July 24, 2009

Via Electronic Filing

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Proposed Rule: Custody of Funds or Securities of Clients by Investment Advisers, File No. S7-09-09, Release No. IA-2876

Dear Ms. Murphy:

The Investment Adviser Association (IAA)[1] appreciates the opportunity to comment on the Commission's proposed amendments to Rule 206(4)-2 of the Investment Advisers Act of 1940, which governs custody of client assets.[2] We support much of this important Proposal, particularly as it pertains to investment advisers that self-custody client assets. We have serious concerns, however, about imposing the surprise examination requirement on investment advisers that maintain client assets with independent third-party custodians and that are deemed to have custody of client assets only in the most technical sense of that term. We also suggest a number of additional modifications to the Proposal.

I. Background

In 2002, the Commission proposed comprehensive reforms to the custody rule in order to conform the rule to modern custodial practices and to provide clarification and transparency to the rule, which had not been amended since it was promulgated in 1962.[3]

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[1] The Investment Adviser Association is a not-for-profit association founded in 1937 that represents the interests of SEC-registered investment adviser firms. The Association's members collectively manage more than $7 trillion in assets for a wide variety of individual and institutional clients. For more information, please visit our web site: www.investmentadviser.org.

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

[3] *Proposed Rule: Custody of Funds or Securities of Clients by Investment Advisers*, Rel. No. IA-2044 (July 18, 2002) ("2002 Proposal").

Amendments to the rule were adopted in 2003[4] and included, among other things, a definition of "custody," clarification of the circumstances under which an adviser is deemed to have custody, and elimination of the annual surprise audit requirement for advisers that have a reasonable belief that a qualified custodian is providing account statements directly to clients.[5]

1. The Current Custody Rule

Under the current rule, SEC-registered investment advisers are deemed to have "custody" of client assets if they hold client funds or securities "directly or indirectly" or if they have any authority to obtain possession of client funds or securities. Investment advisers generally do not maintain physical custody of their clients' assets; instead, client assets are typically maintained with a broker-dealer or bank (a "qualified custodian").[6] An adviser still may be deemed to have custody under the rule, however, if the adviser has authority to withdraw client funds held by the qualified custodian (for example, where the adviser is authorized to deduct advisory fees from a client account). The adviser may also be deemed to have custody under the rule if it acts in any capacity that gives the adviser legal ownership of or access to client funds or securities (for example, an advisory firm is deemed to have "custody" of client funds and securities if one of its employees serves as a trustee to a client trust – even where the trust assets are held at a bank).[7] Accordingly, most registered investment advisers technically are deemed to have custody of client assets under the rule,[8] *but only a small percentage of advisers subject to the rule have actual physical custody of the funds or securities*.

Under the rule, investment advisers are permitted to have "custody" of client funds or securities only if: (1) a qualified custodian maintains those funds and securities; and (2) the

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4 *Final Rule: Custody of Funds or Securities of Clients by Investment Advisers,* Rel. No. IA-2176 (Sept. 25, 2003) ("2003 Custody Release").

5 The IAA submitted extensive comments regarding the 2002 Proposal. *See* Letter Regarding *Release No. IA-2044, File No. S7-28-02, Proposed Rule: Custody of Funds or Securities of Clients by Investment Advisers,* from Karen Barr, IAA General Counsel, to Jonathan Katz, Secretary, Securities and Exchange Commission (Sept. 25, 2002) ("September 2002 Letter").

6 *SEC Proposes Rule Amendments to Strengthen Safeguards of Investor Funds Controlled by Investment Advisers,* SEC Press Release (May 14, 2009) ("SEC Custody Press Release"), available at http://www.sec.gov/news/press/2009/2009-109.htm.

