T H E   M O N E Y   M A N A G E M E N T   I N S T I T U T E
1140 Connecticut Avenue, NW, Suite 1040, Washington, DC 20036-4001 • Phone: (202) 822-4949 • Fax: (202) 822-5188 • www.moneyinstitute.com

July 28, 2009

Via Online Submission

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F. Street NE
Washington, DC 30549

Re: Comments of the Money Management Institute
File Number s7-09-09: Proposed Rule Amendments: Custody of Funds

Dear Ms. Murphy:

I am writing on behalf of the Legal and Regulatory Affairs Committee of The Money Management Institute[1]. We appreciate the opportunity to comment on the Commission's proposal to amend Rule 206(4)-2 under the Investment Advisers Act of 1940 with respect to custody practices of investment advisers (the "Custody Rule").[2] While we have identified a number of concerns in this letter, we agree that the types and magnitude of recent instances of apparent fraud and misappropriation of client assets by investment advisers requires a strong response by the Commission.

One of our concerns with the Proposed Rule relates to the costs estimated in the Proposing Release which we feel are not based on a representative sample, are too low considering likely client behavior, are not specifically analyzed for advisers with authority to debit fees only ("fee debit only advisers"), and fail to reflect the burden on clients in responding to verification requests. We are especially concerned that the methodology used by the Commission to estimate the compliance burden and cost is inadequate and does not separately

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1 **The Money Management Institute (MMI)** Since 1997 MMI has been the leading voice for the global financial services organizations that provide advice and professionally-managed solutions to individual and institutional investors. Through industry advocacy, educational initiatives, regulatory affairs, data reporting and professional networking, MMI supports and advances the growth of managed investments. Our members' advice-driven investment solutions are responsive to an evolving worldwide financial landscape and their organizations are committed to the highest standards of fiduciary responsibility and ethical conduct.

2 *Proposed Rule: Custody of Funds or Securities of Clients by Investment Advisers*, Rel. No. IA-2876 (May 20, 2009) ("Proposed Rule" or "Proposing Release").

analyze the burden that will be imposed on fee debit only advisers. We are concerned that the Proposed Rule is overbroad with respect to its application to three groups of managed account participants: the proposal to require advisers who are deemed to have custody under the Custody Rule because they have the authority to debit client fees from client accounts to undergo an annual surprise examination, the application of the annual surprise examination requirement to sponsors of programs with bundled, all inclusive fees for brokerage, custody and advisory services also registered as broker-dealers, and the proposal to expand the concept of affiliated custody and the rescission of the *Crocker Investment Management* no-action letter. We feel that the cumulative effect of these aspects of the Proposed Rule would have a significant and disproportionate effect on managed account participants. We are additionally requesting guidance that the verification may be done by way of sampling, that specific guidance be provided with respect to the verification as it relates to fee debiting, and that additional guidance be provided to allow advisor flexibility to consolidate auditors for various audit and related services. We are concerned that the amendments to Form ADV will be confusing to clients and propose instead, and as a possible alternative to the annual surprise examination for some advisers, that Form ADV be revised to include more specific disclosures about advisers' custody practices. We also have commented on the Commission's solicitation of comment on the use of certifications by advisers' chief compliance officers. Finally, we note that both Congress and the Commission appear to be active in relation to increasing oversight of pooled investment vehicles and the advisers to them and ask the Commission to consider whether the Proposed Rule should be delayed pending final legislation.

