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Via Electronic Filing

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

RE: Release No. IA-2876; File No. S7-09-09 (Custody of Funds or Securities of Clients by Investment Advisers)

Dear Ms. Murphy:

The Cornell Securities Law Clinic (the "Clinic") welcomes the opportunity to comment on the amendments to the custody rule 206(4)-2 under the Investment Advisers Act of 1940 (the "Rule Proposal"). The Cornell Securities Law Clinic (the "Clinic") is a Cornell Law School curricular offering, in which law students provide representation to public investors and public education as to investment fraud in the largely rural "Southern Tier" region of upstate New York. For more information, please see http://securities.lawschool.cornell.edu.

The Rule Proposal mainly seeks to improve the safekeeping of client assets by requiring all registered investment advisers with custody of client assets to undergo an annual surprise examination. Additional amendments to Rule 206(4)-2 are also proposed: (1) Investment advisers will be required to obtain internal control reports from independent public accountants if the advisers also serve as qualified custodians; (2) investment advisers will be deemed to have custody over client assets if any of their related persons has custody of the client assets; (3) investment advisers will be required to have a reasonable belief that the qualified custodian is sending an account statement to each client; and (4) Forms ADV and ADV-E will be amended to require more information from registered advisers.

The Clinic generally supports the Rule Proposal, with certain modifications as discussed below. The Clinic believes that the Rule Proposal correctly provides an independent mechanism for verifying misuse or misappropriation of client assets in custody of registered advisers. In addition, the Clinic generally supports the four mentioned amendments to the rule 206(4)-2 because they enhance the protection of client assets. The Clinic, however, believes that the surprise examination requirement should not apply to registered advisers who utilize an independent qualified custodian which maintains custody of funds and securities, and directly

sends statements to clients, where the only control exercised by the investment adviser is deduction of fees pursuant to written agreement with the customer.

1. The Clinic Suggests SEC Refine the Surprise Examination Requirement

The Clinic notes that having the surprise examination requirement apply to more circumstances is desirable in light of the recent Ponzi scheme perpetrated by Bernard Madoff[1] and recent enforcement actions against investment advisers for alleged fraudulent conduct.[2] The surprise examination safeguards client assets against misuse by allowing an independent public accountant, among other things, to confirm which assets are held by the custodian and reconcile all such assets to the books and records of client accounts maintained by the investment adviser.

The Clinic, however, does not believe that the mere deduction of fees by an investment advisor pursuant to a written agreement with the customer should be included in the definition of custody, provided that the independent qualified custodian maintains control over client assets and such deductions are reflected in statements sent by the custodian to the customer. We believe that such a mechanism ensures that the customer will be informed of the fee deduction, which should be sufficient to safeguard customer assets.

According to the Rule Proposal, the cost of the surprise examinations for each firm will be approximately $8,100 per year.[3] The Clinic notes the possibility that many registered small firms may not be able to absorb such cost. This could hurt public investors because the cost of the surprise examination would be passed onto the clients in the form of heightened advisory fees. Indeed, the surprise examination requirement may even encourage public investors to choose larger firms because larger firms can better absorb the cost of the surprise examination.

The Clinic, therefore, recommends a clarification in the Rule Proposal to require the surprise examination in all instances except when an independent qualified custodian sends statements to directly clients and where the only control exercised by the investment adviser is the deduction of fees pursuant to a written agreement with the customer.

2. The Clinic Supports the New Internal Control Report Requirement

The Clinic strongly supports requiring an internal control report when an investment adviser also serves as a qualified custodian. The internal control report must include an independent public accountant's opinion regarding the description of controls placed in operation relating to custodial services and tests of operating effectiveness. In addition, the independent public accountant issuing the internal control report must be registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB").

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[1] *See SEC v.Bernard L. Madoff, et al.,* Litigation Release No. 20889 (Feb. 9, 2009).

[2] *See e.g., SEC v. Donald Anthony Walker Young, et al.*, Litigation Release No. 21006 (Apr. 20, 2009); *SEC v. WG Trading Investors, L.P., et al.,* Litigation Release No. 20912 (Feb. 25, 2009); *SEC v. Stanford International Bank, et al.,* Litigation Release No. 20901 (Feb. 17, 2009).

[3] Custody of Funds or Securities of Clients by Investment Advisors, 74 Fed. Reg. 25354, 25365 (proposed May 27, 2009) (to be codified at 17 C.F.R. pt. 275 and 279).

When an investment adviser also acts as a qualified custodian, the risk of misuse or misappropriation of client assets is at its peak. In such a situation, client assets are especially vulnerable to fraud because investment advisers exercise total control over the client assets. As a result, the Clinic believes that the surprise examination requirement alone is insufficient to protect client assets in circumstances where an investment adviser also serves as a qualified custodian. Therefore, the Clinic believes that the benefit of the internal control report requirement outweighs its cost.

3. The Clinic Supports the Revision of the Definition of Custody to Include Related Persons

The Clinic supports the revision of the definition of custody in the Rule 206(4)-2 to include the custody maintained by related persons. The current Rule 206(4)-2 is unclear as to when an adviser will have custody of client assets if the adviser has access to the client assets through a related person. The Rule Proposal resolves such ambiguity by explaining that an adviser will always have custody of client assets in such situation. The Clinic believes that investment advisers will subsequently have a clearer understanding of what is expected of them, thus potentially reducing the risk of abuse.

4. The Clinic Supports Eliminating the Alternative Delivery Option

The Clinic supports eliminating the alternate deliver option for sending statements to clients. By always requiring registered advisers to have a reasonable basis for believing that the qualified custodian sends statements to the clients, the advisers no longer have a total control over what they decide to report to their clients. With the qualified custodian always in the picture, an independent mechanism for verifying misuse of client assets is better ensured. We also support making the "reasonable belief" standard subject to "due inquiry," so that investment advisers have an obligation to ascertain a factual basis for their belief that the qualified custodian is sending statements directly to customers.

5. The Clinic Supports the Amendments to Forms ADV and ADV-E

The Clinic supports the amendments to the language of Forms ADV and ADV-E. The amended language will allow the Securities and Exchange Commission to improve its risk-based examination program because registered advisers will be required to report more information to the Commission. For instance, registered advisers will be required to provide information about the accountants performing the surprise examination, report all related persons who are broker-dealers, and provide additional information about their custodial information. The Clinic believes the cost of the amendment should not be significant given that registered advisers should already have all this information. Consequently, the Clinic believes that the benefit clients will receive from the Commission's enhanced risk assessment outweighs the cost of the amendment.

Conclusion

The Clinic greatly appreciates the opportunity to comment on this Rule Proposal. The Clinic generally supports the Rule Proposal because the Rule Proposal provides better protection of client assets. However, the Clinic believes that the new surprised examination requirements need not apply to an investment adviser which utilizes an independent qualified custodian to maintain client assets and to directly send statements to clients.

Respectfully submitted,

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