NAIFA
National Association of Insurance and Financial Advisors
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July 27, 2009

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

Via Electronic Mail: rule-comments@sec.gov

Re: File Number S7-09-09: SEC Request for Comments on Proposed Rule Change RIN 3235-AK32; Custody of Funds or Securities of Clients by Investment Advisors

Dear Ms. Murphy:

This letter will present the views of the National Association of Insurance and Financial Advisors ("NAIFA") in response to the Securities and Exchange Commission's invitation to submit comments on the issues raised by the Proposed Rule Change on Custody of Funds or Securities of Clients by Investment Advisors.

NAIFA is a national federation of over 700 state and local associations, whose members live and work in every congressional and state legislative district. NAIFA represents the interests of approximately 200,000 agents, advisors and their associates nationwide. NAIFA's members are bound by NAIFA's Code of Ethics and are full time professionals in insurance and related financial services. Founded in 1890, NAIFA is the nation's oldest and largest trade association of insurance and financial services professionals. NAIFA's mission is to advocate for a positive legislative and regulatory environment, enhance business and professional skills, and promote the ethical conduct of its members. Over half of all NAIFA members are licensed as registered representatives of broker-dealers and market and service various types of financial products, investments and securities.

The proposed rule change would significant alter Investment Advisers Act Rule 206(4)-2, the "Custody Rule," which requires advisors with "custody" of client assets to maintain certain controls to protect those assets from being lost, misused, misappropriated or subject to the advisor's business setbacks, such as insolvency. Any investment advisor that is required to be registered with the SEC is subject to the Rule. The proposed change would require every adviser with custody of client assets to engage an independent public accounting firm to conduct an annual surprise audit to verify client assets. The independent public accountant would then file a certificate with the SEC within 120 days of the audit stating that it has completed such examination. If the accountant finds any discrepancies, they must be reported to the SEC within one day of discovery. The accountant must also file a notice with the SEC within four days of resignation, dismissal, or removal.

NAIFA recognizes the importance of investor protection and understands why the SEC is looking to bolster its already strong custody rules. We think the proposal is unnecessary, however, and are concerned about its effect on the consumer and smaller investment advisors and their representatives.

Our comments will focus on the following points:

- First, the proposed change does not provide significant additional protection for investors. The surprise audit requirement would be in addition to the Custody Rule's current requirements that advisors with custody retain those client assets with a qualified custodian and for the custodian to directly send account statements to clients. The current requirement gives investors the ability to sufficiently identify and detect erroneous or fraudulent transactions. An additional surprise audit requirement would be superfluous.

- Second, the cost of this requirement will ultimately harm consumers. Requiring the roughly 9,500 federally registered investment advisory firms to undergo surprise audits by outside auditors would be tremendously costly. Much, if not all, of the extra costs of these surprise audits are likely to be passed on to consumers.

- Third, we are not aware of any major abuses occurring when investment advisers merely exercise their authority to deduct fees from client accounts. It is inappropriate to extend the annual surprise audit requirement to advisers who have "custody" merely because they are authorized to deduct fees from client accounts.

1. **<u>The proposed rule change does not provide significant additional protection for investors.</u>**

The SEC proposal would require that advisers with custody of client assets must undergo an annual surprise examination by an independent public accountant, in addition to the requirements that advisers with custody must have client assets held by a qualified custodian and have the custodian send quarterly statements directly to the client. The premise behind the surprise examination requirement is to provide "another set of eyes" on client assets to prevent fraud and misappropriation of client funds by registered advisers. Instead of providing real protection, however, this proposal merely layers on duplicative and *ad hoc* regulation that adds cost with no substantive benefit.

The Custody Rule's current requirements – that advisors with custody retain those client assets with a qualified custodian and that the custodian directly send account statements to clients – provides significant and sufficient investor protections, and there is no need to add another costly and ineffective requirement. The third party custodian already acts as a gatekeeper to the advisor's ability to pull funds from client accounts, making it virtually impossible for a an advisor using a major third party custodian, (such as Charles Schwab, TD Ameritrade, Fidelity, etc.) to 'drain the account' through fees, as they will not process withdrawals that exceed a certain percentage per year. Additionally, it is unlikely that an investment adviser would be "surprised" by an audit that the adviser paid for. This requirement is too easily circumvented and made pointless.

2. **The proposed rule would result in unnecessary costs to the consumer.**

Although the spirit of this proposed rule change is to give investors more protection, investors will be paying a high price for only a marginal benefit. The unintended consequence of this proposed rule change is that the costs will end up flowing down from the adviser to the end client, making investments more costly and less profitable, which will result in advisory services being less accessible to smaller investors.

The SEC estimates that over 9,500 registered advisers would pay an average of $8,100 in accounting fees for the newly required surprise examinations. The proposed regulation adds significantly to costs without concurrently adding benefits. The wrongful taking of client assets is a criminal act. Increasing the regulatory burden on the entire industry will only punish the overwhelming majority of honest, law-abiding advisors, and it is not going to change the fact that there are a small number of bad actors out there who are willing to break the law no matter what the regulatory requirements are. Moreover, the proposal will not change or enhance the authority of the SEC and law enforcement officials to go after these bad actors.

3. **The proposed "surprise audit" rule should not apply to advisers that merely are authorized to deduct fees from client accounts.**

As a final point, if the only reason advisers are considered to have "custody" of funds is because they have the authority to debit management fees from the client's account, the SEC should at a minimum exempt those advisers from the surprise examination requirement. The ability to withdraw fees from a client account does not give investment advisors complete control of the cash and other assets inside the account. The fact that Bernard L. Madoff Investment Securities LLC of New York self-custodied assets may have allowed their scheme to remain hidden for years. But that does not mean that advisers with the limited authority to deduct fees cause similar risks to the public. Adoption of the proposed revision to the Rule would force many small advisory firms to stop deducting fees from their clients' accounts and instead wait to be reimbursed by the client, which could create cash flow problems for the firm. Imposing this requirement on these types of advisers would create significant burdens without the benefit of any new or additional investor protections.

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In sum, NAIFA strongly encourages that the proposed change, requiring that every adviser viewed to have “custody” of client assets engage an independent public accounting firm to conduct an annual surprise audit to verify the client’s assets, not be adopted. Requiring advisers to use qualified custodians and having the custodians send quarterly statements directly to the client both provides sufficient protection and is cost-effective and fair.

Thank you for your consideration of our views. Please contact the undersigned if you have any questions regarding our comments.

Yours Truly,

/s/ Gary A. Sanders

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Gary A. Sanders
Vice President, Securities and State
Government Relations