

MEMO# 15157

September 11, 2002

ICI DRAFT COMMENT LETTER ON SEC'S PROPOSED AMENDMENTS TO THE CUSTODY RULE UNDER THE ADVISERS ACT

[15157] September 11, 2002 TO: INVESTMENT ADVISERS COMMITTEE No. 18-02 RE: ICI DRAFT COMMENT LETTER ON SEC'S PROPOSED AMENDMENTS TO THE CUSTODY RULE UNDER THE ADVISERS ACT As we previously informed you, in July, the Securities and Exchange Commission proposed for comment substantial amendments to update and modernize Rule 206(4)-2 under the Investment Advisers Act, which governs custody by investment advisers.* Attached for your review is a copy of the Institute's draft comment letter on the proposed amendments, which is briefly summarized below. Comments on the proposed amendments must be filed with the SEC by Wednesday, September 25, 2002. Please provide any comments you may have on the Institute's draft letter by Wednesday, September 18 to Anu Dubey by phone (202-326-5819), fax (202-326-5827) or e-mail (adubey@ici.org) or Tamara Reed by phone (202-326-5825), fax (202-326-5827) or e-mail (tamara@ici.org). SUMMARY OF THE INSTITUTE'S COMMENTS The Institute's draft letter expresses general support for the Commission's proposals, but recommends several modifications to ensure that the amendments are effective in achieving their intended goals. In summary, the Institute's letter makes the following comments:

- We strongly recommend that the definition of "custody" in the rule be consistent with longstanding staff interpretations of this term. In particular, we oppose including in this definition arrangements in which advisers deduct fees from client custodial accounts in accordance with specified conditions. We also request that, if custody continues to be imputed to advisers from their affiliates under certain circumstances, the Commission revise the rule to specify such circumstances. Furthermore, we recommend that the definition of "custody" in the rule be revised to be consistent with the definition in Form ADV.
- We recommend expanding the types of assets that may be held by a foreign qualified custodian to include all funds and securities in the account of a client that is held outside *

* See ICI Memorandum No. 14950 (July 24, 2002). 2 of the United States. To clarify the meaning of the term "primary market," we also recommend that the Commission either revise the rule to define this term or to provide guidance as to its intended meaning in the adopting release.

- We strongly recommend that the rule be revised to permit an adviser to satisfy the account statement delivery requirements if, with respect to securities of a registered investment company, it has a reasonable basis for believing that the registered investment company's transfer agent sends the required statements to the adviser's client.
- We recommend that the Commission revise the delivery requirements applicable to account statements sent by the custodian to conform them to current industry practice (i.e.,

monthly statements only for accounts in which there was activity during the month and quarterly statements for all other accounts). We further recommend that the account statements be permitted to be sent to a client's designee. • We request clarification that the one business day period within which any "finding" of a material discrepancy by an auditor must be reported to the Commission begins to run when the auditor, based upon a review of the facts and circumstances, which may include consulting with the adviser or ascertaining additional information, has reason to believe that a material discrepancy exists. • We support the proposed elimination of the balance sheet requirement in Item 14 of Part II of Form ADV for advisers with custody and recommend that this requirement also be eliminated for advisers that require prepayment of advisory fees more than 6 months in advance or in an amount greater than \$500. SPECIFIC COMMENTS REQUESTED In addition to seeking comment on the draft letter overall, the Institute would appreciate comments on the following four issues: Deduction of Fees from Client Accounts. The letter discusses, as one of the reasons we oppose including in the definition of "custody" arrangements in which advisers deduct fees from client custodial accounts in accordance with specified conditions, the potential for increased liability that flows from being deemed to have custody of client assets. The Institute seeks comment on whether there are other arguments that we could put forth in our letter to support our assertion that the rule should continue to permit advisers to deduct fees from client assets, in compliance with specified conditions, without being deemed to have custody of those assets. Inadvertent Receipt of Assets. The proposed definition of "custody" excludes the inadvertent receipt of client funds or securities by the adviser if the adviser returns them within one business day of receipt. The letter currently recommends that the one business day period be revised to a "promptly, but within no more than three business days" period. The Institute seeks comment on whether three business days is an appropriate maximum time limit for this purpose. 3 Transition Period. With respect to an appropriate transition period for compliance with the proposed amendments, the letter recommends that the adopting release provide for a transition period of at least ninety days. The Institute seeks comment on whether ninety days is an appropriate period of time. Clearing Agencies/Securities Depositories. The letter does not include a recommendation that the definition of "qualified custodian" include clearing agencies and securities depositories. Based upon our review, it appears that including transfer agents in the list of qualified custodians obviates the need to also include clearing agencies or securities depositories. The Institute specifically seeks comment on this issue. Anu Dubey Assistant Counsel Attachment (in .pdf format)