A. Current Custodial Practices in Managed Accounts

1. Common Arrangements

The Proposed Rule would likely have a significant effect on three types of advisers participating in managed accounts: managers in unbundled managed account programs who only have authority to debit advisory fees, sponsors of bundled fee programs, and managers who are affiliated with sponsors or custodians. While many managed accounts are established through bundled fee programs, in which only the sponsoring broker-dealer debits fees from the account; a growing number of accounts are managed in unbundled managed account platforms in which fees for advice, management, custody and brokerage are separately calculated and debited[3]. A typical structure of an unbundled managed account program would involve a primary investment adviser who maintains the relationship and communicates with the client. The primary adviser generally advises the client on the investment manager(s), strategies and other account features to be used for the client's account. In addition to allowing advisers to debit fees from client accounts, many custodians also offer a range of additional possible authorizations for primary advisers including the authority to dispose of assets and open accounts. Alternatively, clients may wish to maintain an account with an investment manager on their own but seek to have the account consolidated for reporting or custody purposes of accounts and investments with a

[3] *See* MMI Central Newsletter, Issue 16, 2Q2009, page 6 (noting that dual contract programs constitute 25.4% and SMA subadvisory programs constitute 66.1% of separately managed account assets as of March 31, 2009 compared to 20.4% versus 69.2% as of June 30, 2009.) While not entirely synonymous, "SMA subadvisory" generally refers to bundled fee programs while "dual contract" would include many unbundled programs.

particular broker or advisory representative of the sponsor or custodian. For ongoing management of the account, the client, or primary adviser on the client's behalf, generally hires one or more investment managers. The investment manager typically manages the account on a discretionary basis, may communicate with the primary adviser instead of the client, and has authority to instruct the custodian to debit management fees from the account and pay them to the manager, but does not have authority to withdraw cash or securities, close or open accounts, or otherwise access client assets. These authorizations are contained in the client's custodial agreement, which is used by the custodian to determine what type of access will be granted to the manager and primary adviser if applicable. Investment managers in unbundled programs are generally not permitted by the custodian to withdraw assets other than for fees and primary advisers are likewise restricted unless additional authorizations have been granted by the client. Typical custodians for unbundled programs are registered U.S. national or regional broker-dealers subject to significant regulation with respect to segregation and safeguarding of client assets including providing periodic statements to client under Commission and FINRA regulations.

Most individual managed accounts are maintained through bundled fee programs in which the client pays a single asset based fee for all brokerage and advisory services. These programs are traditionally sponsored by a dually registered investment adviser/broker-dealer who provides research and recommendations on managers available in the program, asset allocation and other investment advice, custodial services and is usually the executing broker-dealer for most trades. Generally, managers do not have any of the attributes of custody under the Custody Rule in bundled fee programs and are not subject to the Custody Rule. Many banks also offer bundled fee programs in which the bank is the sponsor and custodian and a registered broker-dealer executes trades. In both bundled and unbundled managed account programs, managers affiliated with the sponsor or custodian are commonly available for use in managed accounts alongside unaffiliated managers.

2. Compliance with the Current Custody Rule in Managed Accounts

Under the current Custody Rule, fee debit only advisers in unbundled managed account programs are able to comply with the rule's requirements with minimal ongoing operational commitment. Custodians provide at least quarterly account statements to clients. Managers and primary advisers generally rely on the custodian's regulatory obligations and the terms of the client's contract with the custodian in order to satisfy the requirement for a reasonable basis and belief that the custodian is sending statements to the clients. In addition, custodians typically send duplicate statements to the managers and primary advisers and also make electronic versions available in the same manner as they do to clients. Managers and primary advisers that are fee debit only advisers in unbundled managed account programs can therefore typically avoid the requirement to undergo an annual surprise examination. Because such managers typically have no authority to open accounts on the client's behalf, they are never required to send the notices for doing so under the Custody Rule. Fee debit only advisers are expressly permitted by the instructions to Form ADV to answer "No" on Item 9.A as to whether they have custody. Their ongoing compliance requirements under the current Custody Rule are limited and include ensuring that the programs they participate in do not grant greater authorization than fee debiting, ensuring that accounts are properly set up in those platforms, and ensuring that employees are aware of the limitations on the adviser's authority. Most bundled program sponsors are subject to the Custody Rule but are exempt from the annual surprise examination requirement due to the fact that the sponsor itself meets the definition of "qualified custodian" under the Custody Rule.[4] Finally, to the extent that managers may be affiliated with the sponsor or custodian, they generally rely on the standards of the *Crocker Investment Management* no-action letter[5] to seek to avoid being deemed to have custody beyond fee debiting authority under the Custody Rule. Advisers and managers with authority to withdraw funds and securities and to open and close managed accounts are currently subject to the Custody Rule and required to undergo an annual surprise examination.

