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July 28, 2009

Ms. Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F. Street, N.W.
Washington, D.C. 20549

Re: *Commission File No. S7-09-09*

Dear Ms. Murphy:

We submit these comments in response to the above-referenced proposal to amend Rule 206(4)-2, the custody rule under the Investment Advisers Act of 1940 (the "Advisers Act").[1] Pickard and Djinis LLP is a law firm specializing in securities regulation relating to investment advisers, broker-dealers and other financial service providers. Our investment adviser client base ranges from firms with billions of dollars of assets under management to solo practitioners. This letter reflects the opinions of a number of our federally registered investment adviser clients.

As the Commission notes, the recent spate of high-profile frauds demonstrates the need for an enhanced focus on protecting investor assets. Unfortunately, the current proposal seems to misapprehend the nature of the problem, and as a result, imposes new burdens on advisers whose custody practices do not pose a substantial risk to investors. We respectfully ask the Commission to refrain from imposing any new requirements on advisers in situations where independent qualified custodians hold the assets of and deliver account statements to the advisers' clients. With regard to other custody arrangements, we ask that any new obligations imposed under Rule 206(4)-2 be narrowly tailored to the risks those obligations are designed to address, and that duplicative requirements be avoided. We further request that the Commission refine the definition of "custody" under Rule 206(4)-2 in order to address certain issues that have arisen since 2003, when the rule was last overhauled.

Finally, we ask the Commission to follow up on this rulemaking by examining both the structure and the enforcement of the regulatory regime imposed on custodians under

[1] *Custody of Funds or Securities of Clients by Investment Advisers*, IA Release. No. 2876 (May 20, 2009), 74 Fed. Reg. 25354 (May 27, 2009) (the "Proposing Release").

the Securities Exchange Act of 1934 ("Exchange Act") and self-regulatory organization ("SRO") rules.

Background

Rule 206(4)-2 defines custody to include both actual custody (*i.e.*, physical possession of client funds or securities) and constructive custody (*i.e.,* the ability to obtain possession of client funds or securities by virtue of a right to withdraw or legal ownership of such assets). In order to safeguard the funds and securities of advisory clients, the rule requires that physical possession of client assets be maintained with a "qualified custodian" such as a bank, broker-dealer, futures commission merchant or certain type of foreign financial institution. As the Commission notes, the custodial activities of such institutions are subject to extensive regulation and oversight.[2] Where an investment adviser itself meets the definition of qualified custodian, the adviser may take physical possession of its clients' funds and securities. Likewise, advisers may maintain clients' assets with qualified custodians who are affiliates.

Rule 206(4)-2 also requires an adviser with actual or constructive custody over clients' assets to have a reasonable belief that the qualified custodian is sending at least quarterly account statements directly to clients or their independent representatives. These statements must identify the amount of funds and securities in the account and all transactions, including deductions of advisory fees, made during the reporting period. By providing independent snapshots of managed accounts, the statements permit clients to identify any erroneous or unauthorized transactions or withdrawals made by an adviser.[3]

In the alternative, advisers can send their own quarterly account statements to clients, but where the statements come from an adviser who is not also a qualified custodian, the adviser must undergo a surprise examination by an independent public accountant on at least an annual basis. Where pooled investment vehicles are involved, quarterly account statements need not be furnished to the investors in the pool so long as the investment vehicle is audited at least annually and distributes its audited financial statements to investors within 120 days of the end of its fiscal year.

Based on information reported on Form ADV, the Commission estimates that 9,575 federally registered advisers have actual or constructive custody of their clients' assets. Of these advisers, only 372 reportedly maintain physical possession of client assets

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[2] *Id,* at note 4 and accompanying text.

