July 27, 2009

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

RE: Proposed amendment to Rule 206(4)-2 (the "Proposed Rule");
Release No. IA-2876 (the "Release");
File Number S7-09-09.

Dear Ms. Murphy,

I am writing for and on behalf of The National Association of Active Investment Managers ("NAAIM") to urge reconsideration of Part II(A)(1) of SEC Release IA-2876, File Number S7-09-09. As a matter of background NAAIM was formed in 1989 as a non-profit association of registered investment advisors who provide active money management services to their clients. Originally called SAAFTI and comprised of a small group of successful firms, NAAIM has grown to include roughly 130 member firms nationwide, managing an estimated $10 billion. NAAIM's purpose is to promote the common interests of those investment advisors who provide active investment management services to clients. NAAIM's membership ranges from small regional firms to large national firms with over $1B AUM.

While NAAIM for the most part applauds the Commissions efforts in advancing the Proposed Amendment to Rule 206(4)-2, NAIIM and its constituent member firms are strongly opposed to the imposition of the surprise audit examination provisions upon investment advisers who utilize qualified independent custodians and whose "custody" of client assets extends no further than the ability to deduct advisory fees from client accounts.

The text of the Proposed Rule tries to characterize the changes imposed on advisors by the Rule as the return to the surprise audit rules that preexisted the adoption of the current Rule in 2003 (at pp 8 & 9). At p 39 of the report it even states that the Proposed Rule would simply "reinstate the surprise audit rule."

However, with respect to the imposition of the surprise audit requirement on advisors whose only connection to custody is the deduction of advisory fees, this is a first. The reinstatement characterization ignores over three decades of these advisors operating within a line of SEC interpretations spanning those three decades.[1]

Prior to the 2003 Rule, advisors were not deemed to have custody if, as was stated in Release 1000, (1) the client provides written authorization permitting the advisor's fees to be paid directly from the client's account held by an independent custodian, (2) the advisor sends to the client and the custodian at the same time, a bill showing the amount of the fee, the value of the client's assets on which the fee was based, and the specified manner in which the advisor's fee was calculated, and (3) the custodian agrees to send to the client a statement, at least quarterly, indicating all amounts dispersed from the account including the amount of advisory fees paid directly to the advisor.

In the 2003 proposed rule, the Commission staff stated that the Commission had designed the proposed rule so an advisor could comply with the amended rule without facing the "burdens they previously sought to avoid,"[2] i.e. the surprise audit provisions. Now we have come full circle.

The test of the new proposal acknowledges that most advisors “do not maintain physical custody.” (p 3) In fact, based on the numbers discussed in the Release, over half of the advisors impacted by the new surprise audit rule are only deemed to have custody because they deduct fees.[3]

The advisors deduct these fees pursuant to a limited power of attorney signed by each client authorizing the advisor’s trading of the account and the deduction of its fees from the account. No other withdrawals are permitted. The mere fact of deducting fees from an account cannot in any way imply that non-fee deductions can be made (a la Madoff). In other words, neither the custodian nor the RIA is provided any legal authority to transfer funds out of an account (other than agreed upon fees), absent permission from the account holder.

Similarly, the staff appears to accept that the qualified custodians utilized by these advisors are already “subject to extensive regulation oversight.” (p. 4) In 2002, the Commission indicated that they did not believe that advisor utilization of these independent custodians “presented additional custodial risk.” (pp 27, 28; fn 55)

What caused the change in position we are now faced with? What is the reason for now imposing the “burdens they previously sought to avoid"? The Release cites the fact that “In recent months, the Commission has brought several enforcement actions against investment advisers and broker-dealers alleging fraudulent conduct, including misappropriation or other misuse of investor assets.” (p 7) In footnote 11 it provides citations of six recent cases. However, none of them relates to activity made possible because of the ability to take fees from an independently custodied account. Nor are we aware of any such annotated cases.