B. Expansion of the Annual Surprise Examination Requirement

The relatively low compliance burden under the current Custody Rule is in stark contrast to the significant burden that the annual surprise examination requirement under the Proposed Rule would impose on fee debit only advisers participating in unbundled managed account programs, bundled fee program sponsors, and managers affiliated with the custodian and who do not have practical access to client assets. We believe that the Commission should exclude these classes of advisers from the Proposed Rule's requirement to have an annual surprise examination. We contend that doing so is appropriate for the following reasons. First, the burden of complying with the annual surprise examination requirement will be significant and would not only have a disproportionate affect on managers participating in managed account programs but would also have a severe and adverse effect on emerging practices in managed accounts. Second, the client's receipt of a statement from the custodian remains a sufficient control for risks related to fee debiting. Third, in contrast to the recent high profile events involving investment advisers with significantly greater degrees of authorization, these categories of advisers continue to present a low risk to clients from misappropriation.

1. Estimated Cost to Advisers is Too Low

a. Use of Previous Estimate Based on Smaller Set of Advisers

We are concerned that the cost of complying with the annual surprise examination requirement has been significantly underestimated. The Commission's estimate of accounting charges for purposes of cost-benefit analysis is $8,100 per year per adviser.[6] Its estimate of the cost of the internal burden is $11,783,989 in aggregate or approximately $1,255 per adviser.[7] According to the Adopting Release, these figures were based on the estimated burden used by the Commission in its 2007 application for approval by the OMB under the Paperwork Reduction Act.

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4 Final Rule: Custody of Funds or Securities of Clients by Investment Advisers, Rel. No. IA-2176 (November 5, 2003) ("The amendments eliminate the exemption from the rule for advisers that are also registered broker-dealers, which are qualified custodians under the rule and for which the exemption is unnecessary.").

5 Crocker Investment Management Corp., SEC No-Action Letter (pub. avail. Apr. 14, 1978).

6 Proposing Release, p. 64.

7 Proposing Release, p. 64.

We believe that the burden and cost of the annual surprise examination will be a function that is in direct proportion to the number of accounts which are required to be subject to the annual surprise examination. Indeed, as the Commission recognized in that approval application: "The number of responses under rule 206(4)-2 will vary considerably depending on the number of clients for which an adviser has custody of funds or securities."[8] The Proposing Release indicated that this $8,100 per year costs estimate was based on a 2007 estimate of approximately 200 advisers that were estimated to be subject to the annual surprise examination requirement.[9] The Commission has estimated that the expansion of the annual surprise examination requirement in Proposed Rule to include fee debit only advisers will result in an additional 9,757 advisers subject to this requirement and that over 7,000 of those are advisers without pooled investment vehicles.[10] Considering the significant increase in the number of advisers that would be subject to the annual surprise examination requirement and the variation in business practices among advisers, we do not believe that the estimates used for purposes of past rulemakings or budgetary reviews should be relied on for purposes of this rulemaking. Instead, we request that the Commission use an updated estimate to ensure a more reliable estimate of the number of accounts per adviser to be subject to the surprise examination requirement.

