

advisers that have custody of client assets.

In the Proposing Release, we estimated the current aggregate annual cost of this requirement at \$11,460,000.<sup>73</sup> For purposes of calculating this cost under the amendments, we estimated the 580 advisers that are paying accountants' fees to comply with the balance sheet requirement under the current rule would no longer incur these costs. Therefore, we estimated in the Proposing Release that the number of advisers subject to this requirement would be reduced to 184, and the aggregate annual cost of this requirement would be reduced to \$2,760,000, for an average annual cost for each adviser registered with us of \$364.<sup>74</sup>

Commenters generally supported the elimination of the balance sheet requirement, but made no specific comment on our estimated numbers. We are adopting this amendment as proposed. These estimated numbers therefore remain the same.

We are also adding an instruction to Item 9 of Part 1A of Form ADV, which asks whether the adviser has custody of clients' funds or securities. Many advisers registered with us deduct fees from clients' accounts but currently answer "no" to Item 9 in reliance on no-action letters issued by our staff. The new instruction would permit advisers that have custody solely because they deduct fees to continue answering "no" to Item 9. Consequently, the new instruction does not affect the collection of information burden of Form ADV.

This collection of information is mandatory, and responses are not kept confidential.

<sup>73</sup> We estimated that each adviser that needed an audited balance sheet in order to comply with the requirement paid approximately \$15,000 on average in accounting fees. According to our records, 184 advisers registered with us require prepayment of fees, and 887 advisers registered with us provide an audited balance sheet to their clients under Part II, Item 14 of Form ADV. (Because advisers are not presently required to file Part II of ADV with the Commission, the 887 figure is from data collected before January 1, 2001.) Since 867 advisers report having custody of their clients' assets, and this number of advisers combined with those who require prepayment of fees exceeds the 887 providing balance sheets by 164, we have estimated that 164 of the advisers with custody also require prepayment of fees. Of the 703 advisers providing balance sheets because of the custody provision (867 advisers with custody - 164 also requiring prepayment of fees = 703), 123 are also broker-dealers that are required to maintain audited financial statements under other rules, and only the remaining 580 advisers incur accountants' fees to comply with the balance sheet requirement under the custody provision.  $\$15,000 \text{ in fees} \times (184 \text{ advisers with advance fees} + 580 \text{ additional advisers with custody}) = \$11,460,000$ .

<sup>74</sup>  $(184 \times \$15,000) / 7,583 = \$364$ .

## VII. Final Regulatory Flexibility Analysis

The Commission proposed amendments to rule 206(4)-2, the custody rule under the Advisers Act, in a release issued on July 18, 2002 ("Proposing Release").<sup>75</sup> An initial Regulatory Flexibility Analysis ("IRFA") was published in the Proposing Release. No comments were received on the IRFA. The Commission has prepared the following Final Regulatory Flexibility Analysis ("FRFA") regarding amendments to rule 206(4)-2 and Form ADV, in accordance with 5 U.S.C. 604.

### A. Need for the Amendments

We are adopting the amendments substantially as proposed. The amendments are necessary to harmonize the advisers' custody rule with current custodial practices, enhance the protections afforded to client assets, and clarify circumstances under which advisers have custody of client assets. The amendments require advisers to maintain client funds and securities with broker-dealers, banks, or other "qualified custodians." If the qualified custodian sends account statements directly to an adviser's clients at least quarterly, the adviser will be relieved from sending its own account statements and from undergoing an annual surprise examination of those clients' accounts. The amendments exempt advisers from the rule with respect to clients that are registered investment companies and exempt advisers to limited partnerships (or other types of pooled investment vehicles) from the account statement delivery requirement if the limited partnerships are subject to annual audit and distribute the audit results to their limited partners.

The amendments add a definition of "custody" to the rule and illustrate the circumstances under which an adviser has custody of client assets. Advisers will benefit from this transparency because they (and their counsel) will no longer need to refer to external materials such as staff no-action letters for these examples. Finally, the amendments eliminate the requirement in Form ADV that advisers with custody include an audited balance sheet in their disclosure brochures to clients; other disclosures now provide clients with information that is likely to be more helpful to them in this regard.

<sup>75</sup> *Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Release No. 2044 (July 18, 2002) [67 FR 48579 (July 25, 2002)].

### B. Significant Issues Raised by Public Comment

The Commission received 49 letters from commenters in response to the Proposing Release.<sup>76</sup> Commenters strongly supported the proposal. As discussed in Section II of this Release, above, the Commission is adopting the amendments substantially as proposed with some changes to respond to commenters' suggestions. The Commission specifically requested comment with respect to the IRFA, but did not receive any comments concerning the IRFA.

### C. Small Entities Subject to Rule

In developing the amendments, we have considered their potential effect on small entities. Under Commission rules, for the purposes of the Advisers Act and the Regulatory Flexibility Act, an investment adviser generally is a small entity if it: (i) Has assets under management having a total value of less than \$25 million; (ii) did not have total assets of \$5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of \$25 million or more, or any person (other than a natural person) that had \$5 million or more on the last day of its most recent fiscal year.<sup>77</sup> The Commission estimates that approximately 28 SEC-registered investment advisers that have custody of client assets are small entities.<sup>78</sup>

### D. Projected Reporting, Record-keeping, and Other Compliance Requirements

The amended rule imposes no new reporting and record-keeping requirements. In addition, we believe that most advisers that maintain custody of client assets, including advisers that are small entities, already maintain these assets with qualified custodians. Therefore, the amendments will not materially increase the effort necessary on the advisers' behalf to comply with the Commission's rules. To the contrary, the amendments provide advisers with the opportunity to eliminate costs they incur complying with the present rule's requirements to send account statements to clients and undergo an

<sup>76</sup> 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 <http://www.sec.gov/rules/extra/s72802csumm.htm>.

<sup>77</sup> 17 CFR 275.0-7(a).

<sup>78</sup> This estimate is based on the information provided submitted by SEC-registered advisers in Form ADV, Part 1A [17 CFR 279.1] as of May 2002.