As the Commission is well aware, Rule 206(4)-2, as currently constituted, provides that a federally registered investment advisor is deemed to have custody of client assets merely on the basis that such advisor has the power to deduct advisory fees from its client accounts. The audit requirements now contained in Rule 206(4)-2 are inapplicable if an independent qualified custodian maintains all client account assets and the advisor has a reasonable belief that such qualified custodian will deliver account statements, not less frequently than quarterly, directly to clients. Such statements, at a minimum, must identify the amount of funds and securities at the end of the period as well as all interim activity in the client account.

When coupled with the requirement that delivery of the fee invoice to the client precede liquidation thereof by the independent custodian, the current Rule 206(4)-2 assures that advisory clients have all information necessary, directly from the independent qualified custodian, to enable reconciliation of the fee amount to the activity in their accounts.

While the Commission indicates that any benefits of the Proposed Rule are "difficult to quantify," none are provided for expanding the surprise audit rule to advisors with client assets at independent qualified custodians who simply deduct fees. Among the Commission's justifications for extension of the surprise audit requirement to advisors who have custody solely because their clients authorize fee liquidation is to "provide another set of eyes on client assets." The current rule already provides two "sets of eyes," those of the qualified custodian (the activity of which is highly regulated and monitored) and those of the client. To impose a required third "set of eyes" is unwarranted by the regulatory history.

We note that many of the commentators suggest that they would choose direct invoice and direct client payment as opposed to subjecting themselves to the surprise audit requirement. We, however, surmise that the procedure of choice may entail an ACH authorization from the client, in which event the Commission's mandate of a third "set of eyes" will come full circle, resulting in the removal of the second "set of eyes" that is now in place.

The other reason advanced for the rule change is that an independent public accountant "may identify misuse that clients have not, which would result in the early detection of fraudulent activities." Not only does an audit of indeterminate timing fail to assure early detection, but the case books are replete with cases of independent accountants failing to detect or conspiring in the most obvious of frauds.[4] And, again, there is no citation of any instance where the existence of an advisor's right to be paid by its client from an independent trust account opened the door to any fraudulent activity.

No one would quarrel with the Commission's reasons for tightening the regulation of advisors who have actual or related-party custody. The case for that is well established and we would support going farther and requiring all advisors to utilize independent custodians. (After all, most advisors already do, and if 95% of investment companies can do so on a cost effective basis, so can other entities. [fn 54] Furthermore, in answer to a Commission interrogatory at p. 28, a number of our members offer "wrap fee" programs marketed to clients of broker/dealer clients with accounts as small as $5,000 and all are custodied at qualified custodians.)

In the final analysis, an objective observer would necessarily conclude that the Release has failed to establish ANY nexus between the benefits it seeks and its imposition of surprise audits on advisors utilizing independent custodians simply to deduct fees.

In section II(B)(4) of SEC Release IA-2876, File Number S7-09-09, the Commission proffers its concern that the protections afforded by imposition of a requirement that all client assets be custodied with an unrelated qualified custodian may not "warrant the additional cost." In the very section of its discussion that focuses on the root cause of the current scandals, the Commission finally raises the specter of cost versus benefit. Why is that concept lost during analysis of application of the surprise audit proposal to advisers whose access to client funds is limited to fee withdrawal under the oversight of an independent, qualified custodian?

There is significant cost associated with the conduct of the annual surprise in terms of both advisory personnel and professional accounting fees. The short-term burden of these costs may fall to the advisory firm, but, ultimately, market forces will pass same to the client.

And the cost of such a "burden" is substantial. Even if the cost figures used in the Release are correct (and we believe they underestimate the true cost), the average firm would expend $9,356 ($8,100 audit fee plus hourly cost of $1,256) each year solely on the surprise audit requirement.

Based on 2004 FPA Financial Performance of Financial Advisory Practices, sponsored by SEI Investments and produced by Moss Adams LLP., firms with annual gross revenues of $250,000 to $1,000,000 (comprised of firms with approximately $25M to $100M AUM and a 1% fee) have an average operating profit of 10.8%. For these firms, the addition of $9,356 will substantially erode operating profit (taking 34.6% of the operating profit of the smaller firms and 8.6% of those with AUM of $100M). Most of our membership falls within this AUM range.