b. Fee Debit Only Advisers Should be Evaluated Separately

It also seems appropriate to perform a separate analysis on the effect of the Proposed Rule on fee debit only advisers. For purposes of analyzing the burden of the rule under the Paperwork Reduction Act, the Commission has categorized advisers expected to be subject to the annual examination requirement in the Proposed Rule into four categories.[11] The first category is advisers who do not have pooled investment vehicles as their clients. This category would include fee debit only advisers in addition to advisers with greater degrees of authority. By soliciting comment on whether fee debit only advisers should be subject to the annual examination, the Commission has implied that a cost benefit analysis should be performed specifically with respect to this class of advisers. We therefore request that the Commission perform a separate analysis on the costs and burden estimated for fee debit only advisers as a separate category. This analysis should reflect a per-account cost and should take into consideration the fact that in many unbundled managed account programs, both the primary adviser and one or more managers may be debiting their respective fees from the same account, resulting in a potentially larger aggregate cost.

c. Estimate of Per Account Burden is Too Low

We believe that the Commission's proposal has underestimated the cost incurred by advisers and their independent auditors to verify assets with clients. As proposed, only the cost of gathering and providing client contact information is included and which is estimated to be only .02 hours per account.[12] We anticipate that clients will have a very low rate of initial responsiveness to any requests from the independent auditors and that obtaining responses will

8 72 Federal Register 51,274 (September 6, 2007)
9 Proposing Release, p. 64.
10 Proposing Release, p. 40.
11 Proposing Release, p. 40.
12 Proposing Release, p. 42.

ultimately require not just repeated requests but also a significant amount of time to respond to client inquiries about any requests that they receive. We request that the Commission revise its estimate of the cost of notifying clients to reflect the burden of repeated requests and additional client communication. In this regard, we encourage the Commission to consider its experience as a result of the recent practice in requesting client verification during examinations by the Commission staff.

d. Cost Estimate Fails to Consider Burden to Clients

Finally, the cost analyses used for Paperwork Reduction Act purposes and related administrative law purposes reflect only the direct and indirect cost to advisors. However, individual clients will also be either required or expected to respond to verification requests from the independent auditors. We request that the Commission consider whether the various cost analyses should include an estimate of the burden on individual clients to respond to such requests and if so, to re-propose the Proposed Rule with the estimated costs of that burden included.

e. Burden Could Divert Compliance Resources

Even using the Commission's initial estimates for the costs associated with complying with the annual surprise examination requirement – approximately $10,000 per year per adviser – the Proposed Rule could make the annual surprise examination requirement a relatively large proportion of smaller advisers' overall compliance costs. Moreover, if the Commission's cost estimates are revised, we anticipate that the average burden could be several times the amount estimated in the Proposing Release and thus could become easily the largest single cost associated with the compliance program of many smaller advisers. This could result in diversion of compliance resources away from areas of greater regulatory and client protection significance.

2. Lack of Significant Regulatory Concern for Managed Account Participants; Alternative Approaches

We are also concerned that the application of the rule to fee debit only advisers, bundled fee program sponsors, and advisers using affiliated custodians is overbroad in that it subjects these classes of advisers to the requirement even though their custodial activities do not appear to contain nearly the same level of risk to client assets.

a. Fee Debit Only Advisers

In the Proposing Release, the Commission asked whether the rule should be amended to exclude fee debit only advisers from the annual surprise examination requirement. We believe that fee debit only advisers should not be subject to the annual surprise examination requirement of the Proposed Rule and request that the Commission exclude such advisers from this requirement in the final rule.

Fee debit only advisers present a considerably lower risk of misappropriation of client assets than other types of advisers subject to the custody rule. Clients typically receive at least quarterly brokerage statements which indicate amounts withdrawn as management and advisory fees. In the event that a fee debit only adviser withdrew funds in excess of the fee to which the client agreed, the client would be able to compare the information received from the custodian with that received from the adviser and raise any discrepancies with the adviser. Moreover, fee debit only advisers' ability to debit fees requires the adviser to instruct the custodian to debit fees. This adds an additional layer of potential review and permits a client to terminate an adviser's fee debiting authority directly with the custodian.

