July 3, 2009

VIA EMAIL

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Comments on Release No. IA-2876; File No. S7-09-09

To the Securities and Exchange Commission:

I appreciate this opportunity to comment on the SEC's proposed amendments relating to Custody of Funds or Securities of Clients by Investment Advisers (the "Proposal") described in the above-referenced release ("Proposing Release"). I offer my comments both from my personal perspective as a long-time investor and user of financial services, as well as from my professional perspective as an investment management attorney with over 20 years of experience assisting registered investment advisers in meeting SEC requirements, including those relating to custody. Please note, however, that the comments I offer are my own and do not necessarily reflect the views of any of my clients.

In general, I applaud the Commission's efforts to beef up safeguards protecting advisory client assets, particularly in light of the Madoff fraud and other recent schemes that have devastated investors and are contributing to a crisis of confidence in our industry. On the whole, however, I believe the Proposal is an over-reaction to recent events. In my view, imposing widespread independent verification (surprise exam) requirements and internal control report (Type II SAS 70) requirements will result in costs and burdens not justified by the protections to be gained in exchange. An explanation of my viewpoint follows, along with some alternatives that I urge the Commission to consider instead.

1) Would the Commission's Proposal have stopped Madoff?

To fully air the pros and cons of the Proposal, we should first consider the '$64 billion question': Would Madoff's Ponzi scheme have been stopped, or caught much sooner, if the Proposal had been in place during the years he perpetrated his fraud?

I believe the answer to that is 'no' for a number of reasons. First, for the vast, vast majority of the time during which his scheme was perpetrated, Madoff's firm was registered as a broker-dealer, not as an investment adviser.[1] As such, the adviser custody rule did not even apply. Indeed, it appears many of the regulatory problems that allowed Madoff to conduct his long-standing fraud were rooted in:

- the broker-dealer rules,[2]
- the interface between the broker-dealer rules and the adviser rules,[3] and/or

[1] One might argue that Madoff's firm should have been registered as an adviser when it was not. But that just highlights the stark reality that nothing in the adviser custody rule is going to protect investors from a fraudster who is willing to flout legal requirements, whether they be registration requirements, custody requirements, reporting requirements, inspection requirements or other requirements.

[2] For example, what is it about the broker-dealer regulatory regime that would allow a broker-dealer routinely sending account statements to clients to essentially hide the accounts from both SEC and FINRA inspection for decades?

[3] Even today, for example, could a broker-dealer running a Madoff-like scheme take the position that it is not an adviser because it is not "advising" clients, but is merely acting as a broker-dealer executing an investment strategy that another adviser devised or adopted for its clients (such as its hedge fund clients), an argument that can be gleaned from some of the Madoff case documents? Certainly nothing in the adviser custody rule would safeguard against that. Indeed, unless

- the regulatory oversight afforded (or not afforded) in that case.[4]

Reforms in those areas are likely to be more fruitful in preventing the next Madoff.

Second, there will always be bad actors simply bent on perpetrating fraud no matter what, by blatantly ignoring the law or by skirting around it through strained interpretations or skillful exploitation of gray areas, often preying on trusting and vulnerable victims. Sadly, no matter what regulatory burdens are imposed on those who operate in an honest and compliant manner, these types of bad actors are all but impossible to prevent entirely.[5]

Of course, the fact that not all wrongdoers will be stopped does not mean you shouldn't strengthen the adviser custody rule. Indeed, I support certain changes to the rule. But since Madoff and other recent fraud cases are among the catalysts cited for the Proposal, we should ask whether the new requirements will indeed avoid a repeat of those cases. In response, I believe we should admit openly – just so there are no false expectations -- that custody rule amendments will not keep <u>every</u> client's assets safe from <u>every</u> wrongdoer in <u>every</u> case. Predictably, we will face more Ponzi schemes and fraud cases in the future, no matter what rule amendments are adopted.

So, if custody rule amendments aren't enough, what should be done to avoid another Madoff? As the Commission is already aware, this will take a "full court press," attacking this problem from many angles in addition to custody, such as ● beefing up inspection and investigation, including gathering more useful information from registered advisers on Form ADV, ● stepping up enforcement, including pursuing "gatekeepers" who fail in their obligations, ● plugging legal and regulatory gaps, particularly between investment advisers and broker-dealers, ● coordinating more effectively among regulators and law enforcement agencies, ● better handling of whistleblower tips and referrals, and ● enhancing investor education, to name just a few. I am pleased to hear the Commission is taking action on many, if not all, of those fronts.[6] Of course, even these measures will not work perfectly in every case, but together they will have a better chance to prevent the next Madoff than any amendments the Commission might make to the adviser custody rule.

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the <u>other</u> adviser in that case (for example, a hedge fund adviser) was itself a registered adviser, the adviser custody rule would, once again, not even apply.

On a related issue, you are already aware of the acute need to resolve issues surrounding the "broker-dealer exemption" from the Advisers Act as to when a broker-dealer can provide "advice" without registering as an adviser. Without doubt, the continued muddled state of the law in that area provides unscrupulous operators with yet another avenue for avoiding regulatory safeguards.

In the same vein, I would urge you to further clarify when a broker-dealer can appropriately ward off FINRA scrutiny of advisory accounts and advisory activities by taking the position that they are not brokerage related and are therefore out of FINRA's reach. While it does not make sense to have FINRA inspecting advisers, FINRA examiners should at least be able to look at advised accounts that are custodied by the broker-dealer and should be able to convey any relevant information they learn about the advisory business to other appropriate regulators (such as the SEC).

[4] By now, it is painfully obvious that avoiding a future Madoff will require better communication and better coordination among FINRA examiners, SEC broker-dealer examiners and SEC adviser examiners, not to mention a significant beefing up of investigation and enforcement stemming from whistleblower tips.

[5] Especially pernicious among these are the "enterprise-wide" frauds where essentially everyone in the firm is involved -- from senior management on down -- either consciously orchestrating the fraud or naively accommodating it. Generally speaking, the collusive aspects of enterprise-wide frauds allow them to be bigger and more expansive than lone-actor frauds and undercut the effectiveness of any safeguards that may be – or may appear to be – in place.

[6] See Speech by SEC Staff: Strengthening Examination Oversight: Changes to Regulatory Examinations, by Lori A. Richards, SEC Director of the Office of Compliance Inspections and Examinations, SIFMA Seminar (June 17, 2009) (Richards Speech) at: http://www.sec.gov/news/speech/2009/spch061709lar.htm.

2) Should the Commission defer making changes to the custody rule -- and resulting changes to Form ADV -- in order to coordinate them with other pending and upcoming changes?

Yes. If "smart regulation" is your goal, then you should approach custody rule changes holistically, hand-in-hand with other important pending changes.

While I support the idea of making certain custody rule amendments, now is not the right time to make them, in my view. Advisers just went through major changes to the custody rule as recently as 2004.[7] Moreover, major changes to Form ADV, Part 2 are still pending.[8] If custody rule amendments are adopted, additional changes to Part 2 may be necessary in order to properly reflect those amendments. In addition, if the Commission pursues any number of other changes under discussion, such as:

- increasing the assets under management (AUM) threshold for advisers permitted to register with the SEC,[9]
- requiring hedge fund advisers to register, and/or
- "harmonizing" the broker-dealer and investment adviser regulatory regimes,

even more changes to Form ADV will likely be required. Additional changes to the custody rule may be warranted as well.[10]

Accordingly, I would strongly urge the Commission to defer any more changes to the custody rule and Form ADV until these other significant pending issues have been fully aired and decided, rather than proceeding in a piecemeal fashion which will result in inefficiency, confusion and unnecessary cost. Instead, the Commission should take a more integrated approach to get it done once and get it done right.

No matter what additional reforms are adopted on custody, I believe Form ADV should be torn up from its roots and entirely revamped, to make it easier for clients to understand, less burdensome for advisers to complete and more useful for the Commission in its efforts to oversee the industry. I first suggested this in my May 2008 comment letter on amendments to Part 2.[11] But unfortunately, another year has now passed and not only are the Part 2 amendments still languishing, but we have experienced in the intervening months the worst economic crisis since the Great Depression, along with a spate of fraud cases -- including the largest Ponzi scheme in U.S. history – further emphasizing both the inadequacy of the current regulatory regime and the inadequacy of the information about advisers made available to regulators via Form ADV.[12]

I recognize there is tremendous pressure for the Commission to make swift and decisive changes aimed at avoiding another Madoff. However, I urge you to consider the interrelated nature of

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[7] Custody of Funds or Securities of Clients by Investment Advisers, SEC Release No. IA-2176 (September 25, 2003) (compliance date April 1, 2004) (the "2003 Custody Release").

[8] Amendments to Form ADV, SEC Release No. IA-2711; 34-57419; File No. S7-10-00 (March 3, 2008).

[9] See Question 14 below.

