COMMENTS: SEC Release No. IA-2876; File No. S7-09-09
Proposed Amendments to the Custody Rule

Ladies and Gentlemen:

This letter is in response to the Commission's request for comments in **SEC Release No. IA-2876** ("The Release") regarding proposed amendments to Rule 206(4)-2, a.k.a. "the custody rule". **In particular, this letter addresses the requirement of a surprise examination by an independent accountant in cases where advisors deduct fees from client accounts or in cases where advisors serve in a capacity such as a general partner of a limited partnership or in some other capacity of another form of pooled investment vehicle**. If I may, I'll address these two issues separately.

<u>Constructive Custody – Advisors that Deduct Advisory Fees From Client Accounts</u>

As part of the impetus for the proposed amendments, the Commission made reference to several recent enforcement actions that have raised the Commission's level of concern about misappropriation of investor assets by investment advisors. Following is a brief synopsis of the enforcement actions cited by the Commission:

Litigation Release No. 21006	Complaint alleges misappropriation of more than $23 million by an investment advisor from **investors buying into a limited partnership** and use of investor funds in the nature of a **Ponzi scheme**
Litigation Release No. 20998	Complaint alleges seven church members defrauded parishioners of more than $12 million by **encouraging investors to invest in two hedge funds** and then misappropriating the funds
Litigation Release No. 20972	Complaint alleges an **investment advisor providing advice to 15 unregistered investment funds** misappropriated funds, failed to keep required books and records and **failed to keep assets with qualified custodians**
Litigation Release No. 20912	Complaint alleges an orchestrated fraudulent investment scheme **involving the use of an unregistered investment partnership** resulting in misappropriation of as much as $554 million
Litigation Release No. 20901	Complaint alleges that an **affiliated** bank, broker-dealer and investment advisor colluded in carrying out an $8 billion **fraud relating to the sale of so-called certificates-of-deposit** to investors by promising improbable and unsustainable high interest rates

While such cases of misappropriation are certainly serious and any efforts to prevent such misappropriation prospectively are to be commended, **I respectfully suggest that the facts of these enforcement cases are simply not comparable to situations in which investors have provided their investment advisors with limited authorizations to deduct investment advisory fees from investors' accounts held with qualified custodians.**

Virtually every case delineated above involved the use of an unregistered investment vehicle such as a hedge fund or limited partnership in which the investment advisor had significant control and authority over the investor assets, thereby resulting in the access and opportunity for misappropriation. It does not appear that a qualified custodian was engaged to hold custody to the investor assets in any of these cases except perhaps the last (Litigation Release No. 20901), in which the defendants (an investment advisor, bank and a broker-dealer) were all affiliated entities and thereby not independent of one another.

Rule 206(4)-2 already affords meaningful protection for investors by requiring the use of a qualified custodian by advisors with constructive custody. Our firm, Kyle Financial Services, is an SEC-registered investment advisor. We are fee-only advisors so we accept no compensation from money managers, mutual funds, insurance companies or otherwise. Our sole source of investment advisory revenue is fees from our clients calculated on the basis of a percentage of assets managed. To prevent issues that might arise with respect to the valuation of non-marketable assets (such as partnerships), we do not charge advisory fees for non-marketable assets. **We solely charge advisory fees based on a percentage of readily marketable assets held with a qualified custodian.** In that context, we utilize Charles Schwab & Co, Inc. ("Schwab"), a firm with whom we maintain complete independence, as qualified custodian. **Our clients sign written agreements expressly providing us with limited authorizations** through Schwab to trade the account, deduct investment advisory fees and make disbursements to such clients or to accounts of identical registration on their behalf. Clients receive monthly statements directly from the qualified custodian which delineate any disbursements, including fees that have been deducted, and we provide clients with quarterly statements that delineate the calculation of quarterly fees. Further, **Schwab, as qualified custodian and in accordance with Schwab's own compliance practices**, **independently performs calculations of the reasonableness of fees based on industry standards** for fees as a percentage of investor assets.

As such, in cases such as ours:

1. Our clients expressly authorize us to deduct fees directly from their accounts which are maintained with an independent qualified custodian

2. Such clients receive statements on a monthly basis directly from the qualified custodian delineating fees deducted and we supplement those statements with quarterly statements delineating the calculation of fees

3. The qualified custodian performs independent testing regarding the reasonableness of the fees based on industry standards.

Given these facts, in cases such as ours in which an independent qualified custodian is employed and advisor authorizations from clients are notably limited, advisor access to client assets is restricted and the opportunity for misappropriation appears to be negligible. Respectfully, I suggest that requiring an annual surprise audit would most likely only serve to increase costs of doing business, thereby increasing the cost of investment advisory services to investors, while providing little, if any, incremental protection against misappropriation.

I respectfully suggest that the key distinction of cases such as ours from the enforcement actions cited above as impetus for amending the custody rule is the fact that **we utilize an <u>independent</u> qualified custodian with whom we have no legal affiliation**. Given the limited authorizations that our clients afford, our actual and constructive access to client assets is appropriately restricted and our opportunity for misappropriation is negligible.

Consistent with a risk-based approach to advisory regulation, I respectfully encourage the Commission to except from the proposed surprise examination requirement advisors that have custody solely as a result of their authority to withdraw advisory fees from client accounts.

If the Commission endeavors to bolster protection against misappropriation that might arise in the context of advisors that deduct fees from client accounts, perhaps it should consider requiring an annual surprise audit only in cases in which the advisor is not using a qualified <u>independent</u> custodian.

<u>Constructive Custody – Advisors that Serve In a Dual Capacity such as a General Partner</u>

The Commission also proposes that advisors that have constructive custody as a result of serving in a dual capacity (such as a general partner of a limited partnership or perhaps as a Trustee of a trust) be subjected to an annual surprise examination by an independent accountant. I respectfully suggest that cases such as these are far more comparable to the enforcement actions cited above as impetus for the proposed amendments to the custody rule in that **advisors that serve is such dual capacities may have far greater access and opportunity for misappropriation.** As such, the Commission's vigilance is welcome with respect to advisors serving in such capacities. However, I respectfully suggest that the requirement of an annual surprise examination would likely accomplish very little to prevent misappropriation in such cases. **Ill-intended advisors (e.g. Madoff) with the access and opportunity to misappropriate client funds are not likely to be dissuaded from misappropriation by the requirement of an annual surprise examination**.

I respectfully suggest that if the Commission intends to bolster investor protection against misappropriation in such cases of dual advisor capacity, it should likely require advisors serving in such capacity to maintain client funds with an <u>independent</u> qualified custodian. Further, in such cases the Commission should likely require some form of regular reporting (e.g. monthly or quarterly account statements) to be sent directly from the independent qualified custodian to some or all of the partners, shareholders or beneficiaries of such vehicle. In this light, the partners, shareholders and/or beneficiaries of such vehicle, having a vested interest in the stewardship of the investment funds, would have a regular opportunity to review disbursement details and other information from account statements provided directly by an independent custodian. To the extent such partners, shareholders or beneficiaries of such vehicle ever conclude that incurring the costs of an audit or other examination would be necessary or worthwhile, they should have discretion to pursue such course. However, requiring an annual surprise examination on the part of the investment advisor or the vehicle in question would likely only increase the costs of doing business while providing little, if any protection against the kind of misappropriation delineated in the enforcement actions above.

Thank you for the opportunity to provide comments in response to the proposed amendments to SEC Rule 206(4)-2. I commend your efforts to protect investors.

Sincerely yours,

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