

reliance on no-action letters issued by our staff.⁴² Commenters requested that we modify Item 9 to avoid requiring these advisers to amend their Form ADVs in this respect. The new instruction specifies that advisers that have custody only because they deduct fees may answer “no” to Item 9.⁴³ It will be some number of months before the NASD, which operates the IARD for us, completes reprogramming the IARD to implement this change to Item 9. In the interim, advisers registered with the Commission that have custody only because they deduct fees should answer “no” to Item 9 of current Form ADV.

Finally, we are eliminating the requirement that advisers with custody of client assets include an audited balance sheet in their disclosure statements (“brochures”) sent to clients.⁴⁴ Commenters agreed that the requirement is no longer necessary due to the adoption of rule 206(4)–4, which requires every adviser to disclose to its clients any financial condition that is reasonably likely to impair the adviser’s ability to meet its contractual commitments to its clients.⁴⁵

III. Effective Date

The effective date of the amendments is November 5, 2003. Advisers must comply with the amended rule by April 1, 2004. By this compliance date, an adviser with custody of clients’ funds and securities must ensure that those assets are kept in accounts with qualified custodians. Also by this date, the adviser must have established its reasonable belief that the qualified custodians send quarterly account statements directly to the clients or to their independent representatives, or as an alternative, follow the requirements of sending quarterly statements and undergoing an annual surprise examination.⁴⁶ In addition, by this date, advisers to limited partnerships that are not currently subject to annual audits must ensure that those partnerships have become obligated to undergo annual audits if the adviser intends to

rely on the exception in paragraph (b)(3) of the amended rule.⁴⁷

IV. Consideration of Promotion of Efficiency, Competition, and Capital Formation

Section 202(c) of the Advisers Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.⁴⁸

The amendments eliminate unnecessary burdens and thus may permit advisers to operate more efficiently. Because they apply equally to all advisers registered with us, we do not anticipate that they create any competitive disadvantages. We do not expect them to have an effect on capital formation or the capital markets.

V. Cost-benefit Analysis

A. Background

The Commission is sensitive to the costs and benefits resulting from its rules. The amendments we adopt today are designed to harmonize the custody rule with current custodial practices, enhance the protections afforded to advisory clients’ assets, and reduce advisers’ compliance burden. The amended rule requires advisers with custody of client funds and securities to maintain those funds and securities with broker-dealers, banks, or other “qualified custodians.” The amended rule relieves advisers from sending clients quarterly account statements and undergoing an annual surprise examination if qualified custodians send account statements directly to the clients at least quarterly. The amended rule also defines “custody,” incorporating a definition already used in Form ADV, and illustrates common circumstances under which an adviser

has custody. Finally, the amendments make two custody-related changes to Form ADV.

In our Proposing Release, we carefully analyzed the costs and benefits of our proposed amendments and requested comment regarding the costs and benefits to individual advisers and to the industry as a whole. We estimated based on advisers’ filings with us that 867 advisers registered with us (approximately 11 percent) have custody of clients’ assets, that 156 of these firms were broker-dealers (123) or banks (33), that would keep custody of their own clients’ assets and, in their capacity as qualified custodians, send account statements to those clients,⁴⁹ and that in 95 percent of the remaining advisers with custody⁵⁰ qualified custodians would send account statements to 99 percent of clients and the adviser would prepare account statements for the remaining 1 percent of clients.⁵¹ We estimated that the remaining 36 advisory firms⁵² would prepare their own statements for all clients.⁵³ Commenters strongly favored the amendments and agreed that they would ease the regulatory burden on advisers and increase investor protections.⁵⁴ We did not, however, receive specific comments on our cost benefit analyses.

We are adopting the amendments substantially as proposed, with some revisions in response to comments. We believe our original analyses regarding the benefits and costs of the amendments remain accurate. Most of the benefits and costs under the amended rule, however, are not quantifiable.

B. Benefits

Improved protection for advisory clients. The amended rule requires advisers to maintain clients’ securities, as well as clients’ funds, with qualified custodians. Although most advisers

⁴² We are, as indicated earlier, withdrawing those staff letters. See *supra* note 11.

⁴³ The revised instruction applies only with respect to an adviser’s registration with us, and does not affect advisers registered or registering with the states. We note, also, that advisers registering with one or more states must respond separately to Part 1B of Form ADV, which specifically asks whether the adviser deducts fees from its clients’ accounts.

⁴⁴ Part II, Item 14 of Form ADV.

⁴⁵ 17 CFR 275.206(4)–4. See also Section II.E. of the Proposing Release.

⁴⁶ Until the compliance date, advisers may rely on SEC staff letters for exemption from the surprise examination. See SEC staff letters listed in *supra* notes 11 & 15.

⁴⁷ Amended rule 206(4)–2(b)(3). Advisers to limited partnerships that are currently subject to annual audits may rely on this exception immediately upon the rule’s effective date. The rule requires that the limited partnership be subject to an annual audit, but does not specify the means by which that binding commitment must be made. In most cases, we expect that the limited partnership agreement itself will require that the partnership be audited annually. In other cases, the adviser may evidence the commitment through an ongoing letter of engagement with an independent public accountant, or may use its disclosure statement to commit to the investors that the audit will be performed annually.

⁴⁸ 15 U.S.C. 80b–2(c). We are adopting amendments to Form ADV under sections 203(c)(1) and 204 of the Advisers Act. These sections authorize the Commission to prescribe rules as necessary or appropriate in the public interest or for the protection of investors.

⁴⁹ Registered broker-dealers or banks are “qualified custodians” under the amended rule and may custody their own clients’ funds and securities.

⁵⁰ $867 - 156 = 711$ advisers. 95 percent of 711 advisers = 675 advisers.

⁵¹ We based this estimate on our experience examining investment advisers. We estimated that SEC-registered investment advisers have a mean of 670 clients each. Thus, this group of advisers would be preparing their own statements for an aggregate group of $4,725$ clients (670 mean clients per adviser $\times 7$ clients per adviser $\times 675$ advisers = $4,725$ clients).

⁵² $867 - 156 - 675 = 36$.

⁵³ We estimated that these 36 advisers would have $24,120$ clients in the aggregate ($36 \times 670 = 24,120$).

⁵⁴ See *Summary of Comments* prepared by our staff, available in our Public Reference Room in File No. S7–28–02, and on our Web site at www.sec.gov/rules/extra/s72802csumm.htm.