[3] *Custody of Funds or Securities of Clients by Investment Advisers*, IA Release No. 2176 (September 25, 2003) at 5, 68 Fed. Reg. 56692, 56694 (October 1, 2003) ("2003 Adopting Release").

themselves, while 233 maintain client assets with an affiliated qualified custodian.[4] The data also show that roughly 2000 advisers who are not also qualified custodians manage pooled investment vehicles,[5] and the Commission estimates that 190 advisers rely on the alternative account statement delivery option afforded by Rule 206(4)-2.[6] Taken together, these figures indicate that at least seventy percent of advisers with custody of client assets maintain those assets with independent qualified custodians who send account statements directly to clients or their representatives. (Such arrangements are sometimes referred to below as "fully independent custody arrangements.")

In response to recent enforcement actions involving the misappropriation of client assets, the Commission proposes to amend Rule 206(4)-2 to impose new obligations on all advisers with actual or constructive custody of client assets. For the reasons explained below, we submit that the proposal is not tailored to the risks it purports to address and that it would impose burdens on advisers that are not justified by any benefits to investors.

Surprise Exams

One of the biggest changes the Commission proposes to make to the custody rule is to require all advisers with custody of client assets -- including those whose custody derives solely from their authority to withdraw advisory fees from client accounts -- to undergo annual surprise examinations.[7] We believe this proposal will serve absolutely no purpose for advisers whose clients' assets are maintained through fully independent custody arrangements.

None of the enforcement actions the Commission cites as justification for the proposal involves a situation in which client assets were held by an independent custodian who sent quarterly statements to clients.[8] On the contrary, all of these cases involve

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[4] Proposing Release at 40-42.

[5] *Id.* at notes 82 and 85. It is unclear how many of these advisers have the funds' qualified custodians deliver account statements directly to investors and how many send such statements themselves.

[6] *Id.* at note 62. The Proposing Release does not indicate whether any of these advisers also advise pooled investment vehicles.

[7] The Commission also proposes to eliminate the alternative account statement delivery option and to require instead that advisers with custody have a reasonable belief that all clients (other than investors in collective pools) receive statements from the qualified custodian. As noted above, very few advisers avail themselves of this alternative. *Id.* We endorse this part of the proposal.

[8] *Id.* at note 11.

situations in which the adviser directly or indirectly held customer assets and/or maintained exclusive control over investor-level account information. In one case, the investment adviser was already subject to a surprise exam requirement during several years of the alleged fraud.[9] In another case, the defendant claims to have been unaware of the existence of the Advisers Act, making it unlikely that a more restrictive custody rule would have prevented the alleged fraud.[10]

Nor does the Madoff case justify the proposed amendment of Rule 206(4)-2. The defrauded clients in that case reportedly lost money from discretionary, commission-only brokerage accounts. Until the Commission adopted Advisers Act Rule 202(a)(11)-1 in 2004,[11] such accounts were regulated only under the Exchange Act and SRO rules.[12] Even after Madoff's firm became subject to the Advisers Act (which happened toward the end of the fraud), the firm's custody over client assets was still subject to the panoply of protections under the Exchange Act and NASD/FINRA rules. Given Madoff's ability to circumvent all these broker-dealer rules, it is unlikely that the proposed changes to the Advisers Act custody rule would have done much to protect that firm's clients.

The utility of a surprise exam is hardest to discern where an adviser's custody derives solely from its ability to deduct fees from clients' accounts. There is absolutely no evidence that clients are being harmed by direct-fee deduction arrangements; in fact, clients often prefer such arrangements because of their convenience. Moreover, since a surprise exam focuses on the location of client assets and reconciliation of the adviser's

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[9] In *SEC v. WG Trading Investors, L.P., et al*., Litigation Release No. 20912 (Feb. 25, 2009), the SEC alleges that an adviser had been misappropriating client funds since at least 1996. Prior to the 2004 effective date of the amendments to Rule 206(4)-2, all advisers with custody of client assets were subject to a surprise exam requirement.

[10] *SEC v. The Nutmeg Group, LLC et al.,* Litigation Release No. 20972 (Mar. 25, 2009), Complaint at Paragraph 75.