[10] Any substantial revamping of how advisers and brokers are regulated could warrant yet another rewrite of the custody rule. Moreover, adding hedge fund advisers as mandatory registrants under the Advisers Act may well raise new or exacerbate existing issues under the custody rule, such as whether the more exotic forms of investments they often use constitute "securities" subject to the custody rule. It may also justify new exemptions from the rule. See Question 15 below for more on the definition of "securities."

[11] Posted at http://www.sec.gov/comments/s7-10-00/s71000-93.pdf. In that comment letter, I recommended the Commission move forward with changes to Part 2 as soon as possible, without taking the time to revamp the entire Form, because badly needed amendments to Part 2 had been languishing for so many years. Moreover, it was unclear whether the benefit of revamping the entire Form would be apparent to the Commission. Recent events, however, have made the advantages of revamping the Form even more compelling and obvious.

[12] For OCIE to institute a robust risk-based oversight methodology using enhanced surveillance and data mining techniques (see Richards Speech, footnote 6 above), a complete re-think of Form ADV and adviser reporting should be undertaken with a view to providing regulators with the necessary data.

many of the major proposals under consideration before acting in a piecemeal way on custody and its related elements on Form ADV.

3) Whether or not the Commission decides to defer action, how should it approach safeguarding advisory client assets under the adviser custody rule?

Subject to my other comments, I generally support the Proposal to the extent it:

- requires use of a "qualified custodian";
- requires notice of account set-up to be sent to the client in cases where the adviser sets up an account with the custodian for the client;
- requires account statements to be sent by the qualified custodian to clients directly at least quarterly;[13]
- allows use of independent representatives;
- excepts accounts of registered investment companies (where custody is already governed by the Investment Company Act of 1940);
- allows a transfer agent to hold mutual fund shares instead of a qualified custodian; and
- excepts uncertificated, restricted, privately offered securities and pooled vehicles from certain requirements.

However, I would urge you to completely rework most other aspects of the Proposal,[14] including the key definitions that establish when custody safeguards are triggered, as follows –

FIRST: Define "custody" to mean what most people think it means – having physical possession or control of clients' funds or securities maintained for their benefit. As is currently the case, you should except from the definition:

- Physical possession of checks drawn by clients and made payable to third parties;
- Physical possession of checks drawn by clients and made payable to the adviser for the payment of advisory or similar fees due to the adviser;
- Inadvertent receipt of client funds or securities if returned to the sender promptly (within 3 business days);
- Authority to issue instructions to a broker-dealer, trading venue or custodian to effect or settle trades.[15]

When an adviser has "custody," the adviser would have to comply with the relevant safeguards as specified in the table below.

SECOND: Define "asset access" (or some similar term) as any arrangement under which an adviser has the authority to obtain possession of client funds or securities being held by a qualified custodian. This would include:

- A general power of attorney or other arrangement under which the adviser (or its supervised person) is authorized or permitted to withdraw or direct the transfer of client funds or securities out of a client account maintained with a custodian upon instruction to the custodian. Except from the definition:
    - "Fee deduction authority" (as defined below); and

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[13] Although see Question 8 below about omnibus account arrangements, Question 11below about quarterly account statements and Question 15 about account statements covering securities not held by a qualified custodian.

[14] I would also propose to change the title of Rule 206(4)-2 to "Custody and Safeguarding of Advisory Client Funds and Securities" because I am proposing to cover under the rule cases other than where the adviser has "custody," using my definitions.

[15] I agree that an adviser's routine trading authority (discretionary or non-discretionary) to issue instructions in order to effect or settle trades should not constitute "custody" (nor should it constitute "asset access" under my proposed definitions). In that context, funds or securities can be transferred out of a client's account only upon a corresponding transfer of securities or funds into the account. This type of "delivery versus payment" (DVP) arrangement minimizes the risk that an adviser could withdraw or misappropriate the funds or securities in its client's account using that authority. However, to avoid any confusion about whether this constitutes "custody," "control" or "asset access," I would urge you to explicitly except these arrangements from the definitions or, at a minimum, address it explicitly in the Adopting Release.

- Authority to direct the transfer of client funds or securities between accounts of the same client, pursuant to the client's one-time or standing authorization, verified by whatever procedures the qualified custodian (and client) believe are necessary to ensure the authorization is genuine.[16]
- Any capacity, such as a trustee of a trust, general partner of a limited partnership, managing member of a LLC or comparable position for another type of entity, that gives the adviser (or its supervised person) legal ownership of or access to client funds or securities.

Advisers with "asset access" to client funds or securities would have to comply with the relevant safeguards specified in the table below.

THIRD: Define "fee deduction authority" as the authority to deduct the adviser's advisory fees from a client's account upon presentation of an invoice to the custodian, so long as the adviser complies with the fee deduction safeguards specified in the table below, which would include requiring the adviser to send to the client at the same time as the custodian (or before), the adviser's invoice, accompanied by a notice showing the amount of the adviser's fee, the value of the client's assets on which the fee was based, and the specified manner in which the adviser's fee was calculated.[17] "Fee deduction authority" within this definition should be an exception to the "asset access" definition. Thus, in contrast to the Proposal, my approach would except from any surprise exam requirement advisers that fall within the custody rule solely because they automatically deduct their fees, so long as the fee deduction safeguards are followed.[18]

Using these definitions and subject to my more detailed comments elsewhere in this letter, I would propose a restructuring of the safeguards triggered under the rule in various scenarios, as summarized on the following table:

<table>
<tr><th colspan="2" rowspan="2"></th><th colspan="4">SCENARIOS:
ADVISER OR ITS RELATED PERSON HAS….</th></tr>
<tr><th>"CUSTODY"
(meaning "true" custody)</th><th>"ASSET ACCESS"</th><th>"FEE DEDUCTION AUTHORITY"</th><th>OMNIBUS ACCOUNT ARRANGEMENT[19]</th></tr>
<tr><td rowspan="3">SAFEGUARDS</td><td>QUALIFIED CUSTODIAN</td><td>✓</td><td>✓</td><td>✓</td><td>✓</td></tr>
<tr><td>NOTICE OF ACCOUNT SET-UP</td><td>✓</td><td>✓</td><td>✓</td><td>✓</td></tr>
<tr><td>ACCOUNT STATEMENTS SENT BY QC TO CLIENTS DIRECTLY</td><td>✓</td><td>✓</td><td>✓</td><td></td></tr>
</table>

[16] Unlike some commenters, I would not extend this exception to authorizations permitting the adviser to transfer or disburse funds to third parties, even if only in connection with the payment of invoices received.

[17] See Question 9 below for more detail. See also the SEC guidance referenced in footnote 48 below.

[18] Just to be clear, advisers with fee deduction authority that do NOT follow the "fee deduction authority" safeguards would be deemed to have "asset access" and therefore subject to the safeguards that apply to "asset access."

[19] Omnibus account arrangements are addressed in Question 8 below. If the Commission decides to continue permitting omnibus arrangements, then I would propose imposing the safeguards shown on the table.

	INDEPENDENT VERIFICATION (SURPRISE EXAM)	(See Question 4 below)	✓		✓
	INTERNAL CONTROL REPORT (TYPE II SAS 70)[20]				
	FIDELITY BOND	✓	✓		✓
	NOTICE OF FEE CALCULATION SENT TO CLIENT			✓	
	AGREED UPON PROCEDURES			(See Question 9 below)	

Advisers that do not have "custody," "asset access" or "fee deduction authority" would not be covered by the rule.

Various aspects of this approach are discussed in more detail in other Questions below.

4) *What safeguards should apply when an adviser or its related person has "custody," meaning it acts as the "qualified custodian" of an adviser's clients' assets?*

First, I believe an internal control report (Type II SAS 70) should be unnecessary in this scenario because it is redundant of the multiple safeguards already in place at a "qualified custodian."[21] For example, SEC-registered broker-dealers (BDs) acting as qualified custodians are subject to extensive regulations[22] requiring them, among other things, to:

- promptly obtain and thereafter maintain physical possession or control of securities carried by the BD for the account of customers, under extensive regulations governing securities in transit and securities held at the BD as well as at other locations, such as banks or depositories in the name of the BD;
- determine daily which fully-paid securities are in the BD's possession or control and which are not, using detailed written procedures that are subject to regulatory inspection;
- physically examine and count all securities held and perform certain related verifications at least once in each calendar quarter;
- compare the results of the count with the BD's own records;
- record on the BD's books all unresolved differences and, within 45 days, buy-in all short security differences which are not resolved during the 45-day period;
- conduct the count by someone whose regular duties do not include direct responsibility for the proper care and protection of the securities (i.e., a separation of duties);

[20] See my comments under Question 13 below about reports under SOP 07-2 in lieu of reports under SAS 70.

[21] Not only would a Type II SAS 70 be redundant, it would be prohibitively costly for most advisers. Even if the $250,000 cost estimated in the Proposing Release is overstated by a factor of 10, a Type II SAS 70 will still be too costly for most small or medium-sized advisers to afford, particularly if it is required on top of a surprise exam with an estimated cost of $8,100. Indeed, I suspect most qualified custodians that can afford a SAS 70 are probably already getting one.

[22] These requirements stem principally from Rules 17a-5, 17a-13, 15c3-1 and 15c3-3 under the Securities Exchange Act of 1934 (Exchange Act or 1934 Act). BDs not subject to these rules or equivalent substitutes should not be "qualified custodians," in my view.

- maintain strict minimum net capital requirements specified by rule, based on the BD's activities and the risks they pose;
- maintain special reserve bank deposits for the exclusive benefit of customers, in minimum amounts computed under detailed regulations at the end of each week and deposited not later than the second following business day;
- obtain from the bank holding the deposits notification that it has been informed the deposits are for the exclusive benefit of the BD's customers and that it will take certain specified steps aimed at keeping the deposits free and clear for that purpose;
- immediately notify the SEC (and the BD's SRO, such as FINRA) if the BD fails to make a required reserve deposit;
- pay premiums toward and be covered by required SIPC insurance;
- obtain, and review annually for adequacy, a blanket fidelity bond in minimum required coverage amounts covering officers and employees and protecting against misplacement, forgery and alteration (including check forgery), securities loss (including securities forgery) and fraudulent trading, among other things;
- appoint a chief compliance officer and establish and maintain an internal compliance program, reviewed and certified annually by the firm's CEO;
- be subject to periodic inspection by the SEC and the BD's SROs (such as FINRA).

In addition to all these safeguards, BDs must have their financial statements audited at least annually by an independent public accountant in accordance with GAAS, which includes a review of the internal controls and procedures used for safeguarding securities (including appropriate tests) sufficient to provide reasonable assurance that any material discrepancies would be disclosed and, as a specific objective, includes a review of the procedures used to make quarterly securities examinations, counts, verifications and comparisons as required.[23]

I gather national banks, Federal Reserve member banks and other "qualified custodians" are subject to similar internal and external safeguards with respect to their custodial assets.[24] As such, it would appear that any "internal control report" prepared to satisfy the adviser custody rule would be largely – if not completely – redundant of safeguards already in place.[25]

Moreover, if these inherent safeguards are considered adequate to protect the assets held by these custodians in non-advisory accounts, then they should be adequate to protect assets in advisory accounts as well. On the flipside, if the safeguards are inadequate to protect custodied advisory accounts, then the Commission should consider what additional safeguards should be required, in particular for BDs with custody of their customers' assets in other types of accounts. In other words, if assets in advised accounts maintained by a BD need an annual surprise exam verifying every security in every account – on top of the counts, verifications, audits, testing and reviews already required under the BD rules – then I would assert that customer assets maintained by the BD in brokerage accounts and other types of accounts should need a surprise exam too.[26]

I would also reiterate that, under my proposed definitions, the only time an adviser would have "custody" is when the adviser itself, or a related person, is acting as the "actual" or "true" custodian. As such, they would have to be a "qualified custodian" under the rule, subject to the

[23] See Exchange Act Rule 17a-5(g).

[24] See, for example, Custody Services, Comptroller's Handbook of the Comptroller of the Currency, Administrator of National Banks (January 2002); and "Fiduciary Activities," Section 4200.1 in the Commercial Bank Examination Manual of the Federal Reserve Board (effective date November 2003). See also sources cited in footnote 4 in the Proposing Release. Again, if comparable safeguards are not in place, they should not be "qualified custodians," in my view.

[25] Assuming that the advisory accounts maintained by these institutions are indeed covered by those safeguards, which I assume they are.

[26] Although the SEC may not have jurisdiction to govern non-advisory accounts held at other qualified custodians, such as banks, FCMs, and the like, the same assertion could be made about those.

safeguards inherent in using a qualified custodian. And while I agree that self-custody and related person custody pose risks that are not posed with an independent custodian, I do not believe those risks are any different for advisory assets than for the brokerage, banking and other assets custodied by the adviser or its related persons. As such, I am not aware of a rationale for treating advisory accounts differently in this regard. Accordingly, if an adviser falls under the custody rule solely because it or a related person acts as the qualified custodian of the adviser's clients' assets – meaning the adviser does not have any other authority over or access to the client assets in the accounts -- I believe the safeguards already inherent in the qualified custodial relationship should be sufficient protection, without an independent verification (surprise exam) or internal control report.

If nonetheless, the Commission concludes additional safeguards are necessary when an adviser or its related person acts as "qualified custodian," I believe an independent verification (surprise exam) would be more appropriate than an internal control report (Type II SAS 70). At least a surprise exam would be aimed at verifying the existence of funds and securities, which seems more directly suited to safeguarding against misappropriation, and would cover more funds and securities than would likely be verified in connection with a routine audit of the custodian's financial statements.

5) Should all advisers with "custody" be required to use an "independent" custodian?

No. Requiring all advisory assets to be held by an independent custodian would place those assets under a regulatory regime that is inconsistent with – and inexplicably more onerous than – the regulatory regime governing the customer assets of all other financial service providers, including for example broker-dealers, that are not required to maintain their customers' brokerage assets with an independent custodian, and banks, that are also not required to hold their customers' depository, trust or custodial assets with an independent custodian. As previously mentioned, I am not aware of any justification for treating advisory accounts differently, so long as the custodian used to custody the adviser's clients' assets (whether that be the adviser itself, a related person or an independent custodian) is indeed a "qualified custodian" and therefore already subject to adequate safeguards.

In addition, requiring an independent custodian would hinder financial institutions from providing certain advisory services to clients in a complementary or integrated fashion, such as wrap programs sponsored by an adviser (a dual-registered BD/IA or IA along with its BD affiliate) in a program bundling portfolio management with execution, where assets are custodied by the BD executing the trades. Similarly, it is not uncommon for BDs (dual-registered BD/IAs or BDs with advisory affiliates) to first develop a brokerage relationship with clients that evolves into an advisory relationship with respect to accounts that they themselves custody. Banks too may begin with trust or depository relationships with clients that evolve into an advisory relationship. At the point where the relationship becomes advisory, why should the accounts suddenly have to be moved to an independent custodian?[27]

I could not disagree more with the assertion made by some commenters that merely requiring advisers to use an independent custodian would be a simple solution to prevent all the problems we've seen with Madoff and other recent frauds. On the contrary, perpetrators can -- and do -- misappropriate client assets even when an independent custodian is involved.[28] Moreover, it is

[27] I would point out here that nothing in the custody rule hinges on whether the adviser is exercising "discretionary" authority over assets in the client's account. Rather, "custody" hinges on possession, control and access to client assets quite aside from investment discretion to trade inside an account.

[28] Two cases brought by the SEC in just the last month illustrate this point: First, a New York-based adviser allegedly misappropriated millions of dollars from client advisory accounts custodied at a registered broker-dealer, even though the custodian was independent of the adviser and was sending account statements directly to clients. See SEC v. Matthew D. Weitzman, U.S. Dist. Court (SDNY), Case No. 09-CIV-5353 (filed June 10, 2009). Second, a Nebraska-based adviser allegedly misappropriated client assets held at various independent custodians by using fraudulent, excessive or unauthorized advisory fee deductions. See Jindra, footnote 51 below.

overly simplistic to assume that having a rule on the books requiring advisers to have an "independent" anything is going to stop fraudsters like Madoff who are willing to go to extremes.[29] In my view, the negative impact an independent custodian requirement would have on the hundreds, if not thousands, of legitimate, law-abiding, reputable financial institutions providing clients both advisory and custodial services is simply not justified by the protection added.

6) Should custody by an adviser's related person be imputed to the adviser itself?

Although I fundamentally disagree with the Proposal as to which safeguards should be triggered in which of the various "custody" scenarios, I generally support the concept that whatever safeguards are triggered when an adviser has "custody" should also be triggered when the adviser's related person has "custody," [30] given that a related person may well raise the same risks vis-à-vis the adviser's clients' assets. Moreover, I believe addressing related person custody directly in the rule is far better than assuming advisers are even aware of the now 30-year-old *Crocker* no-action letter[31] and other guidance that outlines when an adviser might be deemed to have custody as a result of a related person's access.

That said, I urge you to address related persons in the rule without "imputing" their custody to the adviser as contemplated by the Proposal.[32] Imputing custody in that way causes unnecessary confusion and raises unnecessary issues. For example, if an adviser's related person has "custody" because it acts as the qualified custodian for the adviser's clients' assets, does the adviser answer "yes" to Item 9.A.(1) of Part 1 on Form ADV -- which asks whether the adviser has "custody" -- because the related person's custody is "imputed" to the adviser? This is the same problem that is currently caused under the rule when an adviser is deemed to have "custody" when it really doesn't (within the common meaning of that word), such as when fee deduction authority is defined to be custody. As you know, this causes unnecessary problems answering Form ADV, endless adviser and client confusion, potential conflicts with contracts that prohibit an adviser from having "custody," bonding and insurance problems, and other issues.