The Commission has implicitly acknowledged that advisers that do not have custody other than by debiting fees are a lower risk. Such advisers are currently expressly permitted to answer "No" to Item 9.A on Form ADV Part I question of whether they have custody. Indeed the Proposed Rule would partially continue this practice in the proposed instructions to Item 9.A(1) (although not to the proposed new part 9.C). We believe that the Commission should continue to recognize the lower risk to client assets presented by fee debit only advisers and exempt fee debit only advisers from the annual surprise examination requirement.

Excluding such advisers from the scope of this requirement does not appear to undermine the Commission's efforts to respond to recent misappropriation. Specifically, the Commission has not suggested that there is any pattern of abuses from client fee debiting that would justify such a significant increase in the regulatory burden. We note that Commission has cited in the proposing release recent enforcement actions as background for the Proposed Rule[13]. It appears that each of these matters involve alleged misappropriation by advisers from the assets of various forms of unregistered pooled investment vehicles and that none of the advisers involved was a fee debit only adviser. Aside from a single recently announced enforcement action[14], we are unaware of any other significant enforcement or litigation activity which would suggest that there are problematic fee-debiting or custodial practices among fee debit only advisers. We do not believe that imposing the significant additional burdens on this class of advisers is justified in the absence of evidence of the risk of substantial harm to clients or a pattern of weak controls.

We are, however, aware that through its examination practice the Commission staff has begun to scrutinize fee practices. While we understand that the practice of fee debiting creates the risk that an adviser will over bill, whether intentionally or inadvertently, the annual verification requirement would impose a significant burden on these advisers and would do little to improve fee debiting practices. We therefore request that the Commission exclude fee debit only advisers from the annual surprise examination requirement.

To the extent that the Commission feels additional controls are needed with respect to fee debiting, we encourage the Commission to consider alternatives to the Proposed Rule. The Commission has not sought to regulate fee debiting nor has it provided any significant guidance in regards to fee debiting practices under the Compliance Rule. We urge the Commission to

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[13] Proposing Release, note 11.

[14] *SEC v. Jindra and Envision Investment Advisors, LLC*, Litigation Release 21,113 (June 30, 2009). We also concur with the comments of Valerie Baruch on behalf of the Investment Advisor Association that the facts of this matter, namely that the excessive fees withdrawals were identified by clients and the custodian, seem to vindicate the argument the use of an independent third party custodian is sufficient to reasonably control the risks attendant with advisers debiting fees.

consider less onerous and more effective alternatives to the annual surprise examination requirement for fee debit only advisers, such as a survey or a review of examination findings with respect to fee debiting, informal guidance on the types of fee-related procedures that advisers should considering implementing under the Compliance Rule, or other rules targeted specifically to fee debiting practices.

b. Sponsors of Bundled Fee Programs

The Proposed Rule would also subject broker-dealer sponsors of bundled fee programs to the annual surprise examination requirement. While such sponsors certainly have full custody in their capacity as broker-dealers, they as a practical matter have no custodial authority in their capacity as investment advisers. Their broker-dealer custodial activities are subject to extensive regulatory controls under Commission rules[15] and self-regulatory organization regulations[16]. Subjecting these sponsors to the annual surprise examination requirement would seem to add little additional protection against misappropriation. The Commission has also not identified any pattern of abuse which would justify additional restrictions on bundled fee program sponsors. We therefore request that the Commission exclude bundled fee program sponsors from the scope of the annual surprise examination requirement.

c. Affiliated Custodian

We are also concerned with the Commission's intention to rescind the guidance provided by the *Crocker Investment Management* no-action letter and subsequent additional guidance.[17] Again, we are unaware of any significant regulatory actions or an identified pattern of abuses where the conditions of this guidance have been met. We request that the Commission not rescind the guidance provided in the *Crocker Investment Management* no-action letter. To the extent that the Commission feels greater formal controls are needed between advisers and their affiliated custodians, we ask the Commission to consider formalizing the existing guidance into new rules.

d. Potential Disproportionate Effect on Managed Account Participants

As indicated above, we believe that the burden and cost of compliance with the annual surprise examination requirement will be a proportionate function of the number of accounts in which the adviser has custody. This would have a disproportionate effect on primary advisers and investment managers in managed account programs, whose business may consist of

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15 See, e.g., Rules 15c3-2 (requiring quarterly statements), 15c3-3 (custody and control generally), 17a-5 (requiring audits by PCAOB-registered audit firms), 17a-13 (requiring quarterly securities count) under the Securities Exchange Act of 1934.