It appears from the Release that less than 15% of registered advisors fail to use independent custodians; and only 190 are currently required to undergo surprise audits. Uniformly requiring the 190 to 1600 firms that may not use qualified custodians to use them would better balance the benefits with the costs, and apply those costs where the risks are greatest.

Rightly so, the Commission requires advisors to adopt policies and procedures "reasonably designed" to accomplish their intended purpose. Application of the same "reasonably designed" standard to SEC Release IA-2876, File Number S7-09-09 should result in the realization that Rule 206(4)-2, as currently constituted, provides sufficient investor protection against any abuses related solely to liquidation of advisory fees directly from client accounts. A cost/benefit analysis should cause withdrawal of the extension of the surprise audit provisions to advisers who utilize only qualified custodians for the purpose of obtaining fee deductions.

Using the figures supplied in the Release, it appears that imposing the new $9,356 annual internal and external audit cost on 9,385 more advisors will cost the advisory industry $87,804,910. 61.9% of that will be imposed on advisors whose only "custody" is to deduct fees, pursuant to a signed client authorization, from an independent qualified custodian. That's

$55,742,318 charged to those whose requisite actions have no nexus to the abuses that the Commission seeks to remedy and for which there is no related benefit to offset against the cost.

While we believe that the qualified custodian requirements of the existing Rule provides adequate checks and balances to assure investor protection against abuse of fee liquidation authority (a right granted by the client in writing), we would urge that, if a third “set of eyes” is deemed necessary, such third set be provided on a more cost efficient basis. That is, by the mandate of an annual certification of each advisory firm’s Chief Compliance Officer in a prescribed format. Required bonding of all employees would also provide additional investor protection. If the Proposed Rule is made final, consideration should be given to reinstating the Release 1000 rules.

If, despite the reasoning above, an audit is required, it, too, should be done on a more cost effective basis. To require auditors to confirm all funds and securities in client accounts ignores the success of sampling used in all other audit procedures. We all hear stories of clients who are upset by the random samplings occasioned by a normal audit. The new rule would expand this to 8,214,262 account holders. (fn 135) This is clearly overkill.

In addition, many advisors have multiple custodians scattered across the nation. It should be clear that auditors can rely upon independent qualified custodian statements obtained directly from the custodian in confirming their assets. In the case of the advisor using an independent custodian and whose only incident “custody” is the deduction of fees, the audit should be confined to determining that the fee billed is the amount deducted.

Finally, we applaud the Commission’s focus on those advisory firms that maintain custody of client assets with a related entity. The PCAOB proposal is long overdue and would have revealed the criminal activities at the heart of the recent scandals. An advisor’s dominion and control over the custodian is the breeding ground that permits abuse of the public trust. Root out the problem with a scalpel though; not with an axe.

The historical record establishes that the existing safeguards in place are adequate for the subset of advisors discussed herein and, considering the adverse effects of a mandatory surprise audit on advisors as well as clients, we respectfully request that the Commission leave current Rule 206(4)-2 intact and unchanged with respect to advisors who utilize qualified custodians and have “custody” solely because they have the authority to deduct advisory fees from client accounts.

We thank the Commission for the opportunity to comment on this matter.

Sincerely,

Renee M. Toth
NAAIM President

[1] *See Investment Counsel Association of America, Inc.* (available July 9, 1982), and its progeny; *see also* Staff Interpretations of Certain Investment Adviser Disclosure and Reporting Requirements, Advisers Act Release 1000 (December 3, 1985) ("Release 1000").

[2]*See* 2002 Proposing Release at n. 23.

[3]The Release indicates that at least 9,575 advisors are to be subject to the new audit requirement, of which 190 are already required to undergo a surprise audit (leaving 9,385). Footnote 99 states that 3,617 of these advisors are assumed not to deduct fees. That leaves 5,768 deducting fees, or 61.4% of those newly impacted by the audit requirement.

[4]In the matter of Howard M. Barris and Co. (January 9, 1995).