Nancy Lininger, Founder/Consultant
The Consortium®
PO Box 2682
Camarillo, CA 93011-2682

BY ELECTRONIC FILING rule-comments@sec.gov

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F St NE
Washington DC 20549-1090

RE: File Number S7-09-09 Custody of Funds and Securities of Clients by Investment Advisers

Dear Ms. Murphy,

I appreciate the opportunity to comment on the proposal. I bring a unique and broad perspective on this topic. The Consortium is a consulting firm serving both Broker-Dealers ("BDs") and Registered Investment Advisers ("RIAs"). My financial services clients run the gamut from commission-only, fee-only, and commission or fee. I entered my financial services career as a stockbroker in 1978 for a wirehouse. Turning from sales to compliance in 1983, I became a Compliance Officer first for a BD, and then for an RIA. I founded The Consortium in 1989; where I continue to work with firms on compliance, practice management, and marketing.

Would an annual surprise examination increase protections afforded to advisory clients? Should we except from the surprise examination requirement advisers that have custody of client funds or securities solely as a result of their authority to withdraw advisory fees from client accounts? Is this form of custody, which is common to advisers with discretionary authority, less likely to be subject to abuse?

For advisers with actual constructive custody, the annual surprise examination increases protections against fraud and abuse.

Fee deduction is common to advisers with discretionary authority and is less likely to be subject to abuse. A surprise audit to verify assets, when such assets are held at a qualified custodian serves no purpose. Based on the SEC estimates the surprise audit will run each RIA $8,100. This would be a costly proposition for the adviser, to which there is no benefit.

Fee deductions are detailed on the custodial statement, and the client can verify the math. During SEC audits, the examiners can easily test for proper calculations on random samplings. Fee deduction has not been the source of the egregious conduct that has caused the SEC to review the custody rule.

Another form of custody is acting as trustee. If an RIA manages a family account and acts as trustee (or successor trustee), then the RIA has custody and needs comply with custody rule. Prior to the 2003 custody rule change, there were No Action Letters to grant relief from the custody rule if the only account(s) is an immediate family member (e.g. parent) and not various family members. It further required that a letter be sent to the family member setting forth the custody rule and obtain a signed statement acknowledging the statement. See Kathryn W. Bondoux 8/21/86. I propose that this be adopted as an exception to custody under the new rule.

Should we require advisers to adopt compliance policies and procedures administered by a chief compliance officer, to require that the chief compliance officer submit a certification to us on a periodic basis that all client assets are properly protected and accounted for on behalf of clients?

The Ponzi schemes and other fraudulent activity are being conducted by dishonest people. The dishonest people will lie on certifications, and only cause more regulatory red-tape for the majority of the honest firms. Submitting a certification to the SEC causes more administrative work for an already over-burdened agency. The certification will not assist the SEC in uncovering bad schemes.

Should we specify certain minimum procedures that each chief compliance officer should implement to assure herself that all client assets are properly protected and accounted for? Given the variety of custodial arrangements, is it feasible for us to specify minimum requirements?

Under the Compliance Programs Rule each investment adviser is to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, review those policies and procedures annually for their adequacy and the effectiveness of their implementation, and designate a chief compliance officer to be responsible for administering the policies and procedures.

I believe this principals based approach is sufficient. The SEC can examine for reasonableness and make suggestions for improvement as part of the deficiency letter process. Setting up specific procedures for the honest firms is not going to stop the cheaters from doctoring the books.

Should the rule require surprise examinations to be conducted more frequently than annually or, alternatively, on a regular periodic basis, e.g., semi-annually?

For firms with actual physical possession of securities, the annual independent audit in addition to the annual surprise audit should be sufficient.

Under the Exchange Act, a broker-dealer's financial statements must be audited annually by a registered public accounting firm. This audit must include a review of the broker-dealer's procedures for safeguarding securities. Would the surprise examination's "verification" of client assets provide additional protection for clients of advisers that are also broker-dealers?

