The Asset Management Industry
SERVING INDIVIDUAL INVESTORS

INVESTMENT COMPANY INSTITUTE

**COMMENT LETTER**

September 24, 2002

# Comment Letter on SEC Investment Adviser Rule Amendments, September 2002

September 24, 2002

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Proposed Amendments to the Custody Rule under the Advisers Act (File No. S7-28-02)

Dear Mr. Katz:

The Investment Company Institute1 is pleased to comment on the Securities and Exchange Commission's proposed amendments to Rule 206(4)-2 under the Investment Advisers Act of 1940, the rule that governs custody of client funds and securities by an investment adviser.2 In particular, the Commission has proposed to clarify the rule by adding a definition of "custody" to it, expand the list of entities that may be qualified custodians, and conform the rule to modern custodial practices, thereby reducing burdens on advisers with custody.

The Institute supports the Commission's proposal. We are particularly pleased that, consistent with previous recommendations of the Institute, the Commission's proposal would provide greater flexibility to advisers in connection with their custodial arrangements and eliminate the confusion and inefficiencies of the current rule that result from the various no-action and interpretive letters issued by the staff since the rule was first adopted.3 We strongly support the Commission adding a definition of "custody" to the rule and providing more transparency to this definition by incorporating into it examples taken from the staff no-action letters. We also strongly support the Commission expanding the list of qualified custodians and relieving advisers of the unnecessary burdens occasioned by the current rule. Importantly, we believe the proposed revisions will better serve investors by enhancing the protections that would be afforded to them under the revised rule.

The Institute has a number of recommended revisions to the rule, which are intended to help ensure that the amendments will be effective in achieving their intended goals. In

summary, our comments are as follows:

- 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 of the United States. If the Commission decides not to adopt this recommendation, we request that it clarify the meaning of the term “primary market,” by either revising the rule to define this term or providing guidance as to its intended meaning in the adopting release.
- We recommend that the rule be revised to provide an exception from the rule’s requirements for mutual fund shares that are recorded by its transfer agent in either the name of the adviser’s client or in the name of the adviser as agent or trustee for the client, provided that certain conditions are satisfied.
- 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.

Each of these comments is discussed in greater detail below.

I. Definition of Custody

II. Definition of Qualified Custodian

III. Custody of Mutual Fund Shares

IV. Delivery of Account Statements

V. Surprise Audit

VI. Elimination of Balance Sheet Requirement

VII. Transition Period

# I. Definition of Custody

As mentioned above, the Commission has proposed to amend Rule 206(4)-2 to include a definition of "custody." We support this proposal and, in particular, the inclusion of examples of custody taken from staff no-action letters. We believe that these examples will provide more transparency and clarity to the rule, thereby better enabling advisers to determine whether specific arrangements constitute custody. We do, however, have several recommendations relating to the proposed definition. First, we recommend that one of the examples under which an adviser would be deemed to have custody be revised to be consistent with longstanding staff positions that permit advisers to deduct fees from a client's custodial account without being deemed to have custody.4 Second, we recommend that, if custody continues to be imputed to advisers from their affiliates under certain circumstances, the Commission revise the rule to specify the circumstances under which custody will be imputed. Third, we recommend that the definition of "custody" in the rule be revised to be consistent with the definition in Form ADV. Fourth, we recommend that the exception in the definition for the inadvertent receipt of client assets provide advisers with more flexibility. Each of these recommendations is discussed in more detail below.

## A. Deduction of Fees from Client Accounts

According to the release originally adopting Rule 206(4)-2, the rule was designed to implement the antifraud provisions of the Advisers Act by "requiring an adviser who has custody of funds or securities of any client to maintain them in such a way that they will be insulated from and not be jeopardized by financial reverses, including insolvency of the investment adviser."5 Consistent with the rule's purpose, after the rule was adopted, the staff permitted advisers to continue the widely accepted industry practice of deducting their fees from their clients' custodial accounts, subject to certain conditions, without deeming the adviser to have custody and triggering the rule's requirements.6 In the Proposing Release, the Commission proposes, for the first time, to define these arrangements to constitute "custody" for purposes of the rule. We oppose this change.7