[11] Rule 202(a)(11)-1, which became effective in April 2005, interpreted the scope of the broker-dealer exception to the definition of "investment adviser" under the Advisers Act. In so doing, the rule stated that a broker-dealer's investment advice is not "solely incidental" to the conduct of its broker-dealer business when it "exercises investment discretion . . . . over any customer accounts." Rule 202(a)(11)-1(b)(3). Although Rule 202(a)(11)-1 was invalidated by the D.C. Circuit in 2007, the Commission has proposed to continue subjecting discretionary, commission-only brokerage accounts to the Advisers Act. *Interpretive Rule Under the Advisers Act Affecting Broker-Dealers*, IA Release No. 2652 (September 24, 2007).

[12] These rules include, but are not limited to, Exchange Act Rules 15c3-3 (customer protection), 10b-10 (trade confirmations) and 17a-3 and 17a-4 (books and records), as well as NASD/FINRA Rules 2120 (use of manipulative, deceptive or other fraudulent devices), 2230 (confirmations), 2330 (customer securities or funds), 2340 (customer statements) and 2510 (discretionary accounts).

records with those of the custodian and the client,[13] such an exam is unlikely to uncover instances in which the adviser has miscalculated its advisory fee, which is the primary risk posed by these arrangements. That risk is best addressed by the qualified custodian's delivery of account statements to clients and by the adviser's obligation to monitor fee calculations as part of its overall compliance program.

If the Commission believes clients need more protection than this, we would suggest requiring that each time an adviser presents a bill to a client's custodian for direct payment, it also sends a statement to the client showing the amount of the fee to be deducted, the value of the client's assets upon which the fee was based and the specific manner in which the fee was calculated. The adviser also could be obligated to advise clients that it is their responsibility and not that of the custodian to verify the accuracy of the fee calculation.[14]

Although the benefits of surprise exams to clients whose assets are held in fully independent custody arrangements are illusory, the burdens such exams would place on advisers are all too real. In addition to out-of-pocket accounting fees, advisers would incur internal costs in preparing for and dealing with the examiners each year.[15] In evaluating these costs, we believe it is important to recognize that they would be added to the already substantial outlays of time and money that registered advisers must devote to their compliance programs. We think it is also important to recognize that these substantial compliance costs are shouldered predominantly by small firms. Nearly half of all federally registered advisers have 5 or fewer employees, while roughly ninety percent of advisers have 50 or fewer employees.[16]

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[13] *See* Proposing Release at 6, *citing* note 33 of the 2003 Adopting Release.

[14] These procedures were established under a no-action letter to John. B. Kennedy (June 5, 1996), that the Commission staff withdrew when Rule 206(4)-2 was amended in 2003. Many advisers who directly deduct advisory fees continue to follow these procedures.

[15] The Commission estimates the accounting fees to be, on average, $8,100 per year, and it notes that these estimates are consistent with those made in connection with the last proposed overhaul of the custody rule. Proposing Release at note 102 and accompanying text. In 2002, the Commission estimated the cost of a surprise exam would be $8,000 a year. *Id*. at 46. A service costing $8,000 in 2002 would cost almost $9,600 today. *See* CPI Inflation Calculator available at http://data.bls.gov/cgi-bin/cpicalc.pl. In addition, the Commission estimates that advisers would incur more than $1200 for the time their employees would spend in connection with surprise exams. *Id.* at 63-64. We believe the actual costs of compliance could be substantially higher than the Commission estimates.

[16] National Regulatory Services & Investment Adviser Association, *Evolution Revolution: A Profile of the Investment Adviser Profession* (2008) at 8.

For the foregoing reasons, we respectfully submit that a surprise exam requirement should not be imposed on any adviser whose clients' assets are maintained through a fully independent custody arrangement.

Even where advisers directly or indirectly have possession of client assets, or control the account statements sent to pooled-vehicle investors, the utility of a surprise exam is far from clear. As the Commission notes, in such cases, the accountant seeking to verify client assets might have to rely on custodial reports issued by the adviser or its related party.[17] In cases of egregious fraud like the ones that motivated this rulemaking, those reports could contain far more fiction than fact.[18] We believe that the risks arising from advisers' self-custody arrangements or their delivery of account statements to investors in pooled vehicles are better addressed through other measures the Commission has proposed in this rulemaking, as well as more risk-focused compliance inspections of advisers and improved enforcement of the custody-related Exchange Act and SRO rules.

Defining Custody

The Commission proposes to amend the custody rule to provide that an adviser will be deemed to have custody of any client assets that are directly or indirectly held by a related person in connection with advisory services the adviser furnishes to clients. We believe this change goes too far and could impose burdens on advisers in situations that do not pose risks to advisory clients. Instances in which an adviser has the power to misappropriate assets held by a related party are already covered by Rule 206(4)-2, by virtue of the "indirect" custody concept the Commission articulated in 2003.[19] Instead of creating an irrebuttable presumption concerning related-party custody, we suggest that the Commission substitute a rebuttable presumption incorporating the factors that already apply to a determination of indirect custody.[20] An adviser that claims to have rebutted this presumption should be required to maintain records demonstrating its analysis.

In addition to making this change, we respectfully ask the Commission to address a practical problem that arose from the custody definition that was adopted in 2003. Rule 206(4)-2(c)(1)(i) provides that even momentary possession of client assets qualifies as

[17] Proposing Release at 21.

[18] As indicated above, one of the cases the Commission cites in explaining the need for this rulemaking involved an adviser who would have been subject to the custody rule's surprise audit requirement prior to 2003. *SEC v. WG Trading Investors, L.P., et al.*, *supra.* at note 9.

[19] Proposing Release at 9; 2003 Adopting Release at note 4.

[20] These factors were articulated by the staff in an interpretive letter issued to Crocker Investment Management Corp. (available April 14, 1978).

custody. Unless it is also a qualified custodian,[21] an adviser that inadvertently comes into possession of client funds or securities must return those assets to the sender within three business days of receiving them. Where the adviser receives such assets from the client, returning the assets is unlikely to have untoward consequences. However, where an adviser is forced to return assets to an administrator of a class action settlement account or Fair Funds account; the IRS or other taxing authority; or a bankruptcy trustee, the assets may never been seen again. Moreover, returning inadvertently received client assets to third parties in these types of situations is unlikely to deter such parties from sending assets to advisers in the future.

Because in this respect the custody rule does more harm than good, the Commission staff granted limited no-action relief to advisers who inadvertently receive client assets from third parties.[22] We respectfully request that the Commission incorporate this important relief into the custody rule. In order to harmonize this relief with the existing provisions of the rule, we further request that the phrase "three business days" currently found in 206(4)-2(c)(1)(i) be changed to "five business days."

Another practical concern that has arisen with the custody rule relates to the scope of constructive custody. Rule 206(4)-2(c)(1)(ii) defines custody to include any arrangement under which an adviser is authorized or permitted to withdraw client funds or securities. Read literally, this provision could encompass situations that do not put advisers in a position to misappropriate client assets. The 2003 Adopting Release confirmed that an adviser's authority to issue instructions to a broker-dealer or custodian in connection with the execution or settlement of trades on clients' behalf does not constitute custody under this provision. We request that similar guidance be issued regarding situations in which an adviser is authorized to instruct a qualified custodian to transfer assets between accounts held on behalf of the same client, or to direct the qualified custodian to issue funds or securities directly to the client at the address to which the quarterly statements are sent. As with trading authority, authority to move assets in a closed loop that involves only the

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[21] As noted above, the Commission estimates that only 372 of the 11,272 federally registered advisers are also qualified custodians. Proposing Release at 41.

[22] *Investment Adviser Association* (Sept. 20, 2007). In order to qualify for this relief, (i) the adviser must promptly identify the assets it has received and the client to whom the assets belong; (ii) within five business days following receipt of the assets, the adviser must forward the assets to the client or the client's qualified custodian or must return the assets to the party who sent them; and (iii) the adviser must maintain records of all client assets inadvertently received, including a written explanation of where the adviser sent the assets and when it did so. In addition, any adviser who inadvertently receives client assets in more than rare or isolated instances must adopt written policies and procedures reasonably designed to ensure that these conditions are met.

client and his other custodial accounts does not expose the client's assets to risk of misappropriation by the adviser.[23]

Other Matters

With regard to some of the Commission's other questions about the proposed changes to Rule 206(4)-2:

- We do not believe that advisers' chief compliance officers should be obliged to periodically certify to the Commission that all client assets are properly protected and accounted for. Advisers Act Rule 206(4)-7 already requires advisers to implement procedures reasonably designed to prevent, detect and correct violations of the Advisers Act. Requiring CCOs to make subject-specific certifications regarding their compliance programs increases their already heavy workloads without benefitting clients in any meaningful way. Furthermore, since most advisers do not possess their clients' assets, they are not in a position to certify to the asserts' protection.

- For the reasons stated above, we do not support the proposal to require surprise exams, especially where client assets are maintained by independent custodians who send account statements to clients. However, if an exam requirement is imposed, we do not believe that it should include a testing of the valuation of securities. Valuation is a separate matter from the safeguarding of client assets.

- We support the proposal to require an adviser that directly or indirectly has possession of client assets to obtain an internal control report regarding the adviser's (or its related party's) controls relating to such custodial services. We further support the proposed requirement that these reports include an opinion from an independent public accountant registered with and subject to regular inspection by the PCAOB with respect to the description of the controls and the testing of their operating effectiveness.

- We do not believe that the Commission should require the use of an independent qualified custodian in all cases. Requiring dually registered investment adviser/broker-dealers to transfer physical possession of advised assets to an outside party would be too costly for small advisory clients and would be inconsistent with the operation of wrap fee and similar advisory programs.

[23] We note that five commenters on the 2003 amendment to the custody rule asked for similar clarification. *Summary of Comments on Proposed Amendments to Rule 206(4)-2 Under the Investment Advisers Act of 1940 Addressing Custody of Funds or Securities of Clients by Investment Adviser*, (November 7, 2002).

- We believe that adding the phrase "after due inquiry" to Rule 206(4)-2(a)(3) would be superfluous. The rule already requires advisers to have a "reasonable basis for believing" that the qualified custodian is sending account statements to clients. Since an adviser could not have a reasonable basis without making due inquiry, adding more words to the rule accomplishes nothing. The Commission seems to acknowledge this by confirming that an adviser's receiving copies of the account statements sent to clients would satisfy both the "reasonable basis" test and the "due inquiry" test.[24]

- We do not believe that advisers should be required to send their own account statements to clients. Many clients do not wish to receive two sets of statements regarding their accounts.

- We generally agree that the proposed changes to Form ADV will provide information that the Commission and its staff can use to assess the risk posed by advisers' custody practices and to conduct more informed compliance exams. However, the language proposed to be added to Part 1A, Item 9 of Form ADV is confusing. Instead of distinguishing between "actual" custody and "constructive" custody, the proposed item asks if the registrant has "custody" and whether it or its affiliate acts as a "qualified custodian." We would suggest using the "actual" and "constructive" custody dichotomy and including those terms in the Form ADV Glossary.[25]

Conclusion

For the reasons discussed above, we respectfully request that no new obligations be imposed on advisers whose client assets are held through fully independent custody arrangements, and that the requirements for advisers in other situations be narrowly tailored to the risks attendant to those situations. We also ask the Commission to amend the definition of custody in Rule 206(4)-2 to address issues that have arisen under the version of the rule that was adopted in 2003. Finally, we ask the Commission to undertake a thorough examination of the design and enforcement of the regulation of broker-dealers' custodial activities under the Exchange Act and SRO rules.

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[24] Proposing Release at note 61.

[25] As an aside, we note that in common parlance, "custody" is usually associated with physical possession. Many of our adviser clients who automatically deduct fees from client accounts are confused by the notion that they have custody over their clients' assets when those assets are held at a qualified custodian. Distinguishing between active and constructive custody may alleviate that confusion.

We appreciate this opportunity to comment on this important proposal.

Very truly yours,

Mari-Anne Pisarri

cc: Hon. Mary L. Schapiro
Hon. Kathleen L.Casey
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