July 21, 2009

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

Re: File Number S7-09-09
Custody of Funds or Securities of Clients by Investment Advisers

Dear Commissioners and SEC Division of Investment Management Director and Staff:

The National Association of Personal Financial Advisors (NAPFA), which has over 1,300 NAPFA-Registered Financial Advisors, appreciates the opportunity to comment on the Proposed Rule regarding changes to the custody requirements. For more than 25 years NAPFA has been the professional home for Fee-Only financial advisors who make a commitment to serve consumers in a fiduciary capacity. Our strong principles and high standards have been recognized by other industry organizations, legislators, regulators and the media as being what is best for consumers. We continue to advocate on behalf of investment consumers. NAPFA appreciates the U.S. Securities and Exchange Commission's (SEC's) focus on protecting the lifetime savings and investments of individual Americans.

In SEC Release IA-2876, the Commission has proposed several revisions to rule 206(4)-2 under the Advisers Act that are designed to improve the safekeeping of client assets. Essentially, the changes proposed have the goals of:

(1) Decreasing the likelihood that client assets are misused; and

(2) Increasing the likelihood that fraudulent activities, if engaged in by an investment adviser, are discovered earlier so that client losses are thereby reduced.

NAPFA believes that these goals are admirable, yet has concerns that the proposed rule will not effectively accomplish these goals, may fail a reasonable cost/benefit analysis, and may cause consumers additional expense and inefficiency. In succeeding sections of this correspondence, NAPFA suggests other measures which should be pursued in meeting these objectives.

NAPFA's suggestions result from a survey of its many members, in the analysis of which NAPFA's Industry Issues Committee reviewed over 50 pages of NAPFA-Registered Financial Advisor observations and

recommendations. Additionally, committee members participated in numerous discussions with individual members of NAPFA and others associated with the investment adviser industry.

A. **"Low-Cost" Measures the SEC Can Adopt: Consumer Education; Whistleblower Incentives; Enhanced Anonymous Reporting of Tips.** Prior to providing recommendations as to specific aspects of the custody rule, NAPFA offers the following general low-cost recommendations to enhance the protection of consumers:

- ***Encourage Greater Consumer Oversight.*** Some clients of investment advisers rarely read their statements. Yet, even if greater protections are put in place with regard to the custody requirements, consumers will still need to be actively engaged so that they can identify and report fraudulent behavior if it occurs. Hence, consumers must be actively encouraged to read their custodial statements. To this end, the National Association of Personal Financial Advisors recently reached out to consumers to encourage in actions which strengthen consumer oversight of their financial advisors. For example, NAPFA recently issued the flyer *Are You Worried About Your Financial Advisor?* – found at http://www.napfa.org/userfiles/file/Worried%20About%20Your%20Advisor.pdf (a copy of this flyer is also reproduced as Exhibit A enclosed). Additional efforts, including consumer webinars, are planned. As recently stated by Diahann W. Lassus, CFP®, CPA/PFS, national chair of NAPFA, "Consumers must act if they feel their financial advisor has acted imprudently," said. "The financial advisory community is vast and we would like to believe that every financial advisor will act in the best interests of their clients according to a fiduciary standard, but it doesn't always happen. If consumers suspect any misconduct, they must act on those doubts to protect themselves." The SEC can encourage all providers of consumer financial education to include in their presentations a "Trust but Verify" segment, in which consumers are informed that they should, through their own personal reviews of their monthly or quarterly statements, examine all of the transactions undertaken in the accounts.

- ***Provide Incentives to Whistleblowers.*** NAPFA supports the provisions of the U.S. Treasury Department's "Financial Regulatory Reform, A New Foundation" proposal which authorizes the Security and Exchange Commission (SEC) to pay whistleblowers who report fraud. Even with a far greater number of "cops on the street" and internal controls at securities industry firms; the resources to combat fraud must include the individual reports of consumers and securities industry participants. The whistleblower incentives may prove to be a most powerful fraud-fighting tool.

- ***Enhanced Means of Providing Anonymous Tips.*** Whistle-blower hotlines which don't provide rewards, such as an anonymous means of providing reports of incidents or suspicions to senior management or compliance officers of securities firms, as well as to federal and state securities regulators, also provide a compelling opportunity to detect fraud at its earlier stages and deter its further spread. We encourage the SEC to revise its consumer complaint process, including the online reporting forms available at http://www.sec.gov/complaint.shtml, to provide a more effective means for anonymous reporting of tips. We also encourage the SEC to promote the filing of anonymous tips on its "Investor Information" web page, found at http://www.sec.gov/investor.shtml. NAPFA further suggests that the SEC direct FINRA to establish similar "anonymous tip" avenues at self-regulatory organization web sites, including FINRA's "Investor Complaint Center," found online at

http://www.finra.org/Investors/ProtectYourself/p118628, as well as with state securities regulators. Of course, guidance to investors should exist as to when the filing of an anonymous tip is proper, and what information such a tip should contain.

- ***Anonymous Tips to Investment Adviser Firms.*** In addition, the SEC could require registered investment adviser firms themselves to provide a means for anonymous tips to be received, whether from consumers or from employees or vendors of the firm. For example, an investment adviser firm could be required:
  - to provide clients, concurrent with the annual offer of Form ADV, Part 2, with information on how to submit consumer concerns (either directly or anonymously) to the firm's Chief Compliance Officer (or his or her designee); and
  - to undertake disclosures of the existence of the anonymous tip procedure to employees (both at time of initial hiring and during required annual compliance training).