16 See, e.g., generally FINRA Rules 2330 (control of securities) and Rule 2340 (quarterly statements).

17 This guidance generally establishes several factors used to determine whether an adviser has custody as a result of its affiliate having custody: whether the clients' property might be subject to claims of the adviser's creditors, whether the adviser's personnel have the opportunity to misappropriate client assets, whether the adviser's personnel ever have custody or possession of or access to client property or the power to control its disposition for the benefit of the adviser, whether the adviser's personnel and the affiliated custodian's employees are under common supervision, and whether the adviser's personnel share premises with the custodian.

hundreds or thousands of individual accounts versus the burden imposed on advisers to hedge funds and other pooled investment vehicles with far fewer clients and accounts. This result is at odds with the Commission's apparent current regulatory and enforcement focus on advisers to pooled investment vehicles.

We are also concerned about the effect of the Proposed Rule would have on the evolution of managed accounts. The burden of the surprise examination can be expected to be more onerous for firms that are participating in "unified managed accounts" and other multi-adviser or unbundled programs where only one adviser may have custody but the fee is divided among multiple advisers and brokers. This would be true for overlay managers who may have "custody" due to the ability to debit fees and would therefore be subject to the requirements of the Proposed Rule, but may receive a relatively low portion of the overall fee. It could also have a similar effect on managers participating in programs in which multiple advisers directly manage specific portions of an account and each deducts their fees. Imposing these burdens on these managed account services could undermine their development and the evolution of which has in part been the managed account industry's response to other regulatory and fiduciary concerns, specifically conflicts of interests, the reasonableness of bundled fees for brokerage and advice in accounts with limited trading, and the need to offer greater customization and individualization in separately managed accounts under Rule 3a-4.

C. Nature of Verification

1. Application of Verification to Fee Debiting

It is not sufficiently clear under the Proposed Rule or in the release cited by the Commission as providing guidance what verification means in the context of a fee debit only adviser. In the case of a fee debit only adviser, where the third party custodian is sending a statement for each account to each account holder, the verification would presumably require that the auditor reconcile the values and holdings of each account on the adviser's books to the values and holdings of each account on the custodian books. It is not apparent what purposes this type of review would serve to reduce the risk of misappropriation of client assets from fee debiting. It would, however, be difficult and costly.

While it may seem that such verification could be automated, we believe that there are differences in portfolio accounting methods compared to custodial accounting methods which could make the task of distinguishing between true valuation errors and legitimate discrepancies manual, time consuming and expensive. For example, custodial accounting methods generally do not reflect dividends and other corporate actions until they have settled. By comparison, many advisers' portfolio accounting systems and methodology reflect dividends and other corporate actions on the "ex-date". For dividends and other corporate actions with an ex-date before the end of a statement period but settlement after, this could result in legitimate discrepancies in the values and holdings used for calculating advisory fees versus the values and holdings reflected on custodial statements. These and other types of legitimate discrepancies will likely limit the ability of the auditors to use automated means to systematically reconcile and verify the assets under a fee debit only adviser's "custody."

Moreover, while the verification requirement would reduce the risk of incorrect fees based on an incorrect account value or of unauthorized undisclosed fee withdrawals, it would not reduce the risk of other fee debiting errors or intentional over charging. We note that nothing in the Proposing Release or in the release cited by Commission[18] requires the independent auditor to audit the fee calculations to ensure that the correct methodology has been applied consistent with the applicable client advisory agreement. We also note that fee debiting controls were not listed among the proposed criteria for the internal control report contemplated in the Proposed Rule for advisers using an affiliated custodian.[19] Therefore, to the extent that fee debiting practices represent regulatory risks justifying additional rulemaking, the requirement under the Proposed Rule to undergo an annual surprise verification of assets audit is poorly suited to address them.

