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July 28, 2009

Via Electronic Mail to rule-comments@sec.gov
File Number S7-09-09

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

Re: File Number S7-09-09; Proposed Rule Amendments Regarding Custody of Funds or Securities of Clients by Investment Advisers

Dear Ms. Murphy:

E*TRADE FINANCIAL Corp. is the ultimate parent company of five registered investment advisers ("Advisers") and two registered broker-dealers ("Broker-Dealers"). Our Advisers offer a variety of investment advisory products, including non-discretionary and discretionary advisory services and wrap products. Our Advisers use both the Broker-Dealers and independent third-party qualified custodians to provide execution and custodial services for their customers. Our Advisers also have contractual arrangements with some of their clients for the automatic deduction of advisory fees.

Since our organization has experience with both related person and third-party custodial arrangements, as well as different investment advisory products, we welcome the opportunity to comment on the proposed amendments to Rule 206(4)-2 under the Investment Advisers Act of 1940 ("Advisers Act")("Rule Amendments"), and we applaud the Commission's efforts to improve the safekeeping of client assets.

A. The Definition of "Control" in the Rule Amendments' Definition of "Custody" Should Exempt Common Control Situations Where the Adviser Has No Actual Control

The Commission has proposed an amendment to the definition of "custody" under Rule 206(4)-2 as part of the Rule Amendments to provide that an adviser has custody if client

securities or funds are held directly or indirectly by a "related person."[1] The Rule Amendments would include as "related persons" persons directly or indirectly controlling or controlled by the adviser and persons under common control with the adviser. "Control" would be defined as the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract or otherwise.[2] The Commission states that it "believe[s] that the risks to advisory clients that arise as a result of a related person's ability to obtain client assets, regardless of the separation between the adviser and a related person, may be substantial enough to require the adviser to comply with the custody rule."[3]

In many large financial services companies a separate registered broker-dealer provides custodial services for an affiliated adviser's clients, and both entities are commonly controlled by virtue of their being ultimately held by the same parent company. This situation should not be treated *per se* as the adviser having custody of the assets under Rule 206(4)-2, without evidence that the adviser has influence over the operations, policies and controls of the custodial broker-dealer.[4] If an adviser is commonly controlled with the custodian but has no actual control over the custodian's policies, procedures, and operations, the situation from a risk perspective is no different than a third party adviser with discretionary authority over client assets using an independent qualified custodian. In fact, if the custodian treats both types of custodial customers the same, its corporate relationship to the adviser should be irrelevant.

Given the implications to the investment adviser of being deemed to have custody by virtue of the use of a commonly controlled qualified custodian, the Commission should provide further guidance as to what may constitute the ability to "direct the management or policies of a person, whether through ownership of securities, by contract or otherwise" and choose to include disclosure in Item 9 of Form ADV whereby not only would an adviser check that a related person has custody, but where there is a common control situation, indicate whether it has *actual* influence over the custodian. If the adviser chooses to refute actual control, the adviser would have to provide necessary disclosure in the ADV as to its rationale.

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[1] Investment Advisers Act Release No. 2876 (May 30, 2009) at 18 ("Proposing Release").

[2] *Id.*

[3] *Id.* at 19.

[4] In the Bernard Madoff case, Mr. Madoff had complete control over both the advisory and brokerage operations and could falsify trading confirmations and client account statements. *See* Text of Bernard Madoff's Court Statement, March 12, 2009. A large organization such as ours where the advisory and brokerage businesses do not share an immediate common parent and where the Advisers have no influence over the practices, policies and operations of the Broker-Dealers should not be considered to pose the same fraud risks as custody with related persons where the adviser controls the custodial business.

B. Annual Surprise Examination of Client Assets for Advisers with Custody

1. Fee Discretion Advisers Should Be Excluded from the Surprise Examination Requirement of the Rule Amendments

The Commission has proposed that all advisers with custody of client assets engage an independent public accountant to conduct an annual surprise examination of client assets. Because the Rule Amendments require all advisers with custody to undergo the surprise annual exam, investment advisers who are deemed to have custody only because they have the authority to withdraw advisory fees from client accounts would have to comply with the requirements of the annual surprise examination ("Fee Discretion Advisers"). By including Fee Discretion Advisers, the effect of the Rule Amendments is to require the vast majority of the industry to incur the expense and disruption of an annual surprise examination regardless of who custodies the assets.

The automatic deduction of advisory fees does not present the same level of fraud risk as other discretionary activities of a registered investment adviser. So long as the fee rate and its calculation methodology is clearly stated in an executed investment advisory contract with a client, and the client is receiving periodic account statements that reflect the withdrawal for advisory fees, the client should be able to verify the accuracy of the fees deducted. In fact, the automatic deduction of advisory fees in a client-adviser relationship can be analogized to arrangements customers make with credit card companies and other service providers for direct withdrawal of fees from bank accounts. If the Commission is concerned that Fee Discretion Advisers present a potential for fraud even though they possess no other discretion over the advisory account, the Commission may be able to alleviate its concern by ensuring that advisory contracts are clear in the compensation terms and/or providing that clients receive a form of advance notice of the upcoming deduction (similar to what some services companies provide clients who have automatic account debit arrangements).

When a definition of "custody" was included among the amendments of Rule 206(4)-2 adopted by the Commission in 2003, the Commission included Fee Discretion Advisers.[5] Responding to several commenters' suggestions that the definition exclude Fee Discretion Advisers, the Commission stated, "Removing this form of custody from the definition would mean that clients would not receive the quarterly account statements that are required under the rule, and which are needed so the clients may confirm that the adviser has not improperly withdrawn amounts in excess of its fees."[6] Given the Commission's proposal as part of the Rule Amendments that all investment advisory clients receive quarterly statements from qualified custodians, the Commission already is providing clients with the necessary information, and Fee Discretion Advisers should be excluded from the surprise examination requirement.

[5] *See* Investment Advisers Act Release No. 2176 (September 25, 2003)("2003 Adopting Release").
[6] 2003 Adopting Release at 3.

2. The Annual Surprise Examination Requirement Could Be Replaced By a Risk Analysis Approach

Instead of requiring that all investment advisers with custody of client assets undergo an annual surprise audit examination, the Commission could consider an initial surprise audit examination and a risk rating system that determines whether an investment adviser should undergo annual audit examinations or examinations on a less frequent basis. This process would be similar to the compliance inspection criteria and approach adopted by the Commission's Office of Compliance Inspections and Examinations to determine the frequency of its inspections of registrants.

The Commission could incorporate in a risk based approach a higher risk rating for custodial arrangements with related persons, suggesting a higher frequency for surprise examinations. The Commission could also utilize the annual internal control report requirement it has proposed for custodial arrangements with related persons or self-custody as a guideline to determine the frequency of surprise examinations.

Another suggestion would be requiring the use of annual "call reports" whereby investment advisers and custodians submit reports with the CUSIP number and current face amounts of client assets as well as information about the custody arrangements. The Commission could use the call reports submitted by corresponding advisers and custodians to search for significant disparities as part of a risk based approach.

3. Requiring a Surprise Examination Is Unnecessary Given the Annual Internal Control Report Requirement for Self-Custody and Related Person Custodial Arrangements

The Commission has also proposed that when an adviser or related person serves as a qualified custodian for client assets in connection with advisory services provided by the investment adviser, the adviser has to obtain on its own behalf or from the related person, an internal control report prepared by an independent public accountant (registered with the Public Company Account Oversight Board ("PCAOB")) with respect to the controls relating to custody of client assets. This report would have to be obtained on an annual basis.

Although the annual surprise examination is for the adviser, the preparation of an annual internal control report by a PCAOB auditor arguably makes redundant the annual surprise examination, especially if the adviser self-custodies and if the surprise examination is performed by the same auditor that prepares the internal control report. For small businesses, it represents a burdensome expense regardless of whether the same or different auditor provides both the report and conducts the surprise examination.

The redundancy of an annual surprise examination and annual internal control report is further underscored if an adviser is a qualified custodian by virtue of its registration as a broker-dealer or bank. As the Commission points out in its Proposing Release concerning the Rule Amendments, "a broker-dealer's financial statements must be

audited annually by a registered public accounting firm [and] [t]his audit must include a review of the broker-dealer's procedures for safeguarding securities. The scope of this review must be sufficient for the auditor to provide reasonable assurance that material inadequacies do not exist in a broker-dealer's procedures for safeguarding securities."[7] Given these requirements, we believe that both an annual surprise examination for the adviser as well as an annual internal control report for a related person broker-dealer or bank custodian would be unnecessarily duplicative.

4. The Commission Underestimates the Cost of the Annual Surprise Examination

The Commission states in the Proposing Release that, for investment advisers having to undergo a surprise examination for 100% of their clients, it estimates a cost of $8,100 annually for the surprise examination.[8] However, the Commission estimated at the time that it proposed the 2003 Rule Amendments that "an adviser spends an additional $8,000 annually in connection with undergoing surprise examinations under the existing rule".[9] Although the Proposing Release states that the Commission consulted with a few accounting firms, the cost of the surprise examination would likely be higher than the $8,100 estimated by the Commission since advisers are required to use PCAOB registered auditors, and only a $100 increase in a six year period since the 2003 Proposing Release is not a realistic estimate.[10] The Commission's estimate is not clear as to whether it considers the heightened costs associated with engaging a PCAOB registered auditor for the surprise examination for advisers, such as our Advisers, that use related person custodians.

C. Further Guidance as to ADV-E Disclosure Is Necessary and ADV-E Should Not be Made Publicly Available

The Commission has proposed among the Rule Amendments changes to the Form ADV and Form ADV-E, including that Form ADV-E be filed electronically, be submitted by an auditor within four days of its resignation, dismissal from, or other termination of the engagement and be submitted annually providing a certificate from the auditor describing, among other things, the nature and extent of the annual surprise examination.[11]

It is our view that Form ADV-E should continue to be filed in a manner not publicly available (or at least not immediately so[12]). The disclosures that are the subject of Form ADV-E are primarily meant to benefit the Commission and its oversight of registrants' custodial arrangements and related policies and controls. The information provided

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[7] Proposing Release at 12.
[8] Proposing Release at 47, 64.
[9] Investment Advisers Act Release No. 2044 (July 18, 2002) at 12 ("2003 Proposing Release").
[10] The National Society of Compliance Professionals, Inc. ("NSCP") estimates that the costs may be as high as $25,000 for each annual surprise audit. *See* Comment Letter of NSCP.
[11] Proposing Release at 14-16.
[12] Public release could be delayed until the Commission reviews the filing.

presently and in the Rule Amendments for Items 9 and Schedule D of Form ADV should be sufficient for the public, especially if the adviser has to indicate whether the accountant's report was unqualified, as currently proposed.[13] At a minimum, further guidance regarding the Commission's expectations as to the description of the nature and extent of the annual surprise examination is warranted as well as what would be considered a "material discrepancy". Moreover, publicly disclosing the auditor's resignation, termination, etc. regardless of the circumstances could lead to unnecessary disruption of the advisory business and loss of clients. What if the auditor's resignation has nothing to do with the adviser's custodial practices and instead relates to increased auditor fees that the adviser cannot afford? If the removal, dismissal or resignation raises concern, the Commission can move quickly to alert the public after due investigation. If the Commission determines that the filing and termination statement should be publicly available, the Commission should provide further specificity of the termination/removal/resignation circumstances that indicate risk to client assets and necessitate the ADV-E filing.

D. Requiring the Provision of Account Statements from the Custodian and the Adviser Lessens the Fraud Risk

We agree with the Commission's proposal to amend Rule 206(4)-2 to eliminate the option currently available to advisers with custody to either send clients account statements and undergo an annual auditor examination or have the statements sent by a qualified custodian directly to the client. We believe that, at a minimum, investment advisory clients should receive statements regarding the assets in their account directly from the qualified custodian.

E. Requiring the Use of Independent Qualified Custodians is Premature and Would Potentially Lead to the Demise of Wrap Fee Products

The Commission has requested comment on whether, as an alternative to its proposals in the Rule Amendments, it should instead amend Rule 206(4)-2 under the Advisers Act to require that an independent qualified custodian hold client assets.[14] We appreciate that the Commission has promulgated the Rule Amendments as part of its efforts to seek to provide greater security for investment adviser client assets and has not taken the initial position of requiring all advisers to use independent qualified custodians. Before the Commission considers the adoption of requiring the use of an independent qualified custodian, it is our view that the Commission first evaluate the effect and sufficiency of the Rule Amendments, once adopted in final form. In addition, requiring an independent

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[13] Including this requirement will likely result in auditors having to review the ADV or indicate that their report is unqualified in their opinion letters. It is also not clear if the Commission is stating that the adviser would have to indicate whether the report concerning the annual surprise exam, internal control report or both, is unqualified. It would appear from the proposed amendment of Section 9.C. (6) of Form ADV that the Commission is only requesting this information with respect to an internal control report. Proposing Release at 93. Also, the Commission should consider whether the same auditor that audits a parent company's or related person's financials would be sufficiently disinterested and independent to be permitted to conduct the surprise examination and/or provide the internal control report.

[14] Proposing Release at 27.

qualified custodian for all advisers with custody could have a negative impact on the use of wrap fee products. These products, which are designed to combine custodial, brokerage and advisory fees into a single asset-based fee, are often offered by affiliated advisory and brokerage firms, such as ours, and can provide cost advantages to clients. Requiring the use of an independent custodian undercuts the cost efficiencies of wrap products since brokerage expenses would have to be separated from the investment advisory fees and clients would no longer be paying an all-in-one fee for brokerage, advisory and custodial services.

Moreover, although allegations in some recent enforcement actions cited by the Commission in the Release are so egregious[15] that a regulatory response is necessary to assuage public concerns, any regulatory response should consider that the vast majority of investment advisers adhere to their fiduciary responsibilities in managing their clients' assets and the current regime and controls in place have served the majority of investors well. Accordingly, the Commission should act to lessen the risks that led to the recent enforcement actions without eradicating practices in the industry that have existed for many years and have permitted investment advisers to offer their clients a variety of services and arrangements for the management of their assets.

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We appreciate the opportunity to provide our views on these important issues and would be please to provide any additional information the Commission or its staff may request. Please do not hesitate to the undersigned at 703-236-8524 with any questions regarding these matters.

Respectfully submitted,

/s/ Dilia M. Caballero

Dilia M. Caballero
Associate General Counsel

Cc: The Honorable Mary L. Schapiro, Chairwoman
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes

Mr. Andrew J. Donohue, Director, Division of Investment Management

[15] *See* Proposing Release, footnote 11.