7 An adviser also may be deemed to have custody under the rule if it inadvertently receives client assets and does not return those assets to the sender within three business days. Pursuant to no-action relief granted to the IAA in September 2007, an adviser that inadvertently receives certain settlement checks, tax refund checks, dividend payments or stock certificates will not be deemed to have custody under the rule if the adviser forwards those assets to the client or a qualified custodian within five business days of receipt. *See Investment Adviser Association,* SEC Staff Letter (Sept. 20, 2007). We understand that the no-action relief is still valid, but we recommend that the Commission codify that no-action position in the final rule.

8 Because of the technical nature of the definition of "custody," the vast majority of SEC-registered advisers – 85%– are deemed to have custody under the rule, according to SEC estimates. Proposal *supra* n.2 at n.77.

adviser has a reasonable basis to believe that the qualified custodian sends account statements at least quarterly to each client, or, if the adviser sends the quarterly statements, an independent accountant verifies all of those funds and securities in a surprise examination at least annually ("surprise audit"). Thus, although advisers are deemed to have "custody" of client assets under a variety of circumstances, at all times a "qualified custodian" must actually hold the assets. Advisers that are qualified custodians can self-custody[9] client assets; however, the vast majority of client assets are held by independent third-party custodians.[10]

2. The Proposed Custody Rule

The Commission has decided to revisit the 2003 rulemaking in light of the Madoff fraud and other recent enforcement actions alleging misappropriation or other misuse of client assets. These cases have focused attention on the lack of independent oversight in situations in which a firm acts as both investment adviser and qualified custodian with respect to the same client assets.

The Proposal requires all advisers deemed to have custody of client funds or securities to undergo an annual surprise audit to verify those funds and securities. In addition, the Proposal requires an adviser that serves as a qualified custodian (or that has a related person that serves as a qualified custodian) to obtain a written report from an independent public accountant that includes an opinion regarding the qualified custodian's controls relating to custody of client assets ("internal control report"). The Proposal also includes enhanced disclosure and controls for advisers with custody of client funds and securities.

The IAA supports the safeguards imposed by independent third-party involvement with respect to the surprise audit and internal control report requirements for advisers that self-custody client assets.[11] The IAA also supports the safeguards provided by the enhanced disclosure and controls for advisers, with appropriate modifications. We are concerned, however, that the scope of the surprise audit requirement unnecessarily extends to advisers that maintain client assets with independent third-party custodians but are deemed to have custody of client assets. We are also concerned that the rule requirements apply too broadly

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[9] In a self-custody situation, a firm in its role as registered investment adviser provides investment advice with respect to client assets and the same firm in its role (typically) as broker-dealer or bank serves as qualified custodian for those advisory client assets.

[10] The Commission estimates that of the 9,575 advisers that would be considered to have custody under the proposed rule, all but 372 maintain client assets with an independent third-party custodian. *See* Proposal *supra* n.2 at 40-41.

[11] Earlier this year, the IAA made several recommendations to the SEC with respect to preventing or detecting fraud where no independent custodian safeguards client assets. The IAA recommended that the SEC consider permitting self-custody only where there is an independent third-party that, for example, conducts a special purpose audit to verify client assets or an audit of internal or operational controls. Letter regarding *Self-Custody of Advisory Client Funds,* from Karen Barr, IAA General Counsel, to Mary Schapiro, Chairman, Securities and Exchange Commission (Mar. 6, 2009) ("March 2009 Letter").

to all related persons of advisers, regardless of the relationship between the adviser and its affiliated entity.

II. The Scope of the Annual Surprise Audit is Overbroad

The Commission proposed the surprise audit requirement to provide "another set of eyes" on client assets and to provide additional protection against misuse of those assets. In a surprise audit, an independent public accountant must confirm all cash and securities held with the custodian and reconcile those holdings with the books and records of the adviser, verify the books and records of client accounts maintained by the adviser by examining the records and transactions since the last examination, and confirm with clients all securities in client accounts. The accountant also must confirm with clients, on a test basis, closed accounts or securities or funds that have been returned since the last examination.