2. Use of Sampling

The Commission solicited comment on whether the verification should continue to require the verification of all assets or should permit the use of sampling. We believe that the Commission should provide additional guidance to permit the use of sampling. This is consistent with accepted accounting practices for broker-dealers[20] and for bank trust activities[21].

To the extent that the verification includes contacting individual clients, we do not believe requiring such contact as part of the verification will be effective. We would expect very low response rates from clients and, as noted above, significant additional follow up for those who ultimately do respond. We request that the Commission provide guidance that surprise examination verification requirements need not include direct verification with advisory clients, or at a minimum, provide additional guidance that the auditor does not need to draw a negative inference from the lack of a client responses.

D. Independent Auditor

While we agree that the auditor should be independent of the adviser, several additional clarifications or modifications can maintain the appropriate degree of independence while enabling advisers subject to the annual surprise examination requirement to mitigate the expense and burden of complying with the Proposed Rule by reducing the number of auditors the adviser must hire. Specifically, the Commission should either amend the Proposed Rule or at least provide explicit guidance that the auditor used to conduct the annual surprise examination may

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[18] See Proposing Release at 6 (citing *Nature of Examination Required to be Made of All Funds and Securities Held in Custody of an Investment Adviser and Related Accountant's Certificate, Advisers Act Release 201 (May 26, 1966)).*

[19] Proposing Release, p 23.

[20] AICPA Audit and Accounting Guide: *Brokers and Dealers in Securities, paragraph 5.62 (*"As with any audit, sampling can be utilized in a broker-dealer audit for tests of controls or verifying account balances.").

[21] AICPA Audit and Accounting Guide: *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies, Chapter 20 – Trust Services and Activities, paragraph 20.31 (*"For asset validation, a sample of accounts may be selected, trial balances of assets obtained, and the physical existence of assets for which the trust is responsible determined on a test basis. … The independent accountant might perform the following procedures for the selected accounts: … *i.* Test computation and collection of fees.").

be the same as the auditor used for the internal control report. Similarly, the Commission should revise the Propose Rule to explicitly permit or provide guidance that an adviser may use the same audit firm that it uses for other aspects of its business – such as for compliance with broker-dealer regulations requiring audits. Finally, we are concerned that requiring the auditor to be independent under generally accepted accounting principles may be overly burdensome for many smaller advisers who may rely on their auditors to provide non-audit services. We request that the Commission provide guidance such that advisers could obtain certain non-audit services from the audit firm conducting the annual surprise examination consistent with the standards for independence of the American Institute of Certified Public Accountants even if such services would prevent the audit from meeting the requirements for independence under GAAP. Note that this is essentially the same guidance that was granted on a temporary basis following the adoption of amendments to the Custody Rule in 2005.[22]

E. Amendments to Form ADV

The Commission has proposed amending Form ADV to include Item 9.C. which would require advisers to check boxes on the ADV to confirm compliance with the rule. This would convert part of the ADV into a certification which is a significant departure from its current use. Indeed, the certification may be relied on by clients as statement of fact or official endorsement by the Commission. It could also lead to confusion among clients of a fee debit only adviser because the certifications in Items 9.C(3) and (4) would be checked but the adviser would have answered "No" to Item 9.A.(1)(a) and (b) and the client would still not likely realize that the adviser was disclosing that it had the ability to deduct its advisory fees. We believe that this is not consistent with the purpose of Part I of Form ADV to facilitate public disclosure to advisory clients and provide information to the Commission. Instead, any certifications or other reports to be required by the rule should be included in separate forms provided to the Commission.