B. A Review of the SEC's Key Measures to Protect against Fraud by Investment Advisers, Generally. There are many existing requirements, imposed by the SEC or the states, which already guard against the fraudulent conversion of client assets by participants in the securities industry. For investment advisers, the key controls in place include:

(1) Periodic and/or surprise inspections of investment advisers by federal and/or state securities regulators;

(2) The effective oversight of an investment adviser's Chief Compliance Officer and staff, including but not limited to the adoption of robust policies and procedures within the investment adviser firm designed to detect theft or conversion of clients' assets;

(3) The use of independent third-party custodians to hold the assets of clients of investment advisers; and

(4) An effective surprise audit by a qualified public accounting firm of the investment adviser when the investment adviser holds custody of client assets, or when an investment adviser's affiliated firms holds custody of client assets.

These major measures, along with other requirements imposed upon investment advisers (such as the maintenance of required books and records), work in unison to provide important protections for the consumer of services from an investment adviser.

Each of these solutions has its strengths and weaknesses. Some measures are more effective to identify and correct certain types of problems, while other measures are needed to combat other forms of misconduct. No one measure can be relied upon, alone. NAPFA believes that the SEC should seek to address the concerns it has expressed in the SEC's proposed rule by examining each and every one of these major measures, and judging their effectiveness as to addressing the concerns the SEC has expressed in connection with this proposal.

C. The Custody Rule Proposals: Deduction of Fees as Triggering Surprise Audit Requirements.

It should come as no surprise that NAPFA's members are most affected by, and generally opposed to, the imposition of a surprise annual audit by a PCAOB-certified public accountant, when custody results merely because of an investment adviser's ability to deduct fees from accounts held at qualified, custodians. NAPFA provides these several observations and recommendations as to this aspect of the SEC's proposal:

1. *The SEC Should Continue to Provide An Exception to the Surprise Audit Requirements When Custody Results Only Due to Fee Deductions.* In SEC Release IA-2876, the SEC inquires: "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?" The SEC also makes related inquiries.[1] NAPFA believes the answer to this question is a resounding "YES" – for the reasons stated later in this letter.

2. *The 27-Year Prior Exception for the Surprise Audit Requirements, When Fees Are Deducted From Client Accounts.* In 2003, the SEC noted in SEC Release IA-2176, "*We have been advised by groups representing advisers registered with us that perhaps as many as 90% of SEC-registered advisers deduct fees from their clients' accounts.*" Following various no-action letters issued previously [*see, e.g., Investment Counsel Association of America, Inc*., SEC Staff Letter (June 9, 1982)], investment advisers were not subject to surprise audit requirements merely because fees were deducted from client accounts.

   It should be noted that in 2003, the SEC did not express any great concern over the practice of investment adviser fee deductions, and the SEC placed greater reliance on the ability of clients to detect fraud when the consumers received monthly or quarterly statements directly from independent custodians.[2] As to fee deductions, in 2003 the SEC required that investment advisers who withdraw their fees from clients' accounts send clients invoices detailing how those fees were calculated

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[1] SEC Release IA-2876 provides for the following additional inquiries by the SEC, which are related to the fee deduction issue: "Should we instead specify requirements or restrictions regarding withdrawing fees from client accounts? If so, what should they be? Are there alternatives to the surprise examination that might provide similar protections, or are there additional requirements that we should also consider? For example, should we instead (or also) amend rule 206(4)-7, which requires 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? 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? Should the rule require surprise examinations to be conducted more frequently than annually or, alternatively, on a regular periodic basis, e.g., semi-annually?" Furthermore, the SEC noted that "When we adopted rule 206(4)-7 in 2003, we stated that an adviser's compliance policies and procedures adopted and implemented under the rule should address 'safeguarding of client assets from conversion or inappropriate use by advisory personnel.' See *Compliance Programs of Investment Companies and Investment Advisers*, Investment Advisers Act Release 2204 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)], at Section II.A.1."

[2] The Commission, in SEC Release IA-2044, in which the SEC proposed the rules that led to the 2003 Final Rule on custody, stated: "Advisers that intend to misuse client assets can fabricate client account statements and, because the surprise examination is performed only annually, many months may pass before the accountant has an opportunity to detect a fraud. After reviewing the operation of the current rule and evaluating its benefits and costs, we are proposing an entirely different approach to protect advisory clients — an approach that would rely on periodic disclosure of account information by a qualified custodian rather than rely on a surprise examination. We propose to exempt advisers from the requirements to send quarterly account statements and to undergo annual surprise examinations if the qualified custodian sends

Despite the major changes made in 2003 to the custody rule, at the time of adoption no concerns were expressed by the SEC with regard to the fee deduction exception to the annual surprise inspection requirement, an exception which has existed for decades.[3] Only six years later, the SEC is poised to impose substantial costs upon investment advisers – and without any evidence of abuse in this area.

3. *The Surprise Examination Proposal Contained in IA-2876, Summarized.* The SEC now proposes to require[4] a surprise examination by a public accountant for investment advisers, even if the only means by which the investment advisor possesses "custody" of client accounts is through a fee deduction process. Moreover, the SEC also proposes that public accountants be both registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (PCAOB). The SEC stated its belief that PCAOB registration and inspection will provide the SEC with greater confidence in the quality of the examination performed by the independent public accountant.

