

annual surprise examination.⁷⁹ In addition, we are amending Form ADV to eliminate the requirement that an adviser with custody of client assets provide its clients with a copy of its audited balance sheet, thereby further reducing the advisers' compliance costs. We are also amending Form ADV to add an instruction to Item 9 of Part 1A; this instruction permits SEC-registered advisers that have custody only because they deduct their fees from their clients' assets to continue responding "no" to Item 9.⁸⁰

E. Agency Action To Minimize Effect on Small Entities

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the amended rule, the Commission considered the following alternatives: (a) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for such small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the rule, or any part thereof, for such small entities.

The overall impact of the amendments is to decrease regulatory burdens on advisers. Small advisers, as well as large ones, will benefit from the amended rule. Moreover, the amendments achieve the rule's objectives through alternatives that are already consistent in large part with advisers' current custodial practices. Therefore, the potential impact of the amendments on small entities should not be significant. For these reasons, alternatives to the amendments, such as differing compliance or reporting requirements, simplification of compliance and reporting requirements, or the use of performance rather than design standards, are unlikely to minimize any impact that the amended rule may have on small entities. Regarding exemption from coverage of

the rule amendments, or any part thereof, for small entities, such an exemption would deprive small entities of the burden relief provided by the amendments. Moreover, since the protections of the Advisers Act are intended to apply equally to clients of both large and small advisory firms, it would be inconsistent with the purposes of the Act to specify different requirements for small entities or to establish different compliance or reporting requirements for small entities with regard to this requirement.

VIII. Statutory Authority

We are adopting amendments to rule 206(4)–2 pursuant to our authority set forth in sections 206(4) and 211(a) of the Advisers Act [15 U.S.C. 80b–6(4) and 80b–11(a)].

We are adopting amendments to Form ADV pursuant to the authority set forth in sections 203(c)(1), 204, and 211(a) of the Advisers Act [15 U.S.C. 80b–3(c)(1), 80b–4 and 80b–11(a)].

List of Subjects in 17 CFR Parts 275 and 279

Reporting and recordkeeping requirements, Securities.

Text of Rule

■ For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

■ 1. The authority citation for Part 275 continues to read in part as follows:

Authority: 15 U.S.C. 80b–2(a)(11)(F), 80b–2(a)(17), 80b–3, 80b–4, 80b–6(4), 80b–6a, 80b–11, unless otherwise noted.

* * * * *

■ 2. Section 275.206(4)–2 is revised to read as follows:

§ 275.206(4)–2 Custody of funds or securities of clients by investment advisers.

(a) *Safekeeping required.* If you are an investment adviser registered or required to be registered under section 203 of the Act (15 U.S.C. 80b–3), it is a fraudulent, deceptive, or manipulative act, practice or course of business within the meaning of section 206(4) of the Act (15 U.S.C. 80b–6(4)) for you to have custody of client funds or securities unless:

(1) *Qualified custodian.* A qualified custodian maintains those funds and securities:

- (i) In a separate account for each client under that client's name; or
- (ii) In accounts that contain only your clients' funds and securities, under your name as agent or trustee for the clients.

(2) *Notice to clients.* If you open an account with a qualified custodian on your client's behalf, either under the client's name or under your name as agent, you notify the client in writing of the qualified custodian's name, address, and the manner in which the funds or securities are maintained, promptly when the account is opened and following any changes to this information.

(3) *Account statements to clients.*—(i) *By qualified custodian.* You have a reasonable basis for believing that the qualified custodian sends an account statement, at least quarterly, to each of your clients for which it maintains funds or securities, identifying the amount of funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period; or

(ii) *By adviser.* (A) You send a quarterly account statement to each of your clients for whom you have custody of funds or securities, identifying the amount of funds and of each security of which you have custody at the end of the period and setting forth all transactions during that period;

(B) An independent public accountant verifies all of those funds and securities by actual examination at least once during each calendar year at a time that is chosen by the accountant without prior notice or announcement to you and that is irregular from year to year, and files a certificate on Form ADV-E (17 CFR 279.8) with the Commission within 30 days after the completion of the examination, stating that it has examined the funds and securities and describing the nature and extent of the examination; and

(C) The independent public accountant, upon finding any material discrepancies during the course of the examination, notifies the Commission within one business day of the finding, by means of a facsimile transmission or electronic mail, followed by first class mail, directed to the attention of the Director of the Office of Compliance Inspections and Examinations; and

(iii) *Special rule for limited partnerships and limited liability companies.* If you are a general partner of a limited partnership (or managing member of a limited liability company, or hold a comparable position for another type of pooled investment vehicle), the account statements required under paragraphs (a)(3)(i) or (a)(3)(ii) of this section must be sent to each limited partner (or member or other beneficial owner).

(4) *Independent representatives.* A client may designate an independent representative to receive, on his behalf,

⁷⁹ Under the amended rule, an adviser will not be required to send quarterly account statements or undergo a surprise examination with respect to accounts for which a qualified custodian sends account statements directly to clients at least quarterly.

⁸⁰ These advisers, in reliance on no-action letters issued by the Commission's staff, have responded "no" to Item 9 and have not been required to comply with the custody rule. The letters are being withdrawn and these advisers must now comply with the revised rule.