July 27, 2009

Dear SEC,

I am the president of a California-based Registered Investment Adviser that employs ten persons and has approximately 175 advisory clients.

I am writing to comment on the SEC's proposal to require an independent public accountant's annual surprise examinations of Registered Investment Advisers' (RIAs) clients' assets, specifically with regard to RIAs who are deemed to have custody solely as a result of their authority to withdraw advisory fees from client accounts.

Hereinafter, I use the word "Proposal" to refer solely to that aspect of the SEC's proposal applying to RIAs deemed to have custody solely as a result of their authority to withdraw advisory fees from client accounts. Except for the final paragraph of this letter, in which I support the notion that all RIAs should be required to hold all client assets at independent qualified custodians, I have limited my remarks only to the Proposal.

The Proposal is severely flawed.

1. The SEC has not demonstrated that its Proposal addresses a real problem, as opposed to a theoretical one. We are not aware of any abuses arising from RIAs' ability to withdraw advisory fees from client accounts, nor has the SEC cited any cases of misappropriation of client assets through advisory fee deduction. In fact, not one of the many enforcement actions referenced by the SEC in footnote 11 on page 7 involves such an abuse. The Proposal is a solution in search of a problem. Consequently, the Proposal fails any reasonable cost/benefit test, even if one accepts the SEC's estimate of the cost of the Proposal. (As noted below, we believe the SEC has significantly underestimated the true cost of the Proposal.) The only certain outcome of the Proposal, if enacted, is some combination of higher advisory fees for clients and reduced employment at RIAs.
2. Advisory fees deducted by RIAs already are fully disclosed in the statements sent to clients by the independent qualified custodian. As the SEC itself says on page 5, "Clients can use the statements they receive from the qualified custodians to compare them with the statements (or other information) they receive from their advisers to determine whether account transactions, including deductions to pay advisory fees, are proper." The opportunity for abuse is therefore strictly limited, and any such abuse would be detected quickly.

3. The actual requirements of the accountant's surprise examination vastly exceed the scope of the Proposal. And ironically, there is no reason to believe that such an examination would be effective in identifying an abuse related to advisory fee deduction. For example, the main components of such examinations - confirming and reconciling all custodian-held cash and securities, etc. - fails even to address the potential for unauthorized fee deductions.

4. The SEC significantly mis-estimates the Proposal's likely cost, and even the mere feasibility of the Proposal. According to the PCAOB website, there are approximately 1,100 PCAOB-registered public accounting firms in the US. It is likely that only some small minority of these firms is willing and able to perform the kind of securities-related surprise examinations contemplated by the Proposal. The typical RIA subject to the Proposal generally is a small, private, closely-held company whose relationship with an accounting firm is limited to tax return preparation and does not involve auditing. Expecting 7,126 RIA firms (the SEC's estimate of RIAs not managing pooled accounts that would be subject to the Proposal), most of which do not presently have a relationship with a PCAOB-registered firm, each to be able to engage such a firm seems highly unrealistic. Given the likely imbalance between the supply of willing and qualified accountants and the sudden demand by RIAs, it seems even more unlikely that RIAs could obtain the required accounting services at the SEC's estimated price of $8,100 per annum, or in many cases at any price at all. Viewed from the accounting firm's perspective, given that the average RIA's assets under management could easily exceed $100 million, it is equally hard to imagine any rational accountant accepting the potential legal liability associated with a surprise examination for a mere $8,100 annually.

A reasonable and effective alternative to the Proposal would have the following components.

1. RIAs having all client assets held by an independent qualified custodian should be exempt from any surprise accountant examination requirement.
2. RIA advisory agreements must explicitly disclose that the client is authorizing advisory fee deduction from their account(s).
3. Custodial account agreements must require active (not passive) consent to the withdrawal of advisory fees from the client's account(s).
4. Custodial account statements must clearly identify RIA-initiated advisory fee withdrawals as such.
5. RIAs must provide a fee statement to the client within 30 days of any advisory fee deduction from the client's account. The statement must disclose the amount of the fee, detail the method of fee calculation and identify the specific custodial account(s) from which the fee was deducted. This facilitates client comparison and confirmation with the custodial account statements.
6. The SEC should consider establishing a standardized advisory fee deduction procedure to be enforced by the client's independent qualified custodian. As an example, the procedure could limit RIA-initiated fee deductions to one per calendar quarter and could limit the amount of such quarterly deduction to 0.75% of the assets of an account (or a defined group of accounts belonging to a single client) as measured on the last day of the calendar quarter. Deductions falling outside this standardized regime would require a separate client authorization form submitted to the custodian. (Note that permitting measurement by account

group is important in order to facilitate tax-efficient fee deduction; for example, paying the advisory fee for an IRA from an after-tax account.)

The SEC has requested comment on whether, as an alternative to its proposal, it should simply amend rule 206(4)-2 to require that an independent qualified custodian hold client assets. This strikes us as a simple and elegant solution. We are hard pressed to understand why an RIA's custody of client assets can ever be so important as to justify the costly and complex set of rules necessary to try to police such arrangements. The simplest way to keep the fox from eating the chickens is to bar the fox from the henhouse altogether. No amount of accountant's reports should be expected to prevent a fox from eating the chickens once inside.

Yours sincerely,

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