   Under the SEC's Proposed Rule, during a surprise examination, an independent public accountant generally must (i) confirm with the custodian all cash and securities held by the custodian, including physical examination of securities if applicable, and will reconcile all such cash and securities to the books and records of client accounts maintained by the adviser, (ii) verify the books and records of client accounts maintained by the adviser by examining the security records and transactions since the last examination and by confirming with clients all funds and securities in client accounts, and (iii) confirm with clients, on a test basis, closed accounts or securities or funds that have been returned since the last examination. The results of the examination must be reported by the accountant to the Commission.[5] In addition to the specific procedures an independent public accountant must follow

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monthly account statements directly to each advisory client. *Qualified custodians' delivery of account statements to clients directly should provide clients with confidence that any erroneous or unauthorized transactions or withdrawals by an adviser have been reflected.*" [*Emphasis added.*]

[3] In SEC Release IA-2044 (2002), in discussing the proposals eventually adopted as the first substantive changes to the investment adviser custody rule in over four decades, the SEC stated: "The no-action assurances in these [no-action] letters are conditioned on the advisers' use of alternative procedures to protect client assets, including an independent custodian's periodic delivery, to the clients, of information about the withdrawals. We have designed the proposed rule so that these advisers would be able to comply with the rule without facing the burdens they previously sought to avoid."

[4] In SEC Release IA-2876, the SEC proposes "to amend rule 206(4)-2 to require investment advisers subject to the rule to enter into a written agreement with an independent public accountant to conduct the surprise examination requiring the accountant, among other things, to notify the Commission within one business day of finding material discrepancies, and to submit Form ADV-E to the Commission accompanied by a certificate within 120 days of the time chosen by the accountant for the surprise examination, stating that it has examined the funds and securities and describing the nature and extent of the examination."

[5] The SEC further inquired in SEC Release IA-2876, with respect to the surprise inspection requirements and methodology: "is confirming all client balances necessary to adequately protect investors? If not, what extent of confirmation would be appropriate? Are there any procedures currently required to be performed as part of a surprise examination that should be clarified? If so, how should they be clarified? Have investment advisers' custodial practices or operations changed such that we should revise our existing guidance on performing the surprise examination? If so, what revisions should we make? If the proposed rule is adopted and a greater variety of advisers become subject to the rule's surprise examination requirement, should we provide additional guidance to assist different types of advisers and their accountants in complying with the surprise examination requirement? If so, what additional guidance should we provide?" The SEC also noted: "As stated in note 33 of the 2003 Adopting Release, the accountant must perform the examination in accordance with U.S. Generally Accepted Auditing or Attestation Standards and the standards established by the Commission, except that the accountant must verify all or substantiate *all* client funds and securities covered by the examination. The examination should include confirmation of *all* client cash and securities of which an

during a surprise examination, the SEC already requires that the accountant should perform any additional audit procedures it deems necessary under the circumstances.

4. *"Loophole" or "Justified Exception"?* In discussions with SEC staff, NAPFA has learned that the impetus for the requirement of surprise inspections where custody results only from deduction of fees from client accounts, is the result of a concern at the Commission that a "loophole" may exist which would permit fraud to occur, and that this loophole may be taken advantage of as other means of engaging in fraud are foreclosed. NAPFA believes that the fee deduction exception to the surprise annual inspection requirement should not be characterized as a "loophole," but rather as a logical, justified exception to the requirement. Indeed, this exception exists as a result of a cost-benefit analysis which indicates that:

   a. great benefits exist for consumers with regard to the ability to pay fees through deduction from accounts

   b. the costs of imposing an annual surprise inspection by PCAOB-certified public accountants when custody results solely due to fee deductions are extremely high, especially for smaller investment adviser firms; and

   c. such a surprise annual inspection process by public accountants is inappropriate as a means of detecting fraud without being much more robust and comprehensive.

5. *No Evidence of Harm Exists That Would Be Addressed Through the Burdensome Requirement.* NAPFA is unaware of any instance in which the fee deduction requirement has led to substantial misappropriation of funds from client accounts. Hence, NAPFA questions whether the "remedy" of the SEC's proposals, regarding the surprise audit requirements upon investment advisers who possess custody merely because of fee deductions from client accounts held at qualified custodians, addresses any real, material threat.

6. *The Issue of Proper Valuation Is a Separate One, Best Addressed Through Targeted Rules.* In SEC Release IA-2876, the SEC inquires: "Should we require an accountant to perform testing on the valuation of securities, including privately offered securities, as part of a surprise examination?" NAPFA notes that various SEC enforcement actions have been undertaken with respect to investment advisers who improperly *calculated* fees due to alleged misrepresentations as to the *value* of the underlying securities. Even then, the surprise annual inspection requirement would not enable detection of this form of impropriety, without significantly increased costs of inspections. Imposing such a requirement upon PCAOB-registered public accountants, *if the only reason custody exists is due to fee deductions*, would further increase the cost of such audits.

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adviser has custody, regardless of whether they are held by qualified custodians, and reconciliation of all such cash and securities to the books and records of client accounts maintained by the adviser, as well as confirmation of such information with the adviser's clients. *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)]." [*Emphasis in original.*]

NAPFA notes that if custody results only due to the investment adviser's ability to deduct fees, in circumstances where qualified, independent custodians are always utilized by the investment adviser, then the valuation of publicly traded securities in liquid markets are nearly always undertaken by the qualified custodians and in accordance with SEC rules applicable to broker-dealer firms.

However, if the problem the SEC seeks to address is improper fee calculation due to incorrect valuations of a few illiquid or hard-to-value securities not held at the advisor's primary custodian, but for which the fee would be deducted from the normal custodial account, then the SEC could require other, more targeted measures to address this concern. For example, the SEC could require an investment adviser to disclose to clients the method by which illiquid, unregistered securities are valued for the purpose of fee calculation each time a fee was charged.

