FINANCIAL SERVICES INSTITUTE
VOICE OF INDEPENDENT BROKER-DEALERS AND INDEPENDENT FINANCIAL ADVISORS
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VIA ELECTRONIC MAIL

July 28, 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 Client Assets by Investment Advisers

Dear Ms. Murphy:

On May 27, 2009, the Securities and Exchange Commission (SEC) proposed amendments to Rule 206(4)-2 (Custody Rule)[1] under the Investment Advisers Act of 1940[2] (Proposed Amendments).[3] Among other things, the Proposed Amendments would require an investment adviser who has legal custody of client funds and securities to undergo an annual surprise examination by an independent public accountant. The Proposed Amendments are part of the SEC's response to common elements found in a series of enforcement actions recently brought against investment advisers. These cases, most notably the Madoff and Stanford matters, involved investment advisers who engaged in fraudulent conduct, including misappropriation of investor assets.[4]

The Financial Services Institute[5] (FSI) appreciates the SEC's desire to improve the protections afforded to investors under the Advisers Act. We recognize that the safety and security of client funds and securities is essential to public confidence in our securities markets. However, we have significant concerns about the unintended consequences of the Proposed Amendments. We believe the overly broad Proposed Amendments will impose substantial additional costs and disruptions to business that will be difficult for small retail investment adviser firms to bear. The unfortunate result will be to price advisory services out of the reach of small investors. We discuss these concerns in detail below.

Background on FSI Members

The independent broker-dealer (IBD) community has been an important and active part of the lives of American investors for more than 30 years. The IBD business model focuses on comprehensive financial planning services and unbiased investment advice. IBD firms also share a number of other similar business characteristics. They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of packaged products, such as mutual funds

[1] 17 CFR 275.206(4)-2.
[2] 15 USCA §§ 80b-1 through 80b-21.
[3] See the Proposing Release at http://sec.gov/rules/proposed/2009/ia-2876fr.pdf.
[4] SEC v. Bernard L. Madoff, et al., Litigation Release No. 20889 (Feb. 9, 2009) (complaint alleges that Madoff and Bernard L. Madoff Investment Securities LLC (a registered investment adviser and registered broker-dealer) committed a $50 billion fraud); SEC v. Stanford International Bank, et al., Litigation Release No. 20901 (Feb. 17, 2009) (complaint alleges that the affiliated bank, broker-dealer, and advisers colluded with each other in carrying out an $8 billion fraud).
[5] The Financial Services Institute, Voice of Independent Broker-Dealers and Independent Financial Advisors, was formed on January 1, 2004. Our members are broker-dealers, often dually registered as federal investment advisers, and their independent contractor registered representatives. FSI has 116 Broker-Dealer member firms that have more than 138,000 affiliated registered representatives serving more than 14 million American households. FSI also has more than 10,000 Financial Advisor members.

and variable insurance products; take a comprehensive approach to their clients' financial goals and objectives; and provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their registered representatives. Due to their unique business model, IBDs and their affiliated financial advisors are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.

In the U.S., approximately 98,000 independent financial advisors – or approximately 42.3% percent of all practicing registered representatives – operate in the IBD channel.[6] These financial advisors are self-employed independent contractors, rather than employees of the IBD firms. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans with financial education, planning, implementation, and investment monitoring. Clients of independent financial advisors are typically "main street America" – it is, in fact, almost part of the "charter" of the independent channel. The core market of advisors affiliated with IBDs is clients who have tens and hundreds of thousands as opposed to millions of dollars to invest. Independent financial advisors are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities and client base. Most of their new clients come through referrals from existing clients or other centers of influence.[7] Independent financial advisors get to know their clients personally and provide them investment advice in face-to-face meetings. Due to their close ties to the communities in which they operate their small businesses, we believe these financial advisors have a strong incentive to make the achievement of their clients' investment objectives their primary goal.

FSI is the advocacy organization for IBDs and independent financial advisors. Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisors play in helping Americans plan for and achieve their financial goals. FSI's mission is to ensure our members operate in a regulatory environment that is fair and balanced. FSI's advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. FSI also provides our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

Summary of the Proposed Amendments

The Proposed Amendments would require an investment adviser who has custody of client funds and securities to undergo an annual surprise examination by an independent public accountant.[8] Since all investment advisers who have authority to withdraw asset management fees from client accounts are deemed to have legal custody, this new requirement would have far reaching impact.[9] In fact, the SEC estimates that 9,575 of the 11,272 federally registered investment

[6] Cerulli Associates Quantitative Update: Advisor Metrics 2007, Exhibit 2.04. Please note that this figure represents a subset of independent contractor financial advisors. In fact, more than 138,000 financial advisors are affiliated with FSI member firms. Cerulli Associates categorizes the majority of these additional advisors as part of the bank or insurance channel.

[7] These "centers of influence" may include lawyers, accountants, human resources managers, or other trusted advisors.

[8] The annual surprise examination requirement would also apply to advisers that custody client assets themselves as qualified custodians, custody assets at a qualified custodian that is a related person, or serve as an adviser to audited pooled investment vehicles. An independent public accountant is defined as a public accountant that meets the standards for independence described in Rule 2-01(b) and (c) of Regulation S-X.