Instead, I urge you to consider whether the same regulatory goal can be achieved if the "related person" reference is deleted from subsection (c)(2) of the rule and simply added to subsection (a), as follows:

> "(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 or your related person to have custody of client funds or securities in connection with advisory services you provide to clients unless:…"[33]

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[29] Other cases demonstrate that fraudsters willing to phony up investment returns seem just as willing to phony up account statements from an independent custodian. See, for example, SEC v. PrivateFX Global One Ltd., S.A., et al. (USDC S.Dt. TX, Houston Div.), Civ. Action No. 09-1541 (filed May 21, 2009) (defendants allegedly produced phony bank statements showing positions held at Deutsche Bank when they did not even have an account at Deutsche Bank). In a similar vein, defendants in the Bayou hedge fund fraud allegedly fabricated "independent" audit reports from a completely fictitious accounting firm. SEC v. Bayou Management, LLC, et al. (USDC SDNY), Civ. Action No. 05-CIV-8376 (filed September 29, 2005).

[30] That is, so long as the "custody" (or "asset access") is of client funds or securities "in connection with advisory services provided by the adviser to clients," for the reasons state in the Proposing Release. Also, see my comments under Question 15 below about the definition of "related person."

[31] See Crocker Investment Management Corp., SEC Staff No-Action Letter (Apr. 14, 1978).

[32] See proposed subsection (c)(2) of the amended rule: "You have custody if a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services you provide to clients."

[33] In fact, I believe this wording is better for another reason, because it ties the "in connection with" limitation to the adviser's own custody, as well as to any related person's custody. That way, for example, if a dual-registered BD/IA custodies a client's brokerage assets, but an independent custodian custodies the client's advisory assets, it would not be subject to the rule merely because it custodies the client's brokerage assets. Also, I would suggest substituting the phrase

Although I favor covering related persons under the rule for the reasons stated, there are undoubtedly cases where an adviser and its related person are not truly "related" or are sufficiently separate that additional custody safeguards should be unnecessary. In those cases, advisers should be allowed to rebut the presumptions built into the "related person" and "control" definitions in the rule so that entities otherwise presumed to be "related" can be treated as independent under the rule.[34] I also favor allowing "related persons" to be treated as independent under the rule if, based on the factors outlined in *Crocker*, the adviser can demonstrate that the related person's custodial operations are sufficiently separate from the adviser that additional safeguards are unnecessary.[35]

Advisers rebutting a control presumption or using the *Crocker* factors to treat a "related person" as independent under the rule should be required to prepare a written file memorandum spelling out their rationale and should be required to retain that memorandum in the adviser's books and records subject to SEC Staff inspection.[36]

7) What safeguards should be imposed when an adviser has "asset access"?

As noted in the table in Question 3 above, I believe a surprise exam should be required if the adviser has authority to withdraw, transfer or disburse funds or securities out of a client account, meaning it has "asset access" under my definitions. This safeguard should be imposed whether the qualified custodian is independent, a related person or the adviser itself. In my view, a surprise exam is warranted in this case because the adviser is being given extraordinary authority to access and direct the disposition of assets <u>out of the account</u>, beyond that authorized even in cases of:

- mere custody (i.e., "actual" or "true" custody where the adviser or related person holds and maintains assets for the client's benefit, which under the rule is subject to the safeguards inherent when using a "qualified custodian"); or
- routine discretionary investment authority (i.e., permitting trading in the account simply on a "delivery versus payment" or DVP basis, which under the custody rule is not "custody" or "asset access").

I believe the extraordinary authority granted when an adviser has "asset access" poses a sufficiently great risk of misappropriation to justify the cost of an annual surprise exam. Even the safeguards inherent in using a "qualified custodian" – indeed, even an independent custodian -- would not necessarily protect against misappropriation when the adviser has the legal authority, for example, to disburse funds out of an account, to transfer funds or securities into and out of accounts, or to open and close accounts and move assets elsewhere, all in its discretion and without the client's involvement.

In my view, the annual surprise exam should include verifying that the funds and securities clients believe are in their accounts – and are reflected on their account statements – indeed exist and are being held by the custodian. To be an effective safeguard in this scenario, however, the

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"with respect to which you provide advisory services" for the "in connection with" phrase, since it seems even more precise.

[34] Expressly providing for rebuttal in the rule would help to clarify that the control presumptions found in the rule -- as well as the control presumptions found on Schedules A and B to Form ADV, Part 1 -- are indeed rebuttable, and spell out the appropriate procedure for advisers wishing to rebut the presumption.

[35] For the reasons I already outlined, I would urge you to allow advisers to make this argument on the basis of the *Crocker* factors <u>without</u> building into the rule a "presumption" that a related person's custody is the adviser's custody and therefore <u>without</u> effectively "imputing" the related person's custody to the adviser.

[36] This would be similar to the approach advisers can use to rebut a presumption of materiality when disclosing disciplinary events under proposed Item 9 of Form ADV, Part 2A. See Amendments to Form ADV, SEC Release Nos. IA-2711; 34-57419 (Mar. 3, 2008).

surprise exam should also include a review, at least on a sampling basis, of withdrawals, disbursements and transfers made from the account and the documentation supporting those transactions, along with a reconciliation of cash balances.[37]

Arrangements falling into this category might include:

- advisers that provide bill paying services to their clients or hold the client's "checkbook";
- advisers that are authorized to open and close accounts for their clients, if that includes authority to withdraw, transfer or move the assets out of the account;
- advisers that are authorized to disburse assets out of client accounts to specified third parties;
- advisers (or their supervised persons) who have general powers of attorney over client accounts;
- advisers (or their supervised persons) that act as trustee of client trust accounts; and
- advisers (or their supervised persons) that act as general partner of a limited partnership client, managing member of a LLC client or comparable position for another type of entity client.

Consistent with my proposed definition of "asset access," I would not impose a surprise exam requirement solely because the adviser is authorized to transfer client assets <u>between</u> accounts of the same client, or solely because the adviser has fee deduction authority so long as the adviser adheres to the fee deduction authority safeguards I explained in Question 3.

Moreover, I would <u>not</u> propose to subject accounts over which an adviser has "asset access" to the requirement for an internal control report, in contrast to the Proposal, even when the qualified custodian is the adviser itself or a related person. The protections afforded by a surprise exam of the sort I described, coupled with the safeguards inherent in using a qualified custodian, I believe should be sufficient to safeguard assets in that context. As such, the cost of an internal control report is not warranted, in my view, in the case of "asset access."

8) How should the custody rule treat omnibus accounts set up with the custodian in the name of the adviser (as agent or trustee) and holding assets of more than one client?

Omnibus accounts of this sort raise issues that I do not believe were adequately considered in the Proposing Release. For the reasons explained below, I believe the Commission ought to either:

- Prohibit omnibus arrangements of this sort altogether; or
- Allow them, but then also allow the adviser to send the account statements to clients and impose a surprise exam requirement.

In the omnibus account scenario referenced here, the adviser sets up an account with the custodian in the name of the adviser, for the benefit of (or as agent or trustee for) the adviser's clients.[38] Assets of more than one client are held in the account in an aggregate or "omnibus" fashion, instead of in separate accounts set up in the name of each individual client holding only that client's assets. This type of account set-up and registration is specifically permitted under <u>current</u> and <u>proposed</u> Rule 206(4)-2(a)(1)(ii).[39] Advisers may use omnibus account arrangements

[37] If these measures are not already required in a surprise exam conducted under Accounting Series Release No. 103, then I would urge the Commission to amend it to include them.

[38] This may be done for some or all of the adviser's separate account clients or other clients whose assets may be held in an omnibus or aggregated arrangement. This is different from setting up an account for a pooled vehicle client even though accounts for pooled vehicles may have similar 'aggregated' characteristics. This is also different from DVP-type accounts advisers may set up in their own name at a broker-dealer to facilitate trading on behalf of their clients until transactions can be settled to their clients' individual accounts at the client's custodian broker-dealer or bank.

[39] For an SEC enforcement action involving this type of omnibus account, see <u>In the Matter of Vigil Asset Management Group, Inc. and Thomas Batterman</u>, Advisers Act Release No. 1621 (March 17, 1997).

of this type to protect the identity of their clients from the custodian (for privacy or competitive reasons) or for other reasons.

In an omnibus account, the custodian does not perform the client-level accounting for the account. Rather, it maintains the account only at the omnibus level, on an aggregated basis, processing all transactions into and out of the account without regard to each individual client's proportionate interest. The custodian may not even know who the clients are, how many there are, or in what proportions they share in the holdings in the account or in the transactions processed for the account. Instead, that client-level accounting is performed by the adviser or by someone under the adviser's direction.

In light of this, account statements in this scenario are not sent to clients by the custodian. Rather, statements are generated and mailed to clients by the adviser, because the adviser is the only one with access to the client-level data necessary to generate a personalized statement.[40]

The Proposing Release addresses some of the issues surrounding omnibus accounts under the proposed amendments, but, in my view, only in an incomplete way. Proposed Rule 206(4)-2(a)(1)(ii) would still permit accounts to be set up in an omnibus arrangement, but subsection (a)(3) of the rule would require account statements to be sent to clients directly by the custodian, eliminating the alternative of having account statements sent by advisers. The Proposing Release acknowledges that this will require the adviser to provide the custodian with information it would not otherwise have – client names and addresses – but asserts that client privacy should be adequately protected by privacy laws now in effect.

However, that overlooks the fact that the custodian would need to get from the adviser not only client names and addresses, but also all the client-level data necessary to generate a personalized statement. That data is not kept by the custodian, but by the adviser. So, unless the custodian was the adviser, or perhaps a related person,[41] it would not even have access to that data on its systems.

In my view, it would be an exceedingly bad idea to have the adviser provide all the client-level data to the custodian along with client names and addresses, just so the custodian can generate and mail a statement to satisfy proposed Rule 206(4)-2(a)(3).That would provide little safeguard against the information on the statements from being fraudulent or erroneous, which undercuts the whole point behind having account statements sent to clients by the custodian directly. Worse yet, it could be read as putting the custodian's "stamp of approval" on the statement information, when the information was actually produced by the adviser.

As such, I believe you should either:

- Prohibit advisers from setting up omnibus accounts in this way;[42] or
- Allow omnibus accounts, but in that case, permit the adviser to send the account statement to clients. If omnibus accounts of this nature are going to be allowed, this is the only approach that makes sense to me, if I am correct in understanding that the adviser is the only one with the client-level data on its systems to support the information appearing on account statements.

[40] Given that account statements are being sent by the adviser, not the qualified custodian, I gather that these accounts would be subject to a surprise exam requirement under t he current custody rule because the omnibus account arrangement would be construed to constitute "custody." See Section X in Letter From the Office of Compliance Inspections and Examinations: To Registered Investment Advisers, on Areas Reviewed and Violations Found During Inspections (May 1, 2000) at http://www.sec.gov/divisions/ocie/advltr.htm (an adviser has "custody" if it maintains an omnibus-type account in its own name at a broker or bank in which client securities are maintained after trades settle).

[41] In which case there would presumably be no need to use an omnibus account arrangement to protect the identity of clients from the custodian.

[42] Which would require striking subsection (a)(1)(ii) from the amended rule.

If omnibus accounts are allowed, then appropriate safeguards should be imposed. Since an adviser's authority in maintaining an omnibus account poses risks similar to those in other "asset access" scenarios, I would treat the arrangement as constituting "asset access" under my definitions. As such, I believe a surprise exam requirement should be imposed. That would require a "physical count" of funds and securities in the account to be reconciled to the books and records of the custodian and help to ensure that the assets shown on client account statements – at least in the aggregate -- actually exist and are in fact being held by the custodian. However, in order to be effective, the surprise exam should also be required to trace "upstream" to cover the individualized account data on the adviser's books and records and safeguard against fraud or error at the client-account level.[43] If a surprise exam under current Accounting Series Release No. 103 (ASR 103)[44] does not provide for that, I would urge you to amend it so that it does.[45]

9) *Should an adviser's authority to deduct its fees from an advisory account constitute "custody" under the custody rule?*

No (nor should it constitute "asset access" under my proposed approach). Although automatic fee deduction poses dangers that should be addressed in the custody rule (as explained below), it is counterintuitive and unnecessarily confusing to classify this arrangement as "custody." Even more confusing is your current approach of classifying automatic fee deduction as "custody" under the custody rule, and then instructing advisers to answer "No" to the question "Do you have custody?" in Item 9 of Form ADV Part 1 if the only reason an adviser would otherwise answer "Yes" is because it automatically deducts its fees.[46]

In my view, fee deduction authority should neither be "custody" (under the Commission's definitions) or "asset access" (under my definitions) because, although the practice does pose risks, the risks posed are different than those posed by other scenarios recognized under the rule as "custody" and should be safeguarded in different ways. Automatic fee deduction poses the risk that the adviser will deduct too much from the client's account by intentionally or unintentionally miscalculating its fee or tendering phony invoices…and that no one will catch the problem. Yet, a surprise exam as called for under the Proposal won't catch the problem either, if the exam merely verifies the existence of assets in the client's account.[47] Indeed, even if the surprise exam reconciles cash transfers out of the account to invoices received, an excessive fee deduction would still not be caught if the problem stems from the fact that the amount shown on the adviser's invoice is calculated incorrectly or otherwise does not reflect an amount actually owed.

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[43] For example, a surprise exam should safeguard against the adviser attributing a $10,000 dividend payment on stock held for Client X to a different client in the omnibus arrangement, for example to a client account in which the adviser has an interest. The custodian couldn't necessarily safeguard against this because all it would know is that a $10,000 dividend was paid on stock held in the omnibus account. Client X couldn't necessarily safeguard against this because it might not even know about the dividend so would not know to look for it on an account statement. Thus the surprise exam should be required to independently verify that the $10,000 was received and that it is indeed being held by the custodian in the omnibus account. In addition, it should trace the $10,000 dividend "upstream" to the account of Client X on the books and records of the adviser. Otherwise, it would be inadequate to safeguard against the adviser's potential misappropriation at the client-account level.

[44] See Nature of Examination Required to be Made of All Funds and Securities Held in Custody of Investment Advisers and Related Accountant's Certificate, Investment Advisers Act Release No. 201 and Accounting Series Release No. 103 (May 26, 1966) [31 FR 7821 (Jun. 2, 1966)]; appearing as Section 404.01.b. of the Commission's Codification of Financial Reporting Policies (CCH Federal Securities Laws Regulations and Forms ¶38,221) (ASR 103).

[45] I believe amending ASR 103 as necessary to safeguard in this way is preferable to other safeguards in this context, such as requiring an "Internal control report," not only because a surprise exam is less costly but because it provides a more direct protection against misappropriation than merely assessing controls.

[46] I realize this approach was taken back in 2003 so advisers who had been deducting fees for years would not suddenly have to start reporting on Form ADV that they have "custody," just because fee deduction authority was brought into the "custody" definition and the Commission ended the ability of advisers deducting fees to rely on prior no-action letters to avoid custody. However, in my mind, this just emphasizes how confusing it is to treat fee deduction authority as "custody."

[47] In other words, an accountant could verify that the assets shown on the client's statements are indeed in the account, but the adviser could have still deducted too much for its fee.

As such, the appropriate safeguard to catch a fraudulent or inaccurate advisory fee deduction is the approach allowed under SEC guidance prior to the 2003 Custody Release.[48] Advisers that deduct fees automatically should be required to provide the client and the custodian, along with the invoice, a written explanation of how the fee was calculated, showing sufficient detail so that the custodian and/or the client can double-check the accuracy of the calculation.[49]

Clients that do not want to bother double-checking the fee calculation themselves can rely on someone independent -- an independent custodian, independent accountant or another independent representative -- to do it for them. In addition, percentage limits (say, 2% or 3% per year) can be set up in advance as to the amount that the custodian will permit to be deducted from the account by automatic invoicing, providing another safeguard against the deduction of excessive amounts. I gather safeguards like these are already in use by many advisers and custodians. At least by receiving notice of the adviser's fee calculation, everyone with a stake in the matter will have an opportunity to double-check its accuracy and take timely corrective action when warranted.[50]

I would embrace more stringent safeguards for automatic fee deductions if there were any indication that fee deductions have been used by advisers for widespread fraud or abuse. I am not aware of that,[51] nor did the Commission include any indication of that in the Proposing Release. As such, imposing a surprise exam requirement solely for automatic fee deduction seems not only like regulatory overkill, it seems like a measure unsuited to actually safeguard against the risk posed.

If, nonetheless, the Commission concludes that advisers with fee deduction authority should bear the cost of an independent check against fraudulent or erroneous invoices, then instead of a surprise exam, I would suggest that the rule require an independent accountant to perform annually some type of agreed-upon procedure, tailored to the risk posed. For example, the accountant could verify that:

- the formula used to calculate the fee agrees to the fee provisions appearing in the advisory agreement,
- the fee calculation for each covered period was done accurately (e.g., applied the correct percentage rate against the correct base amount), and
- the fees actually deducted from the account agreed to the fee as so calculated.

While I believe this procedure should be unnecessary, it would be far less onerous than a surprise exam and, more importantly, would actually safeguard against the risk posed.

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[48] See Investment Counsel Association of America, Inc., SEC Staff Letter (June 9, 1982); John B. Kennedy, SEC Staff Letter (June 5, 1996); Securities America Advisors Inc., SEC Staff Letter (April 4, 1997). See also Staff Interpretations of Certain Investment Adviser Disclosure and Reporting Requirements, Advisers Act Release 1000 (December 3, 1985). This guidance supported the position that advisers would not be deemed to have custody due to automatic fee deduction authority if certain safeguards were in place, for example, if (1) the client authorized the arrangement in advance, (2) the account's custodian notified the client at least quarterly of all amounts disbursed from the account and (3) the adviser notified the client of the manner in which the fee was calculated.

[49] I would urge you to codify the exact safeguards in the custody rule itself, rather than make advisers track down and interpret a series of old no-action letters and releases.