7. *The Many Advantages of Fee Deductions.* The fact that the vast majority of SEC-registered investment advisers deduct fees directly from client accounts reflects the numerous advantages to the process:

a. *Income Tax Efficiencies.* From a tax perspective, the deduction of fees directly from client accounts may result in a lesser tax burden placed upon the client. While investment advisory fees are deductible for federal income tax purposes, the deduction is often limited due to the 2% of adjusted gross income (AGI) limitation; some consumers don't come close to the ability to itemize deductions, and due to the phase-outs of itemized deductions for higher-income taxpayers. Moreover, when fees are deducted directly from qualified retirement accounts and traditional IRA accounts, the individual investor need not report the fee deduction as a retirement distribution for that year. For many taxpayers this can result in substantial tax savings. If the SEC imposes the surprise examination requirement on investment advisers who deduct fees, many investment advisers will switch to the manual process of billing, collecting checks from clients resulting in adverse tax consequences for many clients of such investment advisers.

b. *Cash Flow Concerns Met for Certain Clients.* Some clients of investment advisers possess all of their funds in qualified retirement accounts, and they have not yet reached the age (59½) where withdrawals can be made without a penalty (absent disability or some other exception). In such instances, clients often desire that fees be deducted directly from client accounts; particularly in instances where the client's other cash flows (i.e., income) are insufficient to pay the investment advisory fees directly without undue hardship.

c. *Cost Efficiencies for Investment Adviser Firms in Obtaining and Recording Payments.* Significant efficiencies for investment adviser firms result when fees are directly deducted from client accounts. The process of sending out periodic statements of fees, maintaining an accounts receivable listing, receiving checks for payment, making a copy of the front and back sides of the check, depositing it, and indicating receipt of the check in the accounts receivable ledger, can be extremely time-consuming and means the loss of time in which to perform activities that generate income. In addition, follow-up may be required for receivables outstanding through reminder invoices. NAPFA's members report that the ability to deduct fees results in substantially less time devoted to this administrative process, thereby providing an internal cost savings which can be passed on to clients. The resulting higher costs for investment advisers will likely be passed on to clients.

d. *Cost Efficiencies for Investment Advisers with Respect to Portfolio Reports.* The manual process of billing also affects the time spent on performance reporting, which is an integral part of an advisor's business. When fees are directly deducted from client's accounts, the download of transactions from custodians to reporting software has the fee deduction coded by the custodian. This results in ease of generation of performance-related informational reports for clients. In contrast, when payments of advisory fees are made by check, two entries must be made by the investment adviser in the reporting software, the payment of the fee, and the receipt of outside funds in payment of the fee. This manual entry process is both time-consuming and prone to error. For example, systems have emerged to provide *daily* online performance reporting; such daily online reports would be inaccurate until such time as the receipt of the check from the client is appropriately recorded. Given the large volume of checks, for advisors who engage in manual billing processes, it is simply not feasible for investment advisers to input the receipt of fee payments by checks written by the client on the very same day as they are received in the mail. Hence, again, the costs borne by the investment adviser firm which switches to manual billing and collection processes will likely be substantial, and the probability for incorrect reporting of net investment performance to clients would be increased.

e. *Convenience for Clients.* Our NAPFA-Registered Financial Advisors report that their clients greatly appreciate the direct deduction of fees from their accounts, as a matter of convenience. This relieves the client of the obligation to write a check (as most investment advisers do not accept credit cards, due to the often high fees imposed in connection with credit card merchant accounts). Moreover, clients can easily see their fee deductions from client accounts, not only in the statements delivered directly by third-party custodians, but also in the reporting packages issued quarterly, semi-annually or annually by many investment advisers. Fee deductions can also be seen in the custodian's online account information, which is normally available online to the consumer each business day. For many clients of investment advisers, fee deductions also show up in online consolidated portfolio reports - if provided by the custodian, or by the advisor directly using the advisor's own systems or an outsourced third-party provider. Much of the public already pays a substantial portion of their monthly bills by automatic deduction from their personal bank accounts.

8. *The Effectiveness of the Surprise Audit Requirement to Detect Fraudulent Activities Is Questionable.*

NAPFA is most respectful of the role of independent public accountants in compiling and verifying data, whether that data exists from public company annual reports or in other contexts. However, NAPFA is concerned that the PCAOB-certified public accountants, unless their role is to be greatly expanded to become a *de facto* substitute for SEC examinations of investment adviser firms, will often be unable to detect fraudulent activities, due to the limited scope of the present review process and the substantial measures that one engaged in fraudulent activities can undertake to cause such limited-scope examinations to be unable to detect fraud.

For example, suppose a PCOAB-certified public accountant undertakes an inspection of the client accounts of an investment adviser, including contacting the qualified custodian and a sampling of clients. Without a robust examination of the entire operations of the investment adviser firm, the public

accountant would not be informed by a fraudulent adviser of another set of client accounts which are maintained with another custodian (or by the advisor itself), the records of which are not revealed to the auditor. Instead, only the "qualified custodian" records might be provided during the inspection process.

A public accountant undertaking the limited-purpose surprise audit is under no obligation to undertake a comprehensive exam of the investment adviser, which might involve the ability to review (or at least sample) all of the investment adviser's books and records, undertake an e-mail review (by key words or otherwise), and interview a sampling of the employees of the firm. While revenue obtained from the qualified custodians could be compared against an investment adviser's financial statements and tax returns, it is still possible to commit fraud within these financial reports as well, and run revenue through accounts which are not reflected in these records or returns.

In essence, due to the limited scope of the exam, and the lack of training of PCOAB-certified examiners as *comprehensive examiners* of investment adviser firms, major frauds are unlikely to be detected by limited-scope audits. The objectives of the annual surprise audit requirement, to act as a deterrent to fraud, and to expose fraud relatively quickly, will only be partially achieved. It is highly likely that major frauds will continue to go on, undetected, despite a surprise annual examination requirement.

