number or percentage of the other security holders that must approve the transfer; applicable partnership law or the limited partnership agreement would set that standard.

²⁸ See Section II.D.2 of this Release. Otherwise, an adviser to a limited partnership (or other types of pooled investment vehicles) will still be required to maintain custody of privately-offered securities in accordance with the requirements of the rule.

Some privately-offered securities may be difficult to value. Account statements that must be delivered to a client under the rule must report the amount of the client's securities, but the rule does not require those statements to include a valuation of the securities.

C. Delivery of Account Statements to Clients

Rule 206(4)-2, as amended, requires that advisers with custody of clients' funds or securities have a reasonable belief that the qualified custodian holding the assets provides periodic account statements to those clients.²⁹ A number of commenters asserted that some custodial accounts are on quarterly rather than monthly reporting cycles and that moving to a monthly cycle would increase expenses substantially. In response to these comments, the amended rule requires quarterly account statements rather than the monthly statements we proposed. This provision, which requires qualified custodians to deliver account statements directly to advisory clients (and not through the adviser), is designed to assure the integrity of those account statements and permit clients to identify any erroneous or unauthorized transactions or withdrawals by an adviser.³⁰

As we discussed in the Proposing Release, we recognize that there may be circumstances in which an adviser would need to continue using the approach of the current rule.³¹ Accordingly, if a client does not receive account statements directly from the qualified custodian, the adviser must continue sending quarterly account statements to that client and to undergo an annual surprise examination by an independent public accountant³² to verify the funds and securities of that client.³³ The amendments require the

²⁹ Amended rule 206(4)-2(a)(3)(i). An adviser could form this reasonable belief if, for example, the qualified custodian provides the adviser with a copy of the account statement that was delivered to the client.

Account statements may be delivered electronically as well as on paper. Electronic delivery must comply with the Commission's interpretive guidelines on delivering documents electronically. 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*, Release No. 33-7288 (May 9, 1996) [61 FR 24644 (May 15, 1996)]. The guidelines are available at www.sec.gov/rules/concept/33-7288.txt. See also New York Stock Exchange's June 13, 1997 Information Memo (No. 97-32) entitled "Electronic Delivery of Information to Customers by Members and Member Organizations."

³⁰ We understand qualified custodians sometimes use service providers to deliver account statements. The amended rule does not prohibit a qualified custodian from doing so, as long as the statements are not routed through the adviser.

³¹ See Section II.C. of the Proposing Release.

³² Article 2 of Regulation S-X sets forth Commission standards for the independence of accountants. 17 CFR 210.2-01.

³³ Amended rule 206(4)-2(a)(3)(ii). If qualified custodians deliver account statements directly to