In the forty years since the rule was adopted, we are not aware of any abuses reported concerning these arrangements, nor are any cited in the Proposing Release. Indeed, the Proposing Release contains no explanation as to why the Commission has determined to reverse its longstanding view on these arrangements. It does, however, note that the proposed rule has been designed so that advisers that had relied upon the alternative procedures set forth in these no-action letters "would be able to comply with the rule without facing the burdens they previously sought to avoid."8

While the conditions in these no-action letters are somewhat burdensome, advisers have long adapted their operations to them and may view them as preferable to the alternative—i.e., the potential for increased liability that flows from being deemed to have custody of client assets.9 Today, an adviser that bills the client's custodian for its advisory fees in accordance with staff no-action letters, would not appear to be liable for any unauthorized use of assets or malfeasance by the custodian because the adviser does not have custody. Under the Commission's proposal, however, this same adviser would be deemed to have custody. Consequently, an adviser could face allegations that it is somehow a "co-custodian" and, therefore, accountable for any unauthorized conduct by the qualified custodian. As such, the Commission's proposed treatment of these arrangements, while seemingly eliminating procedural burdens imposed by staff no-action letters, may, in fact, have the unintended consequence of increasing an adviser's liability for conduct outside of its control.

Moreover, the Institute submits that deeming these arrangements to constitute custody is not necessary in view of the rule's purpose—i.e., to insulate clients from an adviser's precarious financial situation. We note that these arrangements do not give the adviser unbridled access to the customer's funds and securities held in the custodial account. As a result, the adviser's ability to misappropriate the client's assets would be limited.10 As noted, above, however, the Commission has not cited any such abuses in support of this revision. Accordingly, we recommend that the Commission not deem arrangements under which an adviser deducts its fees from clients' custodial accounts to constitute custody for purposes of the rule so long as an adviser satisfies the procedural requirements specified by the staff in its no-action letters.11 In the event the Commission does not revise the rule to exclude fee deduction arrangements that comply with specified conditions from the definition of custody, we recommend that the adopting release alert those advisers that have operated in compliance with the staff no-action letters and, as such, have not been deemed to have custody, of the need to revise their Form ADV disclosure and comply with the revised rule's requirements, notwithstanding the fact that the adviser has not altered the manner in which it bills for its services.

## B. Imputing Custody to an Adviser from its Affiliate

In a no-action letter issued in 1978, the staff announced the factors that must be considered in order to determine whether an adviser has custody or possession of clients' funds or securities based upon an affiliate of the adviser acting as a custodian for the client.12 Since its issuance, this letter has been widely relied upon by advisers. We note that the proposed rule is silent as to whether custody will be imputed to advisers from their affiliates and, if so, under what circumstances. We recommend that, consistent with the Commission's intent to provide more transparency to Rule 206(4)-2, the Commission revise the rule to clarify how these arrangements will be treated. In particular, if the Commission decides that custody will continue to be imputed to advisers from their affiliates, we recommend that the Commission add an additional example to the definition of "custody" that sets forth the circumstances under which custody would be imputed.13 Also, if custody will continue to be imputed, we recommend that, in the adopting release, the Commission clarify whether the adviser must send out quarterly statements and have the annual inspection because custody has been imputed to the adviser; or, instead, whether the adviser can rely upon the provisions of 206(4)-2(a)(3)(i) and have its affiliate send a monthly account statement to the client because the affiliate has custody.14

## C. Revision of First Example to Reflect Form ADV Definition of "Custody"

The first example in the proposed definition of "custody" would define the term to include the "possession or control of client funds . . . or securities . . . ." We recommend that the phrase "control of" in this example be replaced with "the ability to appropriate" for two reasons. First, this revision would conform this definition to the definition of "custody" in Form ADV,15 thereby providing consistency between this rule and the form. Second, we believe that use of the term "control," as proposed by the Commission, would diminish the rule's clarity. This is because the term is nowhere defined in the rule and, as such, its meaning for purposes of the rule would be vague and ambiguous.16