While the inherent deficiencies of a limited-scope examination can be solved through providing PCAOB-certified public accountants with the education, training and mandate to undertake *comprehensive exams* of investment adviser firms, the costs of such a comprehensive exam would likely be much, much greater than the cost estimates provided in the proposed rule for the limited-purpose exams, again calling into question the overall cost-benefit analysis.

9. *The Costs of Examination Are Likely Higher than the SEC Estimates.* The SEC estimated that the average cost of an annual surprise audit by a PCAOB-certified public accountant at $8,000. This is the same cost estimate the SEC utilized in 2003.[6]

Given the addition of the PCAOB certification and inspection requirement of the relatively few public accounting firms likely to undergo this process and become available to undertake audits, the SEC's continued utilization of this cost estimate is suspect.

NAPFA members, including those who currently and previously practice in the field of public accounting, have provided specific comments on this aspect of higher costs when only PCAOB-certified firms can undertake the audit, with one NAPFA member stating:

> "[We] are located over 200 miles from the nearest firm that is likely to be a member of the PCAOB or otherwise have any experience with this type of engagement, so we'd have travel expenses above and beyond the audit costs. In addition, the hourly rates of those firms are double to triple the rates of our excellent local firms. (I came out of a regional CPA firm in this

[6] In SEC Release No. IA-2176, the Commission stated: "We estimated in our Proposing Release that the amendments would generally reduce the paperwork burden for advisers. We estimated the aggregate burden under the current rule at 1,246,200 hours, and the aggregate cost under the current rule at $5,952,000, assuming that an adviser would pay an independent public accountant $8,000 to conduct an annual surprise examination."

area that did great audit work; on a couple of occasions when we turned to national firms to supplement or succeed us on projects beyond our expertise, the rates were typically in that range."

Many other NAPFA members questioned the estimate of the fee, and suggested that the SEC's estimate would be low, even for smaller registered investment advisers. Several members questioned the impact of the SEC's Proposed Rule on small investment advisers, and suggested that the rule results in an increased barrier to entry for small businesses into the investment advisory profession. One member questioned the overall effectiveness of the measure, from his experience as an auditor with a major public accounting firm:

> "As an auditor with [a Big Four accounting firm] for [many, many] years, I know the values and costs of audited financial statements. Having an independent custodian is a very strong requirement and the SEC is to be supported for making this a requirement of Registered Investment Advisors … Through independent custody, customers are furnished with periodic, generally monthly, statements of their accounts which are mailed directly to the customer by the custodian, independent of the RIA. Thus the customer has a periodic, reasonably frequent chance to review the assets and activity in his/her account. However, in relation to the strengthening of this control, the additional proposed regulation, annual audit, is a significantly higher cost without significant benefits ... [The] audit charge would cost me [a significant portion] of my current gross income … The fieldwork, review of audit product, production of reports for a surprise audit would generally take longer than one month."

Furthermore, at least one NAPFA members indicated that the imposition of this requirement would likely cause them to leave the investment advisory profession:

> "We cannot afford an outside audit and would be forced to consider leaving the investment management business. As a former auditor, I can offer expert testimony that this requirement is meaningless in detecting fraud."

NAPFA concludes that the costs of a PCAOB-certified annual surprise inspection would likely be much more substantial, on average, than the $8,000 amount estimated by the SEC in its Proposed Rule, and that the imposition of this cost does not result in substantial benefits to clients of investment adviser firms.

Moreover, the costs estimates do not appear to fully take into consideration the less tangible indirect (but very real) costs of the investment adviser's time - attention that is diverted from actually working on improving client portfolios and instead must be focused on compliance with regulations that are not really needed and do not meaningfully improve the security of client's assets.

10. *The Higher Burden on Small Investment Advisers.* Even if the "assets under management" threshold for SEC registration is raised to $100 million, the burden of the annual surprise inspection requirement will fall most heavily on smaller investment advisers, especially those that serve Americans with moderate or low incomes and/or account balances.

Generally, there are certainly economies of scale in serving clients, and the cost to audit a private wealth manager-model investment advisory firm, with 40 clients, 160 accounts, and $200 million of total assets under management, will be less than the cost to audit an investment adviser serving "middle America" with 200 clients, 800 accounts, and $100 million of total assets under management.

The impact of the costs on a small firm and its clients was revealed by written comments received by NAPFA's Industry Issues Committee from two NAPFA-Registered Financial Advisors:

> "Should the proposed rule be enacted, I estimate my annual direct costs at $10,000 to $15,000. This would represent my third largest expense after staff salaries and rent. I feel I would have to pass this onto my clients in the form of a specific 'SEC Audit fee' and it would likely add $100 per year per client."

> "The proposed rule does not provide significant additional protection for investors. However, it levies a significant cost that falls most heavily on smaller RIA firms. Certainly the SEC does not want to put small businesses at a disadvantage … An annual financial audit requirement would add no measurable investor protection."

NAPFA is greatly concerned that the growing compliance burden on smaller investment adviser firms, not only from this proposal but also from previously adopted compliance requirements, presents a difficult barrier to entry for new investment advisers.

Moreover, the SEC's rules on custody are highly likely to filter down to state-registered investment advisers. From conversations with state securities regulators, NAPFA has learned that most SEC rules end up being adopted, in some form, by the states, usually regardless of the amount of assets under management. It would be reasonable to conclude that the SEC's surprise annual audit requirement for advisors who possess custody only due to fee deductions would likely be implemented at the state level, as well, through state legislation or administrative rules.

11. *More Effective SEC Oversight Of Investment Adviser Firms Is A Far Better Solution.* NAPFA believes that the inherent limitation of limited-scope exams by public accountants points to the need to examine those functions that should be undertaken by the appropriate actors. As noted near the beginning of this correspondence, four major actors are involved in seeking to protect consumers and their hard-earned from theft or conversion by rogue investment advisers – (1) securities regulators; (2) the Chief Compliance Officer of the investment adviser firm; (3) qualified custodians; and (4) PCAOB-certified public accountants. Each of these actors has an important role to play in protection of consumers, and each should possess those functions which are most cost-effectively and/or appropriately undertaken by that actor.

In the present instance, NAPFA believes that the SEC, due to the limited funding Congress has historically provided to the SEC for its examination and inspection programs, is seeking to find an answer to its historic underfunding problems. Hence, the SEC seeks to delegate its "verification" function to another actor – yet the process of "verification" involves, necessarily, comprehensive

examinations of all aspects of an investment adviser firm, during which process many other inquiries can be undertaken as to compliance with all aspects of investment adviser regulation.

The function of government verification is an important one, as highlighted in recent testimony to the U.S. House Financial Services Committee by Professor Tamar Frankel:

> Today, more than ever we need government gate-keeping examiners. We need to change the way the government regulates. Government regulators should conduct thorough and frequent examinations of broker dealers, advisors and money managers, whether they are registered or exempt from registration, so long as they control a significant size of investors' money in whatever form. These examiners should be top notch experts, well paid and highly valued.[7]

The problems with the lack of funding of the SEC's examination programs for investment advisers are not new. In 1996 the SEC's Office of Compliance Inspections and Examinations noted that "high-risk" investment advisers would likely be examined only once every five years, and "low-risk" investment advisers would be examined as infrequently as once every 40 years.[8] While OCIE has endeavored to utilize its limited resources as effectively as possible, through sweep exams, initial targeted examinations of new advisory firms, and a continued focus on higher-risk firms, the underfunding of the examination function remains extreme. According to testimony delivered to the U.S. House Committee on Financial Services in February 2009:

> The Office of Compliance Inspections and Examinations has 425 staff dedicated to examinations of registered investment advisers and mutual funds, and approximately 365 staff dedicated to examinations of registered broker-dealers. Notwithstanding the explosive growth in the firms it examines and inspects, the staff of the Office has 90 fewer positions than it had at its high-water mark in FY 2006.

Given that there are over 11,000 SEC-registered investment advisers, and nearly a thousand investment companies that also require OCIE's resources for oversight,[9] as Lori Richards of the SEC's OCIE recently stated: "[T]here should simply be more cops on the Wall Street beat than there are today."[10]

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[7] Testimony of Ms. Tamar Frankel, Professor of Law and Michaels Faculty Research Scholar, Boston University School of Law, before the House Committee on Financial Services hearing, "Assessing the Madoff Ponzi and the Need for Regulatory Reform" (Monday, January 5, 2009).

[8] "With the new staff being made available, OCIE hopes to reduce the examination cycle for high-risk advisers to one every five years … one-quarter of its previous length … the lower-risk advisers will be examined, on average, approximately once every forty years." Lori Richards and John Walsh, "Compliance Inspections and Examinations by the Securities and Exchange Commission," *The Business Lawyer*, Vol., 52, No. 96, at p.149 (1996).

[9] "There are approximately 11,300 registered investment advisers and 950 fund complexes with over 8,000 mutual fund portfolios … There are approximately 5,600 broker-dealers, 174,000 branch offices, and 676,000 registered representatives … Our program is risk-based, which means that we seek to accord resources to those firms and issues that present the greatest risk to investors. Our overall examination plan consists of numerous complementary components: routine and periodic examinations of those advisers (about 1,000) that are considered "higher risk;" routine examinations of large broker-dealer firms to evaluate their internal controls; "oversight" examinations of broker-dealers to evaluate the SROs' regulatory programs; cause exams based on indications of violations; "sweep" exams focused on particular risk areas; random examinations of lower risk advisers; and visits to newly-registered advisers." Lori Richards, Speech, "Compliance Through Crisis: Focus Areas for SEC Examiners and Compliance Professionals," National Society of Compliance Professionals (Oct. 21, 2008).

NAPFA believes that Congress, after many years of neglect, should address the needs for oversight of investment advisers through several measures, including but not limited to self-funding[11] of the SEC's examination functions by appropriate fees levied upon investment advisers, broker-dealers, and investment companies. Investment advisers possess a strong desire to ensure that all investment advisers adhere to their fiduciary duties, as the failure by a few investment advisers in betraying the trust of their clients affects the reputation of all investment advisers.

A critical portion of restoration of the confidence of Americans can be undertaken through an embrace of the many positive aspects of the Investment Advisers Act of 1940, and the fiduciary relationships between advisers and clients which are fostered there under. Through cost-effective, comprehensive oversight, directly by the SEC, the verification and review processes of the SEC can aid in this restoration of trust - provided that the SEC receives authority to self-fund its important inspections and examinations programs.

12. *Summary: Why the Fee Deduction Exception to the Custody Rule's Surprise Annual Audit Requirements Should Remain.* NAPFA believes that investment advisers should continue to be able to deduct fees from clients' accounts at qualified custodians, without that sole activity triggering the annual surprise audit requirement, for the following reasons:

    a. The ability to deduct fees directly from client accounts is convenient and tax-advantageous for consumers.

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[10] Lori Richards, Director, SEC Office of Compliance Inspections and Examinations, "Strengthening Examination Oversight: Changes to Regulatory Examinations," SIFMA Compliance and Legal Division St. Louis Regional Seminar, June 17, 2009.

[11] As recently stated by Commissioner Aguilar: "While additional resources are necessary, the SEC must also be provided with the ability to budget and self-fund its operations. This is especially vital. The SEC needs to be able to set multi-year budgets and have the resources to promptly respond to drastically changing markets. In fact, many financial regulators are self-funded and have the ability to respond quickly and plan strategically in a way that the SEC cannot." Commissioner Luis A. Aguilar, U.S. Securities and Exchange Commission, Speech, "NASAA Members and the SEC — United in the Public Interest and Making Investors a Priority," at the 2009 North American Securities Administrators Association Public Policy Conference, Washington, D.C. (April 28, 2009).

The concept of self-funding, and the SEC's request for such authority from Congress, is nothing new. As stated in a Congressional hearing by former SEC Chairman Arthur Levitt *over fifteen years ago* - in 1993: "Additional appropriations will not necessarily address a more fundamental budgetary concern, however. The best way to ensure that the Commission will continue to have adequate resources is for Congress to pass legislation that would make the Commission self-funded. Self-funding would ultimately link the fees paid by registrants and regulated entities to the services provided by the Commission. I should emphasize that self-funding would not remove the Commission from the important Congressional oversight, nor would it involve using fines or disgorgement payments. I strongly urge the adoption of self-funding as a vital and essential step in ensuring that the Commission has the continuing resources to oversee fairly, to oversee efficiently the investment company industry and the capital markets of the Nation." Oversight Hearing on the Mutual Fund Industry, Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs, U.S. Senate (Nov. 10, 1993). In the same hearing, this interchange occurred between then-SEC Chairman Levitt and Senator Faircloth:

"Senator Faircloth. Well, I'm totally supportive of your self-funding. We're 100 percent in agreement. But if you have self-funding, you wouldn't need the mutual fund self-regulatory organization. You could regulate it, couldn't you?

Chairman Levitt. I think we would certainly have the resources to provide the inspectors, without a doubt.

Senator Faircloth. So self-funding is really the answer to it.

Chairman Levitt. Self-funding is the single most important step that the Congress could take to help the country and to help the Commission."

b. The ability to deduct fees benefits investment advisers and their clients through the efficiencies gained in investment adviser operations, resulting in cost savings which can be passed on to clients.

c. The automated recording of fees deducted from portfolios facilitates accurate reporting of portfolio performance.

d. There is no substantial evidence of abuse of the decades-old “fee deduction” exception to the custody rule requirements, including the annual surprise audit requirement.

e. The costs of the surprise annual audit, for firms who simply deduct fees from qualified custodial accounts, are likely to be much higher than the six-year old estimate provided by the SEC, given the imposition of PCAOB-certifications and inspections on examiners and the effect of same on audit fees.

f. The proposal fails any reasonable cost-benefit analysis.

g. If valuation issues are the real concern of the SEC’s proposals, these could be handled more appropriately through targeted, less-costly rules.

h. Limited-scope examinations are ineffective to detect clever fraudsters. Comprehensive examinations, which should address not only custody issues but the entire realm of adherence to the fiduciary and compliance requirements imposed upon investment advisers, should be undertaken by a robust SEC examination process.

i. Even recognizing the current limitations the SEC faces in its funding processes, the cost-benefit analysis of the proposal still fails, as to the issue of annual surprise inspections for investment advisers who possess custody merely due to fee deductions.

NAPFA makes the following additional suggestions to the SEC, as to the manner in which the SEC can better accomplish its stated objectives, but in a less burdensome and cost effective way.

D. Additional Form ADV, Part I Change Suggested. The 2003 amendments revised the instruction to Item 9 of Part 1A of Form ADV, so that SEC-registered advisers that have custody solely because they deduct their advisory fees from clients' assets need not report custody for purposes of Part 1A. Investment advisers previously relied on the SEC staff's no-action letters to report that they do not have custody, with the SEC noting that “an adviser that has ‘custody’ for purposes of rule 206(4)-2 may not necessarily have custody for other purposes.” Since that time, NAPFA has heard anecdotal evidence that many advisers remain confused as to when they should report custody, and that some state-registered advisers are still required by state securities administrators to check off the “custody” box even if they have custody only for purposes of deducting fees.

The 2009 Proposed Rule suggests several amendments to the custody requirement. NAPFA suggests an additional amendment, designed to eliminate the confusion which exists in the investment adviser community as to how to answer the custody question in Form ADV, Part I. NAPFA suggests that two boxes be created to answer the question of custody:

"Do you deduct fees directly from client's accounts held at custodians?" (Y/N)

"Except for the fact that you deduct fees from client's accounts, do you possess custody of client accounts for any other reason?" (Y/N)

Alternatively, the SEC could inquire through a series of sub-questions as to the reasons the investment adviser has custody, with an "other" box reserved for less common answers. For example:

"Do you have constructive custody of client assets because you serve both as trustee and advisor on client accounts? (Y/N)

If yes, do you serve as sole trustee? (Y/N)

"Do you have passwords or access to other client accounts on which you are not listed as the primary advisor?" (Y/N)

If yes, "do you have the ability to direct distributions from the account to the client or to another person?"

E. **Notices to Clients.** Should the SEC require advisers to include a statement in the notice sent to clients urging clients to compare the account statements they receive from the custodian with those they receive from the adviser? ***Yes***.

NAPFA believes that it is important to encourage clients to compare statements from their custodians with invoices received from the advisor. Printing a notice on each invoice should not represent a hardship for any advisor.

Clients might also receive, an annual reminder (which may be at the same time as the delivery of the Form ADV offer, or the annual privacy statement) to review their custodial statements upon receipt. Concerns exist about such a notice causing client distrust. However NAPFA believes the form of the notice can be undertaken with language which softens this. For example, the form of the notice might state: "How You Can Help Us to Protect You – "Trust but Verify." Despite the best efforts of any firm to safeguard client's assets, fraud (such as that which occurs through forgery) could still occur. While we hope that you trust our firm and your advisor, we believe it is nevertheless important for you to verify your investment holdings by comparing statements from your custodian with statements prepared by us.

