

with custody already maintain their clients' securities with banks or broker-dealers as a matter of practice, the rule has not previously required it. Including this requirement in the rule will ensure that all advisers with custody provide this protection to their clients.

Under the amended rule, when qualified custodians send quarterly account statements directly to advisory clients, the adviser is no longer required to send its own quarterly statements and to undergo an annual surprise examination.⁵⁵ Receiving quarterly account statements directly from the qualified custodians will enable advisory clients to identify questionable transactions early and allow them to move more swiftly than relying on an annual surprise examination. Many commenters commended this new approach.

For the small group of advisers that cannot use the new approach and therefore must continue to undergo an annual surprise examination,⁵⁶ the amended rule requires the independent public accountant conducting the examination to advise the Commission of any material discrepancies it discovers in the examination. The Commission will therefore be able to act promptly to prevent further losses resulting from the adviser's malfeasance.

Remove unnecessary regulatory requirements. Commenters generally agreed that the new compliance requirements would reduce their compliance burden. The compliance requirements under the amended rule focus on investment advisers ascertaining whether qualified custodians are sending quarterly account statements to each of the

advisers' clients. This sets forth a much simpler and less expensive compliance procedure for the adviser than sending its own quarterly account statements and undergoing an annual surprise examination.⁵⁷ As discussed above, we expect most advisers will have qualified custodians send clients' account statements directly. The amendments also eliminate the costs of complying with staff no-action letters that set out alternative procedures to the annual surprise examination; advisers previously relying on these letters must now comply with the revised rule. We did not receive comments on our estimates or on quantifying these cost reductions.⁵⁸

The amendments eliminate the requirement set forth in Form ADV that advisers with custody must include, in their disclosure brochures sent to clients, a balance sheet prepared and audited by an independent public accountant.⁵⁹ Eliminating the balance sheet requirement will reduce advisers' compliance burden.⁶⁰ The amendments also revise the instruction to Item 9 of Part 1A of Form ADV, so that SEC-registered advisers that have custody solely because they deduct their advisory fees from clients' assets need not report custody for purposes of Part 1A. These advisers currently rely on our

staff's no-action letters to report that they do not have custody; they commented that requiring them to change their response to Item 9 would confuse their clients.⁶¹ This revision avoids requiring these advisers to amend their registration statements.⁶²

Improved clarity and transparency of the rule. The amendments will improve the clarity and transparency of the rule by adding a definition of "custody" to the rule and by providing examples of the custodial situations most likely to be encountered by an adviser in today's securities markets. Advisers will benefit from this transparency because they (or their counsel) will no longer need to refer to other materials such as staff no-action letters for these examples. Commenters generally responded favorably to the insertion of the definition and examples.

C. Costs

The amendments require that all client funds or securities be maintained with qualified custodians. This requirement may impose costs on the advisers that currently have physical possession of client assets. We estimated in the Proposing Release that the additional cost of this requirement, if any, would be minimal because most advisers already maintain client assets with banks or broker-dealers.⁶³ Many commenters confirmed that their custody arose through their access to their clients' funds or securities, not through any physical possession of them, and this requirement would not impose additional costs on them.

In addition, the amendments exempt advisers with custody from the costs of undergoing annual surprise examinations and sending account statements only when qualified custodians send account statements directly to the advisers' clients at least quarterly. This condition may impose costs on a small number of advisers that do not already have qualified custodians deliver account statements directly to the advisers' clients.⁶⁴ These advisers

⁵⁵ We proposed that qualified custodians send account statements to clients monthly. 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.

⁵⁶ As we discussed on our Proposing Release, based on information collected from Form ADVs, 867 advisers registered with the Commission—approximately 11%—report having custody. Of these, 156 are "qualified custodians" that may custody their own clients' assets; we expect these 156 firms will all send quarterly custodial account statements to their clients and thus will be exempt from annual surprise examinations. Of the remaining 711 SEC-registered advisers with custody, we expect 675 (95%) will have qualified custodians deliver account statements directly to 99% of their clients, and will need to send statements and undergo annual surprise examinations only with respect to the remaining 1%. We expect the remaining 36 advisers will continue to be subject to the annual surprise examination requirement with respect to all of their clients.

⁵⁷ In the Proposing Release, we estimated that approximately 744 advisers (those that report having custody but are not registered broker-dealers) were required to undergo annual surprise examinations under the current rule, and that on average, an adviser spends approximately 335 hours (0.5 hours per client for an average of 670 clients) and pays \$8,000 annually in fees to an independent public accountant in connection with undergoing the examination. We also estimated that under the amended rule, only 36 advisers will continue to incur these full costs of an annual surprise examination with respect to all their clients; we estimated that another 675 advisers will incur these costs only with respect to one percent of their clients, spending approximately 3.5 hours and paying \$1,000 annually in fees in connection with the annual surprise examination.

⁵⁸ The Commission does not collect information on the number of advisers that currently do not comply with the custody rule in reliance on SEC staff no-action letters, but that will be subject to the revised rule.

⁵⁹ This change will not, however, impair client protections. A balance sheet may give an imperfect picture of the financial health of an advisory firm, because many advisers, including very profitable firms, have few financial assets. Moreover, rule 206(4)–4, which did not exist when the balance sheet requirement was adopted, requires every adviser to disclose any financial condition that is likely to impair its ability to meet its contractual commitments to its clients; this disclosure is more useful to clients than a balance sheet.

⁶⁰ The Commission staff has estimated, in connection with Paperwork Reduction Act analyses, that an adviser not otherwise required to prepare audited financial statements presently spends approximately \$15,000 annually to comply with this requirement, and that approximately 580 advisers with custody are currently incurring these costs. See *infra* note and accompanying text.

⁶¹ Because those staff no-action letters are being withdrawn, these advisers must now comply with the amended custody rule.

⁶² We have been advised by groups representing advisers registered with us that perhaps as many as 90% of SEC-registered advisers deduct fees from their clients' accounts.

⁶³ In our Proposing Release, we estimated that no more than 1 percent of advisers with custody keep any clients' securities in places other than accounts with qualified custodians, and even these advisers maintain almost all of their clients' assets with qualified custodians.

⁶⁴ In the Proposing Release, we have estimated that most qualified custodians are delivering account statements to advisers' clients and that less than 1% of advisory clients (excluding investors in

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