## D. Inadvertent Receipt of Client Funds or Securities

As proposed, the definition of "custody" would exclude the inadvertent receipt of client funds or securities by the adviser, so long as the adviser returns them to the sender "within one business day" of receipt. The Institute supports this exclusion, but recommends two revisions to it. First we recommend that the "within one business day" period specified in

the rule be revised to a “promptly, but within no more than three business days” period. We are concerned that one business day may not be enough time for an adviser to return assets that are inadvertently received. By contrast, requiring an adviser to act “promptly, but within no more than three business days” would allow the adviser a more reasonable and realistic time frame within which to take action, while still ensuring that an adviser returns the assets within no more than three business days. We note that because an adviser has a fiduciary duty toward its clients, under this revised standard, the adviser would have a duty to take action with respect to the assets without delay.

Second, we recommend that, in addition to returning the assets to the “sender,” the adviser be able to forward them to an intended third-party recipient, if it is clear to the adviser to whom the assets were intended to be sent. This would be more efficient for the client and avoid the delays that would arise from the adviser returning the assets to the sender, and then for the sender to resend them to the intended recipient.

# II. Definition of Qualified Custodian

## A. Foreign Qualified Custodians

The Commission has requested comment on the definition of “qualified custodian” for purposes of foreign securities. While the Institute supports the entities the Commission has proposed to be qualified custodians for foreign securities, we are concerned that the assets that may be held by these foreign custodians—foreign securities, cash, and cash equivalents—are too narrowly defined. The Institute recommends that the assets that may be held by foreign qualified custodians be expanded to include all funds and securities in the account of any client held outside of the United States. There may be instances, for example, where an adviser’s client holds U.S. securities in an account maintained by a foreign custodian. Under the proposal, assets that do not qualify would have to be transferred to an eligible institution. This appears to be an unnecessary burden that would increase a client’s custodial costs without providing any increased protection.

If the Commission decides not to expand the types of assets that may be held by a foreign custodian as we recommend, we request that the Commission clarify the intended meaning of the phrase “securities for which the primary market is in a country other than the United States,” which is used to describe the foreign securities that may be held by a foreign custodian. We note that it may be difficult to determine whether the “primary” market for a particular security is outside of the U.S. because the security may trade in both the U.S. market and foreign markets. To clarify the meaning of the term “primary market,” the Institute recommends that the Commission either revise the rule to define this term or to provide guidance as to its intended meaning in the adopting release.[17]

# III. Custody of Mutual Fund Shares

Under the current version of Rule 206(4)-2, investment advisers are not required to custody the securities of their clients with any particular type of entity. As proposed to be revised, however, the rule would limit the entities that may maintain custody of a client’s securities to the entities included in the definition of “qualified custodian.” With respect to client securities that are mutual fund shares, this proposed revision could effectively bar an adviser with custody of client assets from causing a client to acquire mutual fund shares in the name of the client or in the name of the adviser as agent or trustee of the client. This is because mutual fund shares may be uncertificated securities that are not physically possessed—or custodied—by any entity. Instead, the only record of the client’s ownership

of these shares may be through the book-entry record maintained by the fund's transfer agent. As such, the only way an adviser could comply with the provisions of the proposed rule with respect to these shares would be to acquire mutual fund shares through, or transfer such shares to, an intermediary that is a qualified custodian such that the qualified custodian is recorded as the registered owner of the shares on the mutual fund's books.[18] We submit that such a result is not necessary to protect investors and will serve no purpose other than to increase an investor's custodian costs.

To avoid this result, the Institute recommends that subsection (b) of the rule be revised to provide an exception from the rule's requirements for mutual fund shares that are recorded by the fund's transfer agent in either the name of the adviser's client or in the name of the adviser as agent or trustee for the client, provided that the adviser notifies the client in writing of such account promptly upon its opening, including the fund's name, and address;[19] and the adviser either (1) has a reasonable basis for believing that the fund or its transfer agent sends to the client a statement of the client's account(s) with the mutual fund[20] or (2) (a) sends a quarterly statement to its client identifying the amount of funds and securities held in the account at the end of the period and setting forth all transactions in the account during that period and (b) complies with the requirements of subsections (a)(3)(ii)(B) and (C) of the proposed rule.[21]

In support of this recommendation, the Institute notes that this accommodation of mutual fund shareholders would protect a client's mutual fund shares to the same extent as if they were held in a brokerage account and would ensure that the client is provided regular account statements—either by the fund or its transfer agent or by the adviser—thereby enabling the client to monitor activity in its mutual fund account. Accordingly, permitting advisers to maintain (and to continue to maintain) these securities in this manner would be fully consistent with the rule's purpose and would provide the same level of protection that the rule would provide to a client's other non-mutual fund assets.