[50] Indeed, this approach allows a double-check to occur every time the adviser's fee is deducted, not just once a year at an annual surprise exam, even assuming a surprise exam would catch this type of problem.

[51] I am aware of the recent case filed by the SEC against an adviser who allegedly misappropriated client assets through automatic fee deduction. See SEC v. Ryan M. Jindra and Envision Investment Advisors, LLC, et al., USDC-NE (Case No. 8:09-CV-00216-JFB-TDT) (filed June 30, 2009) (Jindra). While this case suggests that safeguards are warranted with fee deductions, it is not evidence of widespread abuse warranting widespread surprise exams. Moreover, it appears from the Complaint in that case that the safeguards the independent custodians had in place may have been sufficient to detect and stop the fraudulent charges. Indeed, a surprise exam at the end of the year may not have added any safeguard at all.

In short, I believe fee deduction authority should not be deemed "custody" (or "asset access" in my definitions) but rather should be safeguarded by requiring the adviser to send notice of the fee calculation to clients and custodians along with the invoice. That way:

- Clients and advisers can still choose to use the convenience of automatic fee deductions, but clients will be adequately protected from the risks posed.
- In fact, clients would be better protected from the risks posed than they would be by a surprise exam as called for under the Proposal.
- Fee withdrawal authority would not be classified as "custody" for any purpose, avoiding the resulting confusion.
- The Commission can avoid the "No but really Yes" approach to Item 9 on Form ADV for advisers that have "custody" only because of fee deduction authority.
- Conflicts with common provisions in advisory agreements prohibiting the adviser from having "custody" (or stating that the adviser will not have "custody") will be avoided for advisers that only have fee deduction authority and no other type of "custody."
- Potential conflicts, problems, issues and other consequences under contracts, rules, statutes, interpretations, no-action letters, insurance policies, and so on, addressing "custody" will be avoided as well for advisers with only fee deduction authority.

10) Should an adviser's authority to direct transfer of funds or securities <u>between</u> client accounts constitute "custody" under the custody rule?

No (nor should it constitute "asset access" in my proposed approach). This is an arrangement often undertaken at the direction -- and for the convenience -- of the client and with sufficient safeguards that it should not be treated as "custody" (or "asset access"). First, the adviser cannot divert client assets to itself in this manner, either directly or by transferring amounts to a fraudulent third party. Rather, transfers can only be made between the client's own accounts. Second, the client can provide written authorizations for these transfers (on a standing or one-time basis) to verify that the transfers are indeed authorized, using whatever procedures a qualified custodian would typically use to ensure that authorizations are genuine. Third, the transfers would be reported on account statements sent by the qualified custodian directly to the client, so that clients would have notice of the transfers no later than receipt of their next account statement (which I propose be no later than the end of the month in which the transaction occurs).

As such, the risk posed by this arrangement does not warrant being subjected to a surprise exam or internal control report requirement.

11) Should account statements be sent to clients quarterly, or more frequently?

Account statements should be required to be sent not less frequently than quarterly, <u>plus</u> after the end of every month during which there is a transaction in the account (or at least in which there is a deduction from or transfer of assets out of the account). That way, clients will have the opportunity to double-check any transactions that occur in their accounts -- including any automatic advisory fee deductions -- after the end of the month in which they occur, even if they occur during a month other than quarter end.

12) Should investment advisers be required to obtain fidelity bonds?

Yes. I believe fidelity bonding is an additional safeguard that the Commission should require in certain cases under the adviser custody rule.

The Commission last considered whether advisers should be required to obtain fidelity bonds in 2003,[52] pointing out that investment advisers are among the only financial service providers

[52] See Compliance Programs of Investment Companies and Investment Advisers, Release Nos. IC-25925, IA-2107 (Feb. 5, 2003) at http://www.sec.gov/rules/proposed/ic-25925.htm#fidelity.

handling client assets that are not required to obtain fidelity bonds.[53] Of course, many advisers already obtain fidelity bonds to satisfy other legal requirements, such as the broker-dealer rules (for dual-registered BD/IAs). Other advisers obtain bonds simply as a matter of business practice, such as advisers to registered investment companies that are often covered jointly by the fidelity bond covering their funds. Many states also require state-registered advisers to be bonded,[54] which suggests that the cost of bonding should not be prohibitive even for smaller advisers.

Although the Commission declined to require bonding in 2003, I believe every adviser with "custody" of, or "asset access" to, client funds and securities (using my definitions of those terms, as explained above in this letter) should be required to be bonded as an additional safeguard against loss. Coverage ought to be required from a reputable insurance company and, at a minimum, ought to protect against losses from larceny, fraud or embezzlement by advisers or their personnel. Required amounts of coverage can follow the model adopted for bonding under the Investment Company Act of 1940 or state Blue Sky bonding requirements based on the amount of client funds and securities over which the adviser has "custody" or "asset access."

Excepted from the adviser bonding requirement should be any adviser that is already bonded consistent with other applicable legal requirements, so long as the bond obtained to meet those other requirements names the adviser as the assured and covers its advisory business, advisory personnel and advisory client assets over which it has "custody" or "assets access." This would avoid the need for double bonding and I believe substantially cut back on the number of advisers for which this would impose a new requirement.

I envision this bonding requirement would cover, for example, advisers (or their supervised persons) that act as trustees or general partners of client accounts and advisers that provide bill paying services to their clients and can therefore authorize withdrawals, disbursements or transfers from the client's account.[55] This would also cover advisers acting as qualified custodians for their clients' assets, but for the exception I propose for advisers with alternative bonding, since qualified custodians would likely already be bonded in order to meet bank, broker-dealer or other "qualified custodian" requirements.

The following points are important to emphasize regarding bonding:

- I am <u>not</u> suggesting fidelity bonding will be a panacea to recover lost client assets in a large-scale Ponzi scheme or enterprise-wide fraud like the Madoff debacle.[56] Even the maximum coverage available under any fidelity bond is unlikely to cover a fraction of the assets lost in Madoff.[57] However, I believe fidelity bonding <u>could</u> be helpful to cover losses in the more common occurrence of wrongdoing by rogue advisory personnel or incidental wrongdoing within an advisory organization.

[53] <u>Id</u>. at Section II.4. and footnote 74.

[54] <u>Id</u>.

[55] Consistent with my position in Question 3 above, I recommend excepting out of the "asset access" definition (and therefore the bonding requirement) advisers with authority to direct the transfer of client funds or securities <u>between</u> accounts of the same client, as well as advisers with fee deduction authority, so long as the other safeguards I discussed above are followed.

[56] As with other safeguards, bonding requirements are unlikely to protect against perpetrators who are simply willing to flout the law.

[57] Because of this, I also considered whether advisory accounts should be protected under an FDIC- or SIPC-like insurance arrangement and concluded that insurance would also probably be inadequate to cover losses in a fraud like Madoff. Moreover, it would be redundant to the extent that advisory assets covered by the custody rule are already required to be held by a "qualified custodian" which itself is likely to be covered by FDIC or SIPC insurance. While FDIC and SIPC insurance would not necessarily protect against fraud or failure of an <u>adviser</u> -- as opposed to the insured custodian -- it provides some measure of protection, particularly in the case of self-custody or related person custody. As such, I would urge the Commission to avoid including in the definition of "qualified custodian" any institution that is not subject to a similar insurance arrangement (or equivalent substitute protection).

- To avoid the “moral hazard” of bonding, advisers should not be permitted to advertise or tout their fidelity bonding in such a way that puts clients or potential clients off their guard or misleads them about the scope or amount of coverage available.[58] Rather, clients should be encouraged to do as much due diligence on their adviser as they would in any other circumstance and protect themselves through all other available means (such as routinely checking their own account statements, etc.).

13) What other issues weigh against requiring an “internal control report”?

As noted in my comments above, I oppose the requirement for an “internal control report,” which the Proposal calls for in any case where the adviser or its related person acts as the qualified custodian. As explained, I believe an internal control report would be redundant, unnecessary and overly costly to justify in that context. However, I also object to the requirement for an internal control report because:

- the framework and standards applicable to the report are left undefined in the Proposal;
- the Proposal seems to contemplate the wrong type of internal control report; and
- there is too great a risk that an internal control report will be used by the wrong parties for the wrong purpose.

The Proposing Release contemplates that the “internal control report” called for under the custody rule would take the form of a Type II SAS 70 report. I am not an accounting expert, but as far as I am aware, SAS 70s are usually obtained in the context of auditing financial statements, for the purpose of providing multiple users of a service provider (like the many mutual funds that all use a particular custodian) with one audit report on the service provider’s processes, thereby eliminating the need for each user’s auditor to perform its own, duplicative audit procedures on those processes in order to complete its audit of the user’s financial statements. In that context, each user’s auditor must decide for itself whether the SAS 70 report obtained from the service provider’s auditor is adequate for its purposes, with the overarching goal of ensuring that its audit opinion on the user’s financial statements is properly supported in accordance with GAAS and GAAP standards.