[9] SEC registered investment advisers that have authority to deduct advisory fees from client assets have custody and are subject to the Custody Rule, but are not required to report that they have custody on Form ADV under Item 9 of Part 1 of Form ADV.

adviser firms would be subject to the surprise examination requirement.[10] On average, these advisers would pay an accounting fee of $8,100 per year for the surprise examination.[11]

The Proposed Amendments also would require investment advisers subject to the Custody Rule to enter into a written contract with an independent public accountant to conduct the surprise examination.[12] The agreement would require the accountant to notify the SEC within one business day of finding any material discrepancies and to submit an annual certificate to the SEC on Form ADV-E within 120 days of the surprise examination.[13] The annual certificate would describe the nature and extent of the examination and state that the accountant had examined the funds and securities in the custody of the adviser.[14] The contract would also require the accountant to file a Form ADV-E within four business days of resigning, being replaced, or choosing not to be reappointed as the adviser's auditor.[15] The adviser would file Form ADV-E electronically via the Investment Adviser Registration Depository and it would be made publicly available.[16]

The Proposed Amendments also would impose an additional audit requirement for adviser firms that custody managed client assets themselves or custody these assets at a qualified custodian that is a related person. This requirement would directly affect dually registered firms that are self-clearing or hold assets at a clearing firm affiliate. Such firms would be required to obtain a written report from a Public Company Accounting Oversight Board (PCAOB) registered independent public accountant that includes an opinion regarding the sufficiency of their internal accounting controls.[17] The SEC states that the cost of preparing an internal control report relating to custody would vary based upon the size and services offered by the dual registered firm, but estimates an average cost of $250,000 per year.[18] These firms would also be required to have their annual surprise examination performed by a PCAOB accounting firm.[19]

The Proposed Amendments would also require all investment advisers that have custody of client assets to have a reasonable belief, after due inquiry, that the qualified custodian sends account statements directly to their clients at least quarterly.[20] The "due inquiry" standard could be met by requiring the custodian to provide the investment adviser with a copy of each client statement or by receiving each quarter a written confirmation from the qualified custodian that the required statements were sent to clients.[21] Advisers would also be required to provide a written notice urging their clients to compare the account statements they received from the custodian with those they receive from the adviser.[22]

Finally, the Proposed Amendments would make necessary amendments to Form ADV to accomplish its purposes. These amendments would affect Items 7 and 9 of Form ADV Part 1A and Schedule D.[23]

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[10] 74 FR 25363.
[11] 74 FR 25365.
[12] 74 FR 25355.
[13] 74 FR 25356.
[14] 74 FR 25357.
[15] Id.
[16] 74 FR 25358.
[17] 74 FR 25359.
[18] 74 FR 25365.
[19] 74 FR 25360.
[20] 74 FR 25361.
[21] See footnote 61 of 74 FR 25361.
[22] 74 FR 25361.
[23] 74 FR 25362.

Comments on the Proposed Amendments

FSI has significant concerns with the Proposed Amendments. We discuss these comments below:

- **Focus should be narrowed to cover activities that place client assets at risk** - The Proposed Amendments should be more narrowly focused to address the recent Ponzi schemes uncovered by the SEC. Since these schemes did not involve the common industry practice of investment advisers deducting client authorized advisory fees from managed accounts, the Proposed Amendments would impose significant additional regulatory burdens and expenses on investment advisers with little or no enhancement of investor protection. FSI urges the SEC to limit the scope of the Proposed Amendments to those adviser firms that have physical custody of client funds or securities.
- **Smaller firms will face too heavy a burden** - The burdens imposed by the Proposed Amendments will fall most heavily on smaller investment adviser firms who provide essential services to middle-class investors, but lack the resources necessary to absorb the costs of the surprise audit or the disruption of business such an audit will cause. Investment adviser firms affiliated with IBD firms provide financial services to individuals in small towns throughout the United States. These services, and conveniences like automated fee debiting, are needed now more than ever. Once again, we urge the SEC to exclude adviser firms that do not have physical custody of client funds or securities from the Proposed Amendments.
- **Rising costs of compliance will push advice out of the reach of small investors** - Investment advisers will likely pass the audit costs on to their clients or eliminate their fee debiting service in order to avoid the implications of the Proposed Amendments. As a result, investment advisors will be forced to either price advisory services out of the reach of needy investors or eliminate a convenient billing method chosen by many of their clients.[24] We urge the SEC to support universal access to advisory services by reducing the cost of compliance inherent in the Proposed Amendments. This can be best achieved by exempting investment advisers who do not have physical custody of client funds and securities from the new requirements.

Conclusion

We are committed to constructive engagement in the regulatory process and, therefore, welcome the opportunity to work with you to enhance investor protection through our alternative proposal.

[24] Please note that changing the method by which advisory fees are collected will also entail substantial costs for the investment adviser by forcing the firm to dedicate resources to collection activities.

Thank you for your consideration of our comments. Should you have any questions, please contact me at 770 980-8487.

Respectfully submitted,

Dale E. Brown, CAE
President & CEO