For single legal entities that are dual registered, if the SEC is satisfied with the audit requirements for broker-dealers, there is no need to add additional audit requirements simply because the firm has the additional registration. However, the broker-dealer audit should be inclusive of the advisory assets.

We request comment on the feasibility of requiring that advisers obtain a surprise examination with respect to privately offered securities.

Privately offered securities, which often cannot be held by a qualified custodian, does seem to be an area that can be subject to abuse. Privately offered securities should be subject to heightened scrutiny in some manner.

A ''related person'' would be a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser. For purposes of this definition we would define ''control'' as the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise.

The proposed amendments would simply deem advisers whose ''related persons'' hold client assets to have custody under the rule if those assets are held by the related person in connection with the advisory services provided by the adviser. We believe that the risks to advisory clients that arise as a result of a related person's ability to obtain client assets, regardless of the separation between the adviser and a related person, may be substantial enough to require the adviser to comply with the custody rule.

The underlying purpose of this proposal has merit. It is designed to limit the Madoff-type schemes where slight-of-hand can disguise wrong-doing. If a related-person has custody, then the adviser should be deemed to have custody. If a person has ownership in affiliated companies or there is otherwise control, safeguards need to be in place.

With that said, I would like the rule to clarify that when a Registered Representative (agent) of a BD has an "independent" RIA, that the agent does not have control over the BD. Neither does the BD have control over the independent RIA. The BD's compliance responsibilities under FINRA rules in regards to outside business activities and private securities transactions does not give rise to the control issues of concern under the custody rule.

Thus the BD would be able to custody the funds and assets without the RIA being deemed to have custody. This is with the caveat that the agent does not have any ownership of the BD and does not otherwise control the management of the BD. I believe there is enough separation that a Madoff-like scheme could not be perpetuated.

Furthermore, this would penalize the dual-registered rep that offers clients the option of commissions or fees, when the services of the fee-only IA Rep (who places trades at third-party BDs) are undistinguishable to the investor. It would create an even stronger exodus of registered reps from the BD industry. Despite the bad rap on commissions, this option can be less expensive for some investors, and we need to preserve this form of compensation.

Does it make sense to require both an internal control report and a surprise examination? Would these requirements be duplicative? Should we require that the independent public accountant that performs the surprise examination be a different accountant than the accountant that prepares the internal control report? Should we require that the independent public accountant that prepares the internal control report be registered with the PCAOB? Would the requirement of using independent public accountants registered with, and subject to regular inspection by, the PCAOB increase the costs to obtain these reports or make it too difficult to obtain a qualified accounting firm to provide an internal control report?

These are challenging questions. We have been overwhelmed with Madoff schemes and must find a way to put a stop to these fraudsters. We also have to make sure that any solution is not too expensive to jeopardize the livelihood of the investment advisers. The majority of RIAs are small firms.

To the extent that a single audit can be efficient to catch wrong-doers, I am in favor of that. Can the exam be consolidated efficiently? I will let those more familiar with financial audit procedures address this question.

If the two audits remain, I oppose having the audits done by different accounting firms. That would result in duplicative efforts and unjustified costs. In addition to the $8,100 surprise audit, the SEC estimates PCAOB accounting firm internal control reports to run an average of $250,000 per year. I don't know how any small RIA firm will be able to remain in business with such a costly burden.

While I understand the concerns (and real-life situations) of having a small friendly accounting firm perform bogus audits, there is a big price differential in the cost of an audit from a non-PCAOB firm and a PCAOB firm. There must be a reasonable way to ensure the quality of a non-PCAOB accounting firm so that small RIAs with custody can afford the audit.

Remember that there are a few different ways small firms can have "inadvertent" custody other than fee deduction. This includes: acting as trustee for only one client; checkwriting authority for only one client; or, where the client signs authorization forms to allow the RIA to transfer funds between client accounts held at separate (but specified) institutions (e.g., banking accounts).

Sincerely,
Nancy Lininger
The Consortium