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July 10, 2009

Ms. Elizabeth M. Murphy
Secretary
United States Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

RE: Proposed Amendments to Rule 206(4)-2
Release No. IA-2876
File No. S7-09-09

Dear Ms. Murphy:

Ativo Capital Management LLC appreciates the opportunity to express its views in response to the Securities and Exchange Commission's (the "Commission") request for comments on the proposed amendments to Rule 206(4)-2.

The Proposed Rule regarding Custody of Funds or Securities of Clients by Investment Advisors is an overreaching regulatory proposal to a risk concern that can be narrowly defined. The requirement that advisors that use qualified custodians and who solely withdraw fees be subject to a surprise audit where no substantive regulatory risk has been identified is unwarranted as it imposes costs with little definable benefit. In addressing custody issues, there are regulatory voids which create risks and there may be need for some regulatory action and need for greater regulatory agency cooperation to minimize these voids.

Problem Identification

Footnote 11 details the recent enforcement actions that have stimulated the Commission's Proposed Rule. The Commission notes a commonality in that in each case the advisor had custody of customer funds. This is true, but the Commission fails to identify the second commonality that the advisor was an affiliate of another entity as follows:

1. Release No. 21006 – registered investment advisor and a limited partnership
2. Release No. 20998 – registered investment advisor and a hedge fund
3. Release No. 20912 – registered investment advisor and a registered broker/dealer
4. Release No. 20901 – bank, broker/dealer and advisors
5. Release No. 20889 – registered investment advisor and registered broker/dealer
6. Release No. 20972 – failure to use a qualified custodian. The Nutmeg Group was the sole case in which there was no affiliate. Rather it was a simple case of theft and intentional disregard of Rules. It was also the smallest of the frauds.

No case is cited and I recall no case in which an advisor was sanctioned for intentionally charging their clients the wrong amount where they were withdrawing fees from a qualified custodian. The problem is not that advisors have some *de minimus* custody; rather it is that advisors who have affiliates present a unique regulatory risk. The focus should be to on the actual risk rather than the imposition of a rule and its associated costs on those where no problem has been identified.

Proposed Scope

As noted in the Release, the Commission's Proposal would impose an audit requirement on 9,575 advisors out of 11,272 registered (85%). If those advisors who use a qualified custodian and who have no such investment affiliates are excluded (7,126 of the total), the number requiring audit drops to 2,449 subject to audit (26%). I will disclaim any comment on whether these should be audited as proposed since Ativo has no such affiliates and would fall into the first category. My comments are therefore limited to advisors who use a qualified custodian for all assets.

Audit Scope

A standard audit is not a fraud audit. A typical audit engagement letter states "An audit is designed to provide reasonable, but not absolute, assurance and because we will not perform a detailed examination of all transactions, there is a risk that material misstatements may exist and not be detected by us." Where an advisor who does not use a qualified custodian intentionally seeks to defraud his clients there is no reason to assume that records will not also be created to deceive his auditor. Thus, where the advisor has intentionally engaged in fraud, the mere undertaking of a limited scope audit may provide no adequate assurance that "another set of eyes" have adequately observed that advisor's actions.

Where a qualified custodian is used, an auditor's role would be primarily clerical in confirming that the agreed fee was computed based on rate and AUM. To my knowledge this has never been a substantive compliance problem. If such an advisor sought to materially defraud his clients, client funds would be directly diverted by the advisor prior to receipt by the custodian. In such a case, no record would ever be created that could be audited and the audit work proposed by the Commission would not address such situation.

Audit Cost

In the case where a qualified custodian is used, the cost imposed on small advisor is very high in relation to the benefit received. As noted by the Commission as related to the entire proposal, "The potential benefits to investors, however, are difficult to quantify." Where a qualified custodian is used, the benefits may be difficult to quantify as they may be close to non-existent and an audit provides little if any assurance given that the custodian provides quarterly statements. If *all* clients consistently fail to review disclosed fees, the advisor could perpetuate a small fraud, but since no advisor can know with certainty who and when statements will be reviewed the risk in relation to the reward is simply unwarranted.

Furthermore, the Commission has certainly underestimated the direct and opportunity cost to the thousands of small advisors. Footnote 155 assumes compliance clerks would be used. Most small advisors will not have a fulltime compliance officer much less a compliance department with staff. Thus, both the direct and opportunity costs will be significant for these advisors. Given that their limited time must be redirected to managing and working with auditors, productive work cannot be done and establishing an audit priority may distract compliance personnel from other more critical compliance functions.

Statement Delivery Confirmation

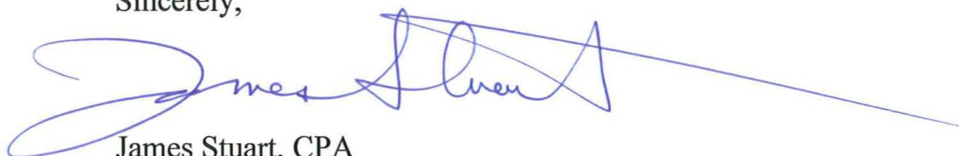
"The proposed rule would require all registered investment advisors that have custody of client assets to have reasonable belief, *after due inquiry*, that the qualified custodian sends account statements directly to their clients at least quarterly." This seems to be a pointless requirement and inference that advisors should place no confidence in the regulatory capabilities of other regulatory agencies. If a broker/dealer is properly registered with FINRA then an advisor should be able to rely on that entity being properly supervised by its regulator. Do such organizations as Schwab, Fidelity and TDAmeritrade need to receive regular inquiries from all of their advisor clients asking whether they provide statements directly to clients. The only thing accomplished by a "due inquiry" requirement is to increase the compliance burden on both parties with no commensurate benefit other than to paper a file with essentially meaningless confirmations of regulatory compliance.

Conclusion

Though the cases cited provide evidence of some need to adjust the custody rule, the proposal of the Commission takes a draconian approach rather than a nuanced approach to solving the problem. Registered investment advisors serve many markets in different ways. Each market requires analysis in order to craft a suitable solution that addresses the specific risk without burdening advisors in other markets with effectively useless procedures and increased costs.

A more careful analysis as to the source of the problem is required, but clearly in the situation where the advisor has affiliated entities not supervised by the Commission changes may be warranted. Another area that requires further analysis is how increased coordination between regulatory agencies might reduce the risk. In the case of an unregistered hedge fund, the advisor may be registered with the Commission and the hedge fund's brokers registered by FINRA. By coordinating their audit and rule making activities, the regulatory voids could more effectively be closed.

Sincerely,



James Stuart, CPA
Chief Operating Officer