

accountant to notify our Office of Compliance Inspections and Examinations within one business day of finding any material discrepancies during an examination.³⁴

We understand that some clients may not wish to receive custodial reports. Under rule 206(4)–2, as amended, clients can choose to have an independent representative receive account statements on their behalf.³⁵ An “independent representative” is a person that (i) acts as agent for an advisory client and by law or contract is obligated to act in the best interest of the advisory client; (ii) does not control, is not controlled by, and is not under common control with the adviser; and (iii) does not have, and has not had

some, but not all, of an adviser's clients (or with respect to some, but not all, of a client's funds and securities), the adviser's quarterly statements and the scope of the surprise examination could cover only the client funds and securities for which custodial statements are not delivered directly. The accountant must ensure, however, that all client funds and securities either are covered by statements sent directly from the qualified custodian or are covered by the surprise examination.

The accountant should perform the examination in accordance with U.S. Generally Accepted Auditing or Attestation Standards, except that the accountant must verify or substantiate all client funds and securities covered by the examination. The examination should include confirmation of all cash and securities held by custodians, including a physical examination of securities if applicable, and reconciliation of all such cash and securities to the books and records of client accounts maintained by the adviser, as well as confirmation of such information with the adviser's clients. See *American Institute of Certified Public Accountants, Audit and Accounting Guide: Audits of Investment Companies* § 11.12 (2002); *Statement of the Commission Describing Nature of Examination Required to be Made of All Funds and Securities Held by an Investment Adviser and the Content of Related Accountant's Certificate*, Investment Advisers Act Release No. 201 (May 26, 1966) (31 FR 7821). The examination must be performed at a time chosen by the accountant without prior notice or announcement to the adviser, and the timing of the examination must be irregular from year to year, so that the adviser will be unaware of the date on which it will take place.

The accountant must file a certificate on Form ADV–E with the Commission within 30 days after the completion of the examination. We would expect that, ordinarily, an accountant should be able to complete its examination and file Form ADV–E within 90 to 120 days of commencing the examination.

³⁴ Amended rule 206(4)–2(a)(3)(ii)(C). The independent accountant may first take reasonable steps to establish the basis for believing a material discrepancy exists. The obligation to notify the Commission arises once the accountant has a basis for believing there is a material discrepancy. Ordinarily, an accountant should be able to determine promptly whether it has a basis for believing there is a material discrepancy.

³⁵ Our proposed amendments permitted the use of independent representatives only for investors in pooled investment vehicles. In response to the suggestions of several commenters, we have decided to permit all advisory clients to designate independent representatives under the rule.

within the past two years a material business relationship with the adviser.³⁶

The rule requires that account statements be delivered to clients. Advisers that take legal title to the client assets they manage, such as advisers that also serve as general partner to investment pools, have asked how they should apply this provision. Because this arises most often in connection with pooled investment vehicles, rule 206(4)–2, as amended, contains a special provision clarifying that account statements (whether delivered by the qualified custodian or the adviser) must be sent directly to the investors in the pool if the adviser to the pool also acts as its general partner, managing member, or in a similar capacity and has custody of client funds or securities.³⁷ Delivery of account statements to the adviser but not to the limited partners would not deter the adviser's misuse of client assets.³⁸

D. Exemptions

1. Registered Investment Companies

Advisers need not comply with the rule with respect to clients that are registered investment companies.³⁹ Registered investment companies and their advisers must comply with the strict requirements of section 17(f) of the Investment Company Act of 1940 and the custody rules we have adopted under that section.⁴⁰

2. Pooled Investment Vehicles

Advisers need not comply with the reporting requirements of the rule with respect to pooled investment vehicles, such as limited partnerships or limited liability companies, if the pooled investment vehicle (i) is audited at least

³⁶ Amended rule 206(4)–2(c)(2).

³⁷ Amended rule 206(4)–2(a)(3)(iii). These account statements may be sent to the investors' independent representative(s) under amended rule 206(4)–2(a)(4). However, as discussed below in more detail, the amendments provide an exemption from amended rule 206(4)–2(a)(3) for advisers with respect to pooled investment vehicles that are audited annually. See discussions in Section II.D.2 of this Release.

³⁸ Registered advisers that provide their advisory services through trusts must also ensure that account statements are delivered to their clients. Where an adviser acts as trustee for its client's trust, the investment advisory agreement often takes the form of a trust instrument. These advisers are acting in a capacity that gives them legal ownership of the client assets and thus have custody. In many cases, the advisory client is also the trust grantor and beneficiary. In other circumstances, the adviser may need to have quarterly statements delivered to an independent representative who may be a co-trustee, lead beneficiary, trust attorney, executor, or, in the case of court-supervised trusts, the court.

³⁹ Rule 206(4)–2(b)(4).

⁴⁰ 15 U.S.C. 80a–17(f) and rules 17f–1 through 17f–7 under the Investment Company Act of 1940 (17 CFR 270.17f–1 through 17 CFR 270.17f–7)

annually; and (ii) distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or members or other beneficial owners) within 120 days of the end of its fiscal year.⁴¹ We had proposed a complete exemption for audited pools, but have decided to exempt them only from the reporting requirement and to retain application of the other provisions of the rule, including the requirement that funds and securities be held with a qualified custodian; these requirements provide meaningful protections to investors in these pools for which an annual audit provides an insufficient substitute.

3. Registered Broker-Dealers

The amendments eliminate the exemption from the rule for advisers that are also registered broker-dealers, which are qualified custodians under the rule and for which the exemption is unnecessary.

E. Amendments to Form ADV

We are revising an instruction to Item 9 of Part 1A of Form ADV, which asks whether the adviser has custody of client funds or securities. A large number of advisers registered with us deduct their fees directly from client accounts and therefore have custody, but currently answer “no” to Item 9 in

⁴¹ Amended rule 206(4)–2(b)(3). We are aware that a small percentage of advisers subject to the rule advise foreign pooled investment vehicles that prepare their financial statements in accordance with International Accounting Standards or some comprehensive body of accounting standards other than U.S. Generally Accepted Accounting Principles (“U.S. GAAP”). An adviser may use such financial statements to qualify for this exception with respect to pools that have a place of organization outside the U.S. or a general partner or other manager with a principal place of business outside the U.S., if such financial statements contain information that is substantially similar to financial statements prepared in accordance with U.S. GAAP and contain a footnote reconciling any material variations between such comprehensive body of accounting standards and U.S. GAAP. To ensure such material variations are adequately described, the financial statements should discuss and quantify them in the manner described in Item 17 of Form 20–F (17 CFR 249.220f) (except that the financial statements need not provide reconciliation to Regulation S–X as required of issuers under Form 20–F). For both U.S. and foreign pooled investment vehicles, the rule provides that “audit” has the meaning under section 2(d) of Article 1 of Regulation S–X (17 CFR 210.1–02(d)), and pooled investment vehicles' financial statements must be audited in accordance with U.S. Generally Accepted Auditing Standards.

We proposed to require distribution of the audited financial statements within 90 days, but have extended that period to 120 days so that funds of funds will have enough time to complete their financial statements. Funds of funds, as pointed out by commenters, usually wait for the completion of the financial statements of the underlying investment funds before confirming their own data and finalizing their own financial statements.