We note that the Commission has not proposed amending Form ADV to require fee debit only advisers to indicate that they have custody. The original basis for not requiring fee debit only advisers to answer "Yes" to Item 9.A.(1)(a) appears to be the anticipated burden of requiring a large number of advisers to update their Form ADV. However, with the full implementation of the IARD system, this concern seems no longer sufficient to prevent more straight-forward disclosures. We encourage the Commission to consider amending Form ADV to require specific disclosure of the fee debiting or other custodial practices as a potential alternative to the annual surprise examination requirement. Doing so would provide more accurate and useful information to the Commission staff for it to understand the degree to which an adviser has access to client assets and would permit the Commission examination staff to focus on those advisers engaged in forms of custody with potentially greater risk to advisory clients or to focus on fee debiting practices specifically such as through a sweep examination.

F. Chief Compliance Officer Certification

In the proposing release, the Commission also requested comment on whether chief compliance officers should provide an annual certification that the adviser's controls are reasonable. We believe that this proposal would be a substantial departure from the approach to

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[22] *See* Deloitte & Touche LLP, SEC No-Action Letter (August 28, 2006).

the role of the chief compliance officer contemplated in Advisers Act Rule 206(4)-7 (a/k/a the "Compliance Rule") as interpreted by advisers and by the Commission staff[23]. Specifically, it has been generally accepted that CCOs are expected to engage in a healthy internal debate over what policies, procedures and controls are "reasonable" under the rule and the staff has indicated that it is not expected that the CCO always prevails, but instead that senior management appropriately consider the CCO's views. The certification requirement would replace this model of flexible implementation with a more rigid one in which the CCO's position would either dictate the advisers business practices or in which the CCO's were pressured to certified practices that they do not believe are sufficient. Moreover, it could potentially undermine the CCO's ability to identify risks internally and to seek improvements in fee debiting processes – since an internal risk assessment could be construed as inconsistent with a previous certification. We do not believe that a CCO certification is useful or appropriate as part of the Custody Rule or the Compliance Rule. We therefore ask that the Commission not include such a requirement in the Custody Rule.

G. Effect of Pending Legislation

Finally, we urge the Commission to consider delaying the Proposed Rule in order to measure the effect of several pieces of proposed legislation which if enacted would generally give the Commission greater supervisory authority over various forms of pooled investment vehicles and/or their advisers. Considering that many of the abuses the Commission is seeking to address relate to such entities, the authority in any final legislation may provide the Commission with more direct and more effective means of addressing risks with respect to advisers' custody practices.

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[23] *See, e.g.,* Lori Richards, Speech before the Investment Company Institute/Independent Directors Council Mutual Fund Compliance Programs Conference: The New Compliance Rule: An Opportunity for Change (June 28, 2004) ("Commenters on the rule expressed concern that normal internal debate and discussion with a compliance officer — about whether a law or regulation has been violated, about a new compliance policy or procedure, or even normal supervisory instructions or guidance given by the Chief Compliance Officer's boss — could be construed as "undue influence." This provision is clearly not intended to suppress the normal give-and-take discussions within any firm."); Lori Richards, Remarks before the National Society of Compliance Professionals National Membership Meeting (October 25, 2005) ("What I meant by that was that compliance professionals are not guarantors for the firm's compliance with the law. They aid, educate, guide, detect, and check, but the firm's business-line employees are first and foremost responsible for their own conduct.")

We appreciate the opportunity to comment on the Proposed Rule. While we are concerned about several aspects of the Proposed Rule, we support the Commission's efforts to implement controls to prevent and detect the types of fraudulent activity and misappropriation of client funds which have recently come to light. Please feel free to contact us if we can be of further assistance to the Commission. In particular, in the areas where we have proposed that the Commission consider alternatives to the Proposed Rule, MMI would welcome the opportunity to assist the Commission.

Sincerely,

John A. Ehinger Jr.
Member, Legal and Regulatory Affairs Committee
Money Management Institute