In contrast, a similar framework and standards are not available in certain cases where an internal control report is called for under the Proposal. This is because even if an adviser or its related person (i.e., the qualified custodian) is itself audited, the adviser’s client accounts may not be.[59] In those cases, GAAS and GAAP would not provide a useful framework for determining how to prepare an internal control report or how to gauge the adequacy of the report for a user’s own purposes. Moreover, the Proposal does not provide a substitute framework. Rather, it leaves open questions like -- Even if all the custody controls in place at a custodian are covered by the report, what comfort is there that those are the controls that should be in place, and as measured by what standard (for example, that the controls are “adequate” or “sufficient” to provide “reasonable safeguards” against loss due to error or fraud)? In the same vein, what standards apply to define the scope and design of the auditor’s assessment?[60] The Proposal leaves those questions unanswered.

[58] In the same way, advisers are warned against touting their “registered” status so as to represent or imply official imprimatur or government approval. See Section 208(a) of the Advisers Act.

[59] Without doubt, audited financial statements might be prepared for the accounts of hedge funds, mutual funds or other entity clients, but in many cases, an adviser’s client accounts will be unaudited.

[60] Certainly, AICPA and PCAOB standards can provide guidance on how the work should be performed (with due care by practitioners with reasonable knowledge of the subject matter, adequate training, etc., etc.), but if the report is being prepared to satisfy a specific legal requirement, the law ought to specify what standard the work is aiming to satisfy. For example, Exchange Act Rule 17a-5(g) calls for the scope of an auditor’s review of controls safeguarding securities held by a BD to be that which is “sufficient to provide reasonable assurance that any material inadequacies” in the assessed controls would be disclosed.

In any event, a SAS 70 does not seem to be the right type of internal control report to obtain in this context. Rather than focusing on financial controls in the context of audited financial statements (the context contemplated by SAS 70), a report under SOP 07-2[61] would seem to make more sense to obtain, to assess the compliance controls in place. Many of the same basic control objectives could be covered under SOP 07-2 as under SAS 70 (transaction processing, cash and security reconciliations, etc.), but an SOP 07-2 report could cover controls aimed at safeguarding client assets that go beyond those expected in a SAS 70, such as:

- controls to ensure that account statements (and/or audited financials for pooled vehicles) are distributed to clients/investors within the time frames specified in the custody rule;
- controls surrounding escheatment procedures, including tracking lost clients/investors;
- controls aimed at compliance with books & recordkeeping requirements relating to custody, including document retention and destruction; and
- controls over privacy, especially in cases where in order to comply with the custody rule, the adviser must share with the custodian client names, addresses or other information that the custodian would not otherwise have.

Again, I am not an accounting expert and therefore would defer to the audit firm and related expert commenters as to which type of internal control report is the right one to obtain in this context. However, if a Type II SAS 70 is not the right type, I would point out that, among other things, the cost/benefit analysis in the Proposing Release is likely to be off-the-mark in its discussion of the internal control report aspect of the Proposal and should be reworked if you decide to pursue an internal control report requirement, using the correct type of report and more relevant cost data.

Even more problematic, in my view, is that an internal control report – including one rendered under SOP 07-2 – would be highly susceptible to being used by the wrong parties for the wrong purpose. Internal control reports are generally intended for the sole use of the management or auditors of users that outsource to or contract with the service provider,[62] for them to consider the information in the report, along with any information about their own internal controls, in meeting their own compliance, fiduciary or reporting obligations. The reports are not intended to assess or test the service provider's compliance with the federal securities laws or with its contractual obligations.[63] Significantly, no one in the report – neither the service provider nor the auditor – asserts or attests to the fact that the controls assessed are adequate[64] to meet any particular requirement or standard,[65] or even that the controls in place provide a "reasonable safeguard" against loss.

As such, clients, potential clients, regulators and others should not use an internal control report as an attestation or certification that the adviser (or related person) acting as qualified custodian

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[61] See AICPA Statement of Position (SOP) 07-2 - Attestation Engagements That Address Specified Compliance Control Objectives and Related Controls at Entities That Provide Services to Investment Companies, Investment Advisers, or Other Service Providers.

[62] Of course, internal control reports can be useful to the service provider's own management as well.

[63] Indeed, the reports I have seen expressly disclaim that the auditor examined legal or contractual compliance.

[64] That seems to be more what the Proposal is driving at when it asks whether adviser CCOs should be asked to certify periodically that "all client assets are properly protected and accounted for on behalf of clients." Proposing Release at Section II.A.1. Without commenting on the rough extrapolation from Rule 206(4)-7 of a compliance standard for custody ("all client assets are properly protected and accounted for"), and the obvious question of why the CCO should be the one certifying (why not the CEO?), I oppose any certification requirement that does not provide an independent safeguard.

[65] Of course, the most obvious standard to tie to would be the one embedded in the Advisers Act compliance rule, Rule 206(4)-7, which calls for advisers to implement procedures that are "reasonably designed to prevent violation" of the Advisers Act and rules. However, that general compliance program standard does not readily reduce to cover only one aspect of the program, such as safeguarding client assets. Moreover, even if that standard applied to an adviser with self-custody, it would not apply to a (non-adviser) related person acting as qualified custodian, either directly or indirectly, given that Rule 206(4)-7 only requires the adviser's compliance program to cover the adviser and its "supervised persons" (not its "related persons") and does not impose any specific obligation on advisers to oversee service providers, such as custodians.

is meeting its legal or contractual obligations, or as indicative that the custody controls in place are "adequate" as measured against any particular standard. However, the reports are highly susceptible to being used by exactly those parties for exactly those purposes, under the mistaken impression that they provide some type of "assurance" or "proof" to that effect. Even though internal control reports can be very helpful when used for the purposes intended, they are not intended to provide those assurances and, if misunderstood in that way, could do more harm than good.

For all these additional reasons, I urge you to drop the requirement for an internal control report under the custody rule.

14) What should be done to ease the burden of new custody rule requirements on smaller advisers?

In my view, the $25 million AUM threshold used to determine an adviser's eligibility for SEC registration should be raised to $100 million. This would have several advantages:

- It would reduce the number of small advisers that may be overburdened by costly new custody rule requirements, including any surprise exam, internal control report or other requirements imposed under the final rule.
- It would afford a more efficient allocation of the Commission's inspection and enforcement resources to advisers that are large enough to pose greater risk. In an industry that speaks in terms of billions of dollars, it is odd to characterize an adviser with AUM of even $1 billion, let alone $100 million, as anything but "small." Advisers with AUM of only $25 million may be better characterized as "miniscule." Moreover, the exponential increase in new adviser registrations in the last decade makes it critical for the Commission to re-think its allocation of resources, particularly in an era of tight budgets and particularly if even more entities (such as hedge fund advisers and hedge funds) are required to start registering.
- It would help to satisfy those states that want more regulatory control over advisers within their jurisdictions and allow them to impose the regulatory requirements they believe are fitting to address risks posed to their citizens.

This is yet another reason the Commission should not approach custody rule changes in a piecemeal way, but rather in an integrated way that takes into consideration the full reality likely to exist when the new requirements come into effect. I would venture to guess that the cost/benefit analysis in the Proposing Release is substantially off-base if one considers the effect that hedge fund adviser registration or raising the AUM threshold would have on the population of SEC-registered advisers as a whole.

15) What other aspects of the Proposal should be considered?

TOPIC AREA	COMMENT
Definition of "securities"	Please consider and clarify whether various types of alternative investments are considered "securities" within the phrase "funds and securities" as used in the custody rule. One example is swaps. Since swaps are largely carved out of the 1933 Act, but not the Advisers Act, are securities-based swap agreements subject to the rule? This question will become even more important if hedge fund advisers are required to register. There are probably other types of alternative investments, OTC and individually negotiated investments, derivatives and other less common investments that raise similar questions.
Definition of "control"	I have previously expressed my concern about the control definition found in Form ADV[66] -- which you propose to insert into the custody rule -- given that the definition

[66] See Section 17 in my comment letter on Form ADV, Part 2, posted at http://www.sec.gov/comments/s7-10-00/s71000-93.pdf.