F. CCO Certifications. Should an RIA's Chief Compliance Officer (CCO) possess responsibility to certify that "all client assets are properly protected and accounted for"? ***No.***

In NAPFA's view, the CCO already possesses the duty to provide oversight, including the adoption of reasonable measures to seek to prevent and/or detect fraud. The CCO Annual Review already requires a specific review of the procedures to detect fraud. Also, the language as to what is certified is ambiguous, thereby leaving a CCO open for liability for just about anything. Furthermore, any new requirement to review "all client accounts" and "certify" holdings would impose a very time-consuming burden on CCOs, which

compliance resources we believe are better utilized elsewhere, such as in oversight of due diligence processes with respect to investment products and, as stated below, better avenues to detect and prevent fraud.

For example, instead of requiring a time-consuming review by the CCO (or her or his designee) of "all client assets," NAPFA believes that the SEC should provide additional guidance to RIA firm CCOs of the need for forensic testing in this area. For example, the SEC could strongly suggest, or even mandate, that the CCO or her/his designee review all withdrawals from accounts of cash (including wire transfers) and transfers out of securities on a regular basis, as to those withdrawals and transfers which exceed a certain amount. Included in such forensic testing may be a suggestion for the CCO and/or her/his designee to contact clients upon the detection of any suspicious withdrawals or transfers out of securities in large amounts.

In essence, CCO review of withdrawals/transfers out is better than verification of "all client assets" on a periodic basis. It is more efficient and timely, and more likely to lead to the detection of fraudulent activities. The use of qualified, independent custodians, together with the CCO reviews of transaction ledgers, would ensure the integrity of the clients' assets for RIA firms.

In Conclusion The National Association of Personal Financial Advisors (NAPFA) appreciates the opportunity to submit these comments. NAPFA would be more than pleased to have its representatives meet with representatives of the Commission to discuss the ideas, suggestions and concerns noted herein. Thank you.

Respectfully,

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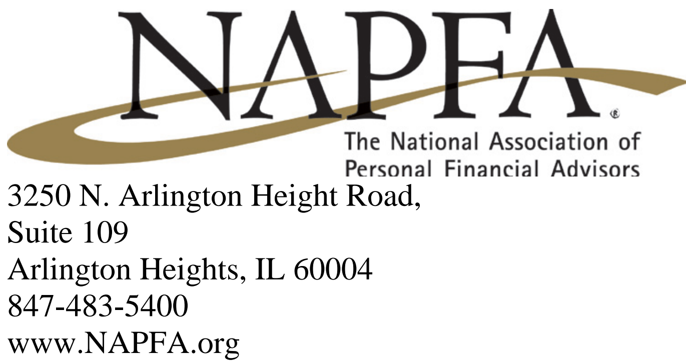
NAPFA has more than 1,300 NAPFA-Registered Financial Advisors across the United States. All NAPFA-Registered Financial Advisors must submit a comprehensive financial plan and undergo a thorough review of their qualifications prior to admission. NAPFA-Registered Financial Advisors all sign a Fiduciary Oath which states that the advisor will only work in good faith and with the best interests of the consumer at heart. NAPFA-Registered Financial Advisors are strictly Fee-Only®, which means they do not accept commissions or any additional fees from outside sources for the recommendations they make to their clients.

EXHIBIT A



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Are You Worried About Your Financial Advisor?

There are a few important steps to take if you suspect wrongdoing on the part of your financial advisor.

Working with a qualified financial advisor can provide peace of mind for consumers who are not comfortable managing their financial lives on their own. But, in a vast industry of hundreds of thousands of financial advisors, some bad apples do exist. There are a few who take advantage of those they promise to help. So, what should consumers do if they suspect their advisor is acting in an unethical manner?

The National Association of Personal Financial Advisors (NAPFA) has been a vocal advocate for the consumer for more than 25 years and stresses that if greater protection is put in place, consumers will still need to be actively engaged so that they can identify and report fraudulent behavior if it occurs.

NAPFA recommends consumers take the following actions if they have concerns about their advisor:

- **Call the advisor immediately.** Consumers must ask their advisors to explain discrepancies or oddities they see on the statement for their account(s). Having this discussion is important since in most cases there is a valid explanation.
- **Ask for an in person meeting with the advisor.** Whether or not a phone conversation takes place with the advisor, consumers should be able to schedule an in person meeting with the advisor and have an open discussion about concerns. If this doesn't resolve the questions or issues, request a meeting with a supervisor as a follow-up.
- **Contact the advisor's independent custodian.** Independent financial advisors process transactions on a client's behalf through an independent custodian. Consumers should contact the custodian if they continue to have concerns about their account(s).
- **Notify the advisor's broker dealer.** Many financial advisors are also registered with a broker dealer. If this is the case with your advisor, make sure the brokerage firm is aware of any potential wrongdoing. Write a letter and send it to the branch manager and home office if the advisor is a registered representative with a broker dealer.

- **File a formal written complaint.** If you are unable to resolve the issues or concerns with meetings and/or discussions you will need to file a formal complaint with the regulatory authorities. If the advisor is a smaller Registered Investment Advisor (RIA), consumers should file a complaint with the state securities regulator. The state's securities administrator can be found at the NASAA website at http://www.nasaa.org/QuickLinks/ContactYourRegulator.cfm. If the advisor is part of a larger firm, file a complaint with the SEC at http://sec.gov/complaint.shtml. If your advisor is affiliated with a brokerage firm, file a complaint with the FINRA at http://www.finra.org and click on "Investors" then on "Complaint Center".