# IV. Delivery of Account Statements

## A. Frequency of Delivery

As proposed, an adviser that uses a qualified custodian to maintain client assets must have a reasonable belief that the custodian delivers monthly account statements to clients. In lieu of requiring delivery of monthly statements for all client accounts, we recommend that monthly statements be required only for those accounts in which there was activity during the month. For all other accounts, quarterly statements would suffice. We submit that this longstanding and widely accepted practice under the Securities Exchange Act of 1934[22] provides ample protection to investors by ensuring that they receive regular reports of activity in their custodial accounts.[23] There is no apparent reason to impose more rigorous delivery requirements under the Advisers Act.

## B. Delivery to Client's Designee

Paragraphs (a)(3)(i) and (a)(3)(ii) of the proposed rule would require account statements to be sent directly to clients. The Institute recommends that these paragraphs be revised to provide that, in lieu of sending the statement to the client, it may instead be sent to the client's designee so long as the designee is not the custodian, the adviser, a person associated with the adviser, or a person under common control with the adviser. This approach, which is consistent with rules under the Exchange Act,[24] would enable a client to appoint another person to monitor his or her account and receive communications regarding the account.[25]

## V. Surprise Audit

The Commission has proposed to add a requirement that an auditor conducting a surprise audit pursuant to paragraph (a)(3)(ii)(C) notify the Commission within one business day of "finding any material discrepancies." While we support this new requirement, we recommend that the adopting release clarify 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. Without this clarification, an auditor may believe that it must notify the Commission of any information that suggests a possible material discrepancy within one business day of the examination, rather than within one business day of the finding.[26] And yet, before making a finding of a material discrepancy, the auditor may need to investigate further, which may take time beyond the date of the examination. Clarifying this requirement in this manner would ensure that the Commission does not receive reports of material discrepancies that have not been thoroughly evaluated and do not have a sound basis, thereby potentially wasting staff time and resources.

## VI. Elimination of Balance Sheet Requirement

We support the Commission's proposed elimination of the balance sheet requirement in Item 14 of Part II of Form ADV for advisers that have custody of client assets. We agree that a balance sheet may give an imperfect picture of the financial health of an adviser and that Rule 206(4)-4, which requires advisers to make certain disclosures to their clients regarding their financial condition, is a better way to alert clients to possible risks to their assets. For these same reasons, we encourage the Commission to additionally eliminate the balance sheet requirement for advisers that require prepayment of advisory fees more than 6 months in advance or in an amount greater than $500.

## VII. Transition Period

With respect to a compliance date for the revised rule, the Institute encourages the Commission to allow advisers ample time within which to make any necessary adjustments to their current business practices and custodial arrangements. In this regard, if the final rule will have the effect of disrupting longstanding billing or custodial practices of advisers,[27] we recommend that advisers be provided at least ninety days within which to be compliant with the revised rule. We note that, during this transition period, the current version of the rule would still be in effect, ensuring that client assets would continue to be protected.

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The Institute appreciates the opportunity to provide comment on this proposal. If you have any questions regarding our comments, or would like any additional information, please contact me at (202) 326-5825, or Anu Dubey at (202) 326-5819.

Sincerely,

Tamara K. Reed
Associate Counsel

cc: Paul F. Roye, Director
Robert E. Plaze, Associate Director
Vivien Liu, Senior Counsel
Jennifer L. Sawin, Assistant Director
Division of Investment Management

**ENDNOTES**

1The Investment Company Institute is the national association of the American investment company industry. Many of the Institute's investment adviser members render investment advice to both investment companies and other clients. In addition, the Institute's membership includes 321 associate members which render investment management services exclusively to non-investment company clients. A substantial portion of the total assets managed by registered investment advisers are managed by these Institute members and associate members.

2 See Custody of Funds or Securities of Clients by Investment Advisers, SEC Release No. IA-2044 (July 18, 2002) (the “Proposing Release”). The page cites to the Proposing Release herein are to the version available on the Commission’s website.

3 See Letter from Craig S. Tyle, General Counsel, ICI, to Barry P. Barbash, Director, Division of Investment Management, SEC, dated July 7, 1998 (“1998 Letter”) and Letter from Craig S. Tyle, General Counsel, ICI, to Paul F. Roye, Director, Division of Investment Management, SEC, dated May 1, 2002 (enclosing Proposals to Improve Investment Company Regulation).

4 See proposed subparagraph (c)(1)(ii). Cf. Investment Advisers; Uniform Registration, Disclosure, and Reporting Requirements; Staff Interpretation, SEC Release No. IA-1000 (Dec. 3, 1985), Investment Counsel Association of America (pub. avail. June 9, 1982), The Institute of Certified Financial Planners (pub. avail. Aug. 15, 1990), John B. Kennedy (pub. avail. June 5, 1996), Securities America Advisors, Inc. (pub. avail. Apr. 4, 1997).

5 See SEC Release No. 123 (Feb. 27, 1962) (Emphasis added).

6 Under the line of no-action letters issued by the staff since the adoption of Rule 206(4)-2, advisers have been able to deduct their fees from the client’s custodial account without being deemed to have custody provided the adviser complies with the following conditions: (1) the client provides written authorization to the arrangement; (2) the adviser follows the procedure of submitting to the client a copy of its bill for advisory services, showing the amount of the fee, the value of assets on which the fee is based, and the basis for calculation of the fee, if the fee is fixed and does not vary with the assets in the account or other factors, at the same time the bill is submitted to the trustee or custodian; and (3) the trustee or custodian sends the client quarterly statements indicating all amounts disbursed from the account. See, e.g., Investment Counsel Association of America (pub. avail. June 9, 1982).

7 We similarly oppose the Commission including within the definition of “custody” arrangements involving advisers that serve as general partners to partnership clients that, under the current rule, are not deemed to constitute custody so long as the general partner complies with the conditions set forth in the PIMS no-action letter. See PIMS, Inc. (pub. avail. Oct. 21, 1991).

8 See Proposing Release, at footnote 23.

9 In fact, to avoid this result, advisers may revise their current practice of billing the custodian—which is mutually convenient for the adviser and the client—and bill their clients directly. This result, which would increase the burdens on both the clients and the adviser, would serve no useful purpose. It would not result in increased investor protection nor would it provide the Commission any greater ability to sanction an adviser who defrauds a client by over billing its account.

10 The conditions set forth in the no-action letters limit the adviser's access to the client's funds and securities and provide for client oversight of disbursals from the account through the receipt of quarterly statements, thereby providing ample protection to investors. See footnote 6, above.

11 In particular, the Institute recommends that the Commission revise the rule to except from the definition of custody those arrangements that comply with the conditions set forth in the staff no-action letters. See footnotes 6 and 7, above.

12 See Crocker Investment Management Corp. (pub. avail. Apr. 14, 1978). These factors are: (1) whether clients' property in the custody of the affiliated company might be subject, under any reasonably foreseeable circumstances, to the claims of the adviser's creditors; (2) whether advisory personnel have the opportunity to misappropriate clients' property; (3) whether advisory personnel ever have custody or possession of or direct or indirect access to clients' property or the power to control the disposition of such property to third parties for the benefit of the adviser or its affiliates; (4) whether advisory personnel and personnel of the affiliated company who have possession or custody of, or control over, or access to, advisory clients' property are under common supervision; and (5) whether advisory personnel hold any position with the custodian or share premises with the custodian and, if so, whether they have, either directly or indirectly, access to or control over clients' property.

13 If the Commission decides to revise the rule as we suggest, we assume that the Commission would look to the factors included in the staff no-action letters to draft the rule text setting out the circumstances under which custody would be imputed to advisers. As such, we reiterate three concerns that we expressed to the Commission in our 1998 Letter regarding the factors set forth in the staff no-action letters and their application. First, it is unclear whether all or merely some of the factors must be met to avoid imputed custody. Second, it is difficult to understand the differences, if any, between certain factors because they often overlap. Third, the specific requirements contained in the factors are unclear (e.g., the circumstances under which the claims of an adviser's creditors over customer assets custodied with the affiliate will be deemed to be reasonably foreseeable). See 1998 Letter, at pp. 4-5 of Appendix B. We recommend that, if the Commission decides to include an additional example under the definition of "custody," the Commission address these concerns to ensure that the example clearly sets forth the circumstances under which custody would be imputed to an adviser.

14 If custody is not imputed to the adviser, we assume that revised Rule 206(4)-2 would not apply to these arrangements.

15 See Glossary of Terms, Form ADV.

16 We note that, although Form ADV includes a definition of "control," that definition does not appear to apply in the custody context. Instead, that definition applies in the context of determining whether natural persons or companies direct the management or policies of

advisory firms.

17 We note that Rule 902 of Regulations S under the Securities Act of 1933 defines the term “Substantial U.S. market interest” in a quantitative fashion, and we would recommend using that approach to determine whether the primary market for a security is outside of the U.S. for purposes of this rule.

18 Under the proposal, the term “qualified custodian” would not include a fund’s transfer agent. We do not believe it would be appropriate to include transfer agents as qualified custodians for purposes of the rule. See, e.g., Letter from Amy B.R. Lancellotta, Senior Counsel, ICI, to Jonathan G. Katz, Secretary, SEC, dated January 31, 2002, at pp. 8-10.

19 Presumably, advisers would also be required to provide similar notice to their existing clients of any such mutual fund accounts that are in existence upon the effective date of the revised rule.

20 Consistent with our comments regarding the delivery of account statements, we recommend that (1) monthly statements be required only for those accounts in which there was activity during the month and quarterly statements for all other accounts and (2) account statements be permitted to be sent to a client’s designee. See IV.A. and B., infra.

21 These provisions of the proposal require the adviser to have an annual examination of the assets by an independent public accountant and require such accountant to notify the Commission of any material discrepancies found during the examination.

22 See, e.g., NASD Rule 2340, requiring members who carry customer accounts and hold customer funds and securities to send customers quarterly account statements; and Rule 10b-10 under the Exchange Act, permitting broker-dealers to provide to customers quarterly reports of transactions effected periodically, in lieu of sending a confirmation to customers upon completion of each transaction. See also Applicability of CFTC and SEC Customer Protection, Recordkeeping, Reporting, and Bankruptcy Rules and the Securities Investor Protection Act of 1970 to Accounts Holding Security Futures Products, SEC Release No. 34-44854 (Sept. 26, 2001), at note 52 and accompanying text.

23 If the Commission decides not to implement this recommendation for all qualified custodians, we recommend that the rule at least provide broker-dealers that serve as qualified custodians relief from the rule’s monthly delivery requirement to avoid imposing the substantial burdens and costs on these entities that would result from their having to change their systems to accommodate this new monthly requirement.

24 See, e.g., Rule 10b-10(b)(2), which permits a broker-dealer to send quarterly account statements to “some other person designated by the customer for distribution to the customer.”

25 This recommendation is consistent with amendments the Commission proposed to Rule 206(4)-6 in 1994, which were never adopted. These amendments would have prohibited certain advisers from exercising investment discretion with respect to a client account unless they reasonably believed that the custodian of the account was providing account statements to the client “or its designee.” See Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements for Certain Advisory Clients, SEC Release No. IA-1406 (Mar. 16, 1994).

26 We recognize that an auditor could make a finding of a material discrepancy on the

same date as it conducts its examination, in which case the auditor would notify the Commission within one business day of the finding, which would also be within one business day of the examination.

27 For example, an adviser that deducts fees from client assets and is currently not deemed to have custody of client assets in reliance on staff no-action letters may elect, under the revised rule, to discontinue these billing arrangements to avoid having custody of client assets. Such an adviser would need time to advise its clients of, and implement, changes in its billing arrangements.

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