	is different than the control definition found in the Advisers Act itself.[67] Having a term defined one way in the statute and another way in the related rules creates unnecessary confusion.[68] If you decide to insert the ADV definition into the rule, please at least provide <u>instructions on how an adviser can rebut the presumptions built into the definition</u>[69] so advisers can appropriately apply the rule in cases where the presumptions are not supported by the facts.
Definition of "related person"	I strongly oppose having one definition of "related person" for the custody rule (anyone controlling, controlled by or under common control with the adviser) and a different definition of "related person" in the glossary of Form ADV (advisory affiliates, plus anyone under common control). One notable group included in the Form ADV definition that would not be covered by the proposed rule definition is the adviser's employees. Which definition would apply to Item 9 of Form ADV, Part 1? I would urge you to avoid this extraordinarily confusing approach.[70]
Definition of "custody"	It is unclear to me why supervised persons are covered by proposed Rule 206(4)-2(c)(2)(iii) but not (c)(2)(ii). I believe these subsections should be treated the same, from the standpoint of covering supervised persons. (Note in this regard that the "related person" reference at the beginning of subsection (c)(2) would not be an alternative way to catch supervised persons, unless they are supervised persons who "control" the adviser, meaning persons who are 25%+ owners, officers, partners, directors exercising executive responsibility, or are otherwise caught by the "control person" definition.[71])
Form ADV Glossary definition of "custody"	I would suggest deleting the phrase "or has the ability to appropriate them" from the Form ADV Glossary definition of "custody." This phrase puts the glossary definition out of sync with the definition in the custody rule. Moreover, one could argue that <u>every</u> adviser has the ABILITY – as opposed to the authority -- to appropriate client securities, albeit illegally.
Treatment of Uncertificated, Restricted, Privately Offered Securities (URPOS)	Under the Proposal, URPOS would be exempt from the requirement that assets be held by a qualified custodian, but not from the requirement that the qualified custodian send an account statement directly to clients. This seems unworkable given that you presumably want the account statement sent by the qualified custodian to show only those funds and securities it maintains.[72] It also raises the question -- how and when will clients get account statements showing the URPOS (or other funds and securities) that are in their advised accounts but <u>not</u> held by the qualified custodian? Instead of eliminating the adviser account statement delivery option, I would suggest that the rule <u>require</u> advisers to send account statements to clients if the qualified custodian's statement does not cover all assets in the advised account.

[67] It is also different from the control definition found anywhere else in the federal securities laws, including in the Investment Company Act, and regulations promulgated under the 1933 Act and 1934 Act.

[68] Not to mention raising questions about the Commission's authority to redefine a statutory term by regulation.

[69] See my comments under Question 6 above.

[70] Which would be even more confusing for an adviser attempting to rebut the presumption that a related person's custody should not be treated the same as the adviser's custody because the related person is not really "related."

[71] As a drafting matter, I also presume subsection (c)(1)(i) should read "Each of <u>a firm's</u> officers…is presumed to control <u>the firm</u>…" (rather than "your firm") since an individual's position as an officer, etc., of a firm <u>other than the adviser</u> could be the link that establishes that firm as under common control with the adviser.

[72] As I mentioned earlier in this letter, it seems like an exceedingly bad idea for the adviser to be handing over to the custodian information produced by the adviser, just so it can be shown on an account statement sent by the custodian.

	The adviser's statement should show at least the URPOS and other funds and securities not held by a qualified custodian. That way, the client would be receiving regular account statements from <u>somewhere</u>, covering all the assets in their advised account. (Of course, pooled vehicles that cover the URPOS on audited financials distributed to investors per the rule would be exempt from this requirement.)
Funds of funds	The Proposing Release does not discuss why the Proposal eliminates the definition of "fund of funds" appearing in the current custody rule, as well as the provision giving "funds of funds" up to 180 days to distribute their audited financial statements. I urge you to consider whether the issues that originally led to including those provisions in the current rule make them necessary to include in the amended rule.
Legend requirements	In general, I strongly favor efforts aimed at investor education and therefore support the Proposal to the extent it calls for legends on account opening notices and account statements urging clients to compare their qualified custodian account statements with any statements or information received from the adviser. I am in support of the similar disclosures proposed for Form ADV, Part 2 as well. I would go even further and recommend that information along these lines be added to the "Investor Information" section of the SEC's own website, if it is not already there. This could be perhaps made part of a larger publication covering "Tips for Protecting Yourself as an Investor" summarizing the actions investors and clients can take to check out their financial professionals and actively avoid becoming victims of fraud or other wrongdoing. Advisers could then be required to include a reference (or link, if electronic) to the Commission's "Tips" website in the adviser's Form ADV, Part 2, or as part of any legend required under the custody rule.
Item 9, Form ADV, Part 1 (custody)	Item 9 generally: Given the way the phrase "cash and bank accounts" is used in Item 9, one could readily assume that the word "funds" in the custody rule is intended to mean "cash and bank accounts." If this is not your intent, I would urge you to clarify this. Item 9.A.(2)(a) and B.(2)(a): The dollar amounts required to be reported should be valued as of what date? The same date used for AUM under Item 5 (under which advisers are allowed to choose any date up to 90 days prior to filing)? Item 9.A.(2)(a) and B.(2)(a): The dollar amounts required to be reported should be calculated in what way? Similar to that for AUM under Item 5, meaning if an adviser has "custody" of a "securities portfolio" consisting of at least 50% "securities," it should report custody of the entire portfolio? Or should it report just the portion that consists of "funds and securities"? I would urge you to avoid, to the extent possible, varying the ways that an adviser's assets are required to be calculated in different places on Form ADV (both Parts 1 and 2), for the sake of advisers and clients alike. Item 9.A.(2)(b) and B.(2)(b): The number of clients required to be reported should be counted as of what date? The date of the ADV filing? Item 9.C.: I would recommend explicitly referring to the custody rule, Rule 206(4)-2, somewhere in the instruction below this item, so advisers will know where to look for definitions of terms like "qualified custodian," "annual surprise examination," (why is this not "independent verification"?) and "internal control report" and to understand more clearly which of the "check all that apply" responses <u>should</u> apply to them.

	Item 9.D.: It seems unnecessarily confusing to ask in Item 9.A. “Do you have custody?” and then in Item 9.D. “Do you act as a qualified custodian?” I would suggest re-writing Item 9 to ask the question “Do you have custody?” (referencing the custody rule) and then ask, “If so, check all that apply,” listing the various ways custody could occur under the rule, something like (paraphrasing here, but assuming you would use wording that parallels the rule): • act as qualified custodian • have physical possession • have arrangement authorizing withdrawal, transfer or disbursement of funds or securities, other than fee deduction authority • have fee deduction authority • have capacity giving legal ownership or access. This way, you could ask for the details of what kind of custody an adviser has – in particular identifying those that have only fee deduction authority – and better discern custodial risk.[73]
Rule 206(4)-2(a)(4) Independent Verification (surprise exam)	It seems very round-about to tie the accountant’s surprise exam responsibilities (filing Form ADV-E, etc.) into the rule only through the written agreement with the adviser. This raises the question -- what happens if an accountant performs a surprise exam but fails to notify the SEC of discovered discrepancies? It seems at worst that the accountant may be in breach of its written agreement with the adviser. The accountant will not have violated the rule because the accountant’s conduct is not governed by the rule directly. Moreover, the adviser is not in violation of the rule if the adviser has a provision in its agreement with the accountant requiring the accountant to notify the SEC in those circumstances, regardless of whether the accountant actually does. I surmise this approach was taken because the rule was adopted under Section 206(4), which governs when an adviser’s practice or conduct is deemed to be fraudulent, and may be an attempt to assign to the adviser appropriate responsibility for arranging the surprise exam without causing the adviser to violate the rule if the accountant then fails to perform. Of course, the rule would make more sense if it simply required the adviser to arrange for a surprise exam, and then directly required the accountant to perform certain acts in conjunction with the surprise exam (filing Form ADV-E, notifying the SEC of discrepancies, etc.). But getting that to tie in properly to the Advisers Act – outside the anti-fraud sections -- may take statutory amendments that I believe would be best done in conjunction with a more complete overhaul of the Act.
Filing of Form ADV-E	Once Form ADV-E is required to be filed via IARD, I would suggest that the form appear in the publicly available electronic database logically associated with (or linked to) the adviser, so that clients and prospective clients can readily find it by conducting a standard search for the adviser on the Investment Adviser Public Disclosure website.
ASR 103	Accounting Series Release No. 103 (ASR 103) sets out the guidelines by which accountants are required to conduct a surprise exam. ASR 103 was first adopted in 1966 and, as far as I can tell, has not been amended since. It is woefully out-of-date

[73] Of course, if you adopt my definitions and approach, you could ask the questions: “Do you have custody?” (meaning “true” custody), “Do you have ‘asset access’?” and “Do you have fee deduction authority?” and then ask for any other necessary details (such as what kind of asset access the adviser has).

	and raises accounting issues that were pointed out by audit firm commenters in 2002.[74] This may amount to a minor headache now with a relatively small number of advisers subject to surprise exams. However, given that the number of advisers subject to surprise exams is projected to balloon from 190 to 9,500 if the Proposal is adopted, I would strongly urge you to update ASR 103, in accordance with the comments made in 2002, as well as my comments elsewhere in this letter and any new comments submitted by commenters knowledgeable about its application.

* * *

Thank you for considering my comments on this important topic. If you have any questions or would like any further clarification about these or related points, please contact me at the phone number referenced below.

Sincerely,

L. A. Schnase
Individual Investor and Attorney at Law
713-741-8821

[74] See letter of PricewaterhouseCoopers, dated September 25, 2002, posted at http://www.sec.gov/rules/proposed/s72802/pricewater1.htm. ASR 103 will be even more dramatically out-of-date if the Proposal is adopted.