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United States Government Accountability Office  
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January 26, 2010

The Honorable Christopher J. Dodd  
Chairman  
The Honorable Richard C. Shelby  
Ranking Minority Member  
Committee on Banking, Housing, and Urban Affairs  
United States Senate

The Honorable Barney Frank  
Chairman  
The Honorable Spencer Bachus  
Ranking Minority Member  
Committee on Financial Services  
House of Representatives

Subject: *Securities and Exchange Commission: Custody of Funds or Securities of Clients by Investment Advisers*

Pursuant to section 801(a)(2)(A) of title 5, United States Code, this is our report on a major rule promulgated by the Securities and Exchange Commission (Commission), entitled “Custody of Funds or Securities of Clients by Investment Advisers” (RIN: 3235-AK32). We received the rule on January 4, 2010. It was published in the *Federal Register* as a final rule on January 11, 2010. 75 Fed. Reg. 1,456.

The final rule amends the custody and recordkeeping rules under the Investment Advisers Act of 1940 and related forms by providing additional safeguards when a registered adviser has custody of client funds or securities. The rule requires such an adviser, among other things, to undergo an annual surprise examination by an independent public accountant to verify client assets; to have the qualified custodian maintaining client funds and securities send account statements directly to the advisory clients; and unless client assets are maintained by an independent custodian (i.e., a custodian that is not the adviser itself or a related person), to obtain, or receive from a related person, a report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board. The Commission states that the amended custody rule and forms will provide the Commission and the public with better information about the custodial practices of registered investment advisers. The Commission also believes that this

rule, together with its examination program's increased focus on the safekeeping of client assets, will help deter fraudulent conduct, and increase the likelihood that fraudulent conduct will be detected earlier so that client losses will be minimized.

The final rule is effective on March 12, 2010. An investment adviser required to obtain a surprise examination must enter into a written agreement with an independent public accountant that provides that the first examination will take place by December 31, 2010. An investment adviser also required to obtain or receive an internal control report because it or a related person maintains client assets as a qualified custodian must obtain or receive an internal control report within 6 months of the effective date.

Enclosed is our assessment of the Commission's compliance with the procedural steps required by section 801(a)(1)(B)(i) through (iv) of title 5 with respect to the rule. Our review of the procedural steps taken indicates that the Commission complied with the applicable requirements.

If you have any questions about this report or wish to contact GAO officials responsible for the evaluation work relating to the subject matter of the rule, please contact Shirley A. Jones, Assistant General Counsel, at (202) 512-8156.

signed

Robert J. Cramer  
Managing Associate General Counsel

Enclosure

cc: Florence E. Harmon  
Deputy Secretary  
Securities and Exchange Commission

REPORT UNDER 5 U.S.C. § 801(a)(2)(A) ON A MAJOR RULE  
ISSUED BY THE  
SECURITIES AND EXCHANGE COMMISSION  
ENTITLED  
"CUSTODY OF FUNDS OR SECURITIES OF  
CLIENTS BY INVESTMENT ADVISERS"  
(RIN: 3235-AK32)

(i) Cost-benefit analysis

The Commission analyzed the potential costs and benefits of the final rule. Though the Commission states the benefits to investors may be hard to quantify, it believes that the benefits will be substantial, including, generally, increasing investors' confidence when obtaining advisory services from registered investment advisers. In addition, the Commission believes the amendments to the rule could, to a limited extent, promote efficiency and capital formation as a result of such increased investor confidence. In particular, the Commission states that increased investor confidence could lead to more efficient allocation of investor assets, which could result in an increase in the assets under management of investment advisers and, depending on how those assets are invested, a potential increase in the availability of capital. Additionally, the Commission anticipates that investment advisers will find it easier to understand and comply with the rule as a result of the amendments, which may result in cost savings for advisers. The Commission believes the amendments will improve the clarity of the rule by adding several definitions.

The Commission estimates that the aggregate costs for complying with the amendments to the final rule and related forms will be \$126,278,204. Of this amount, the Commission estimates that \$1,195,000 is a one-time computer system programming cost related to account statement legends, while the remainder will be recurred on an annual basis. The recurring costs under the rule are for the surprise examinations, internal control reports, and the burden hours associated with the changes to two related forms.

(ii) Agency actions relevant to the Regulatory Flexibility Act, 5 U.S.C. §§ 603-605, 607, and 609

The Commission estimates that as of November 2, 2009, approximately 73 SEC-registered investment advisers that have custody of client assets were small entities that will be subject to the surprise examination requirement, and that no more than eight small entity advisers that have custody of client assets will be subject to the requirement of obtaining or receiving an internal control report.

(iii) Agency actions relevant to sections 202-205 of the Unfunded Mandates Reform Act of 1995, 2 U.S.C. §§ 1532-1535

As an independent regulatory agency, the Commission is not subject to title II of the Unfunded Mandates Reform Act of 1995.

(iv) Other relevant information or requirements under acts and executive orders

Administrative Procedure Act, 5 U.S.C. §§ 551 et seq.

The final regulations were issued using the notice and comment procedures found at 5 U.S.C. § 553. On May 27, 2009, the Commission published a notice of proposed requirements for custody of funds or securities of clients by investment advisors. 74 Fed. Reg. 25,354. The Commission received more than 1,300 timely comment letters, which are addressed in the final rule. 75 Fed. Reg. 1,457.

Paperwork Reduction Act, 44 U.S.C. §§ 3501-3520

The final rule contains collections of information subject to review by the Office of Management and Budget (OMB) under the Act. The Commission submitted the collection of information requirements to OMB for review under control numbers 3235-0241, 3235-0049, and 3235-0361.

Statutory authorization for the rule

The Commission states the final rule is authorized by the Investment Advisers Act of 1940. 15 U.S.C. § 80b.

Executive Order No. 12,866 (Regulatory Planning and Review)

As an independent regulatory agency, the Commission is not subject to the review requirements of the order.

Executive Order No. 13,132 (Federalism)

As an independent regulatory agency, the Commission is not subject to the review requirements of the order.