The surprise audit requirement would apply to *all* advisers considered to have custody under the rule, whether or not they serve as qualified custodians that actually hold client assets.[12] We do not believe such a requirement is warranted when client assets are held by independent third-party custodians. The use of independent third-parties to hold client assets serves to safeguard client funds and securities, thereby significantly limiting opportunities for misappropriation or fraud.[13]

Opportunities for fraud or misappropriation are further limited by the fact that advisers usually do not direct clients to use particular custodians. Rather, more typically, clients choose the qualified custodian that will hold their assets and clients negotiate the custodial arrangements directly with the custodian. In those situations, the adviser does not make custodial arrangements, does not negotiate their terms, is not a party to the custodial agreement, and may only direct the custodian as permitted by the terms of the investment advisory agreement, in accordance with the procedures established by the client and the custodian.

In situations in which an independent third party holds client assets, the surprise audit would impose unnecessary expenses in exchange for limited meaningful additional safeguards

[12] The audit would apply to advisers that deduct fees from client accounts, write checks or withdraw funds on behalf of a client, act as a general partner and an adviser to a limited partnership, act as a trustee to an advisory client trust, and that have a general power of attorney over client accounts, as well as advisers with related persons that have custody of client assets.

[13] Although an independent custodian significantly limits opportunities for misappropriation, we do not recommend that the Commission require all investment advisers to use independent third-party custodians to hold client assets. It is not always practical or possible for investment advisers to use independent custodians, particularly with respect to wrap fee account programs. Instead, opportunities for misappropriation by advisers that self-custody client assets can be significantly limited with the adoption of the proposed requirements with respect to surprise audits and the internal control report, as well as the use of accountants registered with and subject to inspection by the Public Company Accounting Oversight Board (PCAOB) .

and, as such, is not warranted.[14] In particular, the surprise audit will not benefit clients of advisers that are deemed to have custody solely because they have authority to deduct fees from client accounts, or clients of advisers that serve as trustees to some client accounts, or clients of advisers to pooled investment vehicles that are audited annually, and that distribute financial statements in accordance with the rule.

1. The Surprise Audit Will Not Benefit Clients of Advisers That Are Deemed to Have Custody of Client Assets Solely Because They Have Authority to Deduct Fees from Client Accounts

The IAA strongly opposes imposition of the surprise audit requirement on the almost 6,000 advisers that are deemed to have custody solely because they have the authority to deduct fees from client accounts.[15] Adequate additional safeguards already exist for these arrangements. Advisers that have the authority to deduct fees from client accounts have extremely limited access to client assets.[16] The adviser's fees are negotiated with the client and the fee schedule is disclosed to the client in the firm brochure and in the advisory agreement. Clients specifically agree to have fees deducted from their accounts, and, in fact, it is our understanding that clients usually ask to have fees automatically deducted as a matter of convenience.[17] The calculation of fees is detailed in the invoices advisers send to clients and clients can compare any invoices received from their adviser with the quarterly account statements sent directly by the custodians.[18] These safeguards ensure a high degree of

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[14] See subsection 1 below for a discussion of the costs of surprise audits. In the Proposal, the Commission requested comment regarding alternatives to the surprise audit requirement, including amending the compliance program rule to require the Chief Compliance Officer (CCO) to submit a certification indicating that all client assets are properly protected and accounted for on behalf of clients. CCOs are not in a position to personally vouch for client assets maintained with an independent third-party qualified custodian. Investment advisers should not be required to guarantee the actions of an independent custodian, particularly if that custodian was chosen by the client.

[15] The Commission recognizes that advisers exercising discretionary authority typically have arrangements with clients to withdraw fees from client accounts and estimates there are 5958 advisers deemed to have custody solely because they have authority to deduct client fees. *See* Proposal *supra* n.2 at n.77 and n.99.

[16] We continue to support the position set forth in our 2002 Letter, in which we noted that the SEC's inclusion of fee billing arrangements in the definition of custody is inconsistent with the common understanding of what it means to have custody and has become outdated. *See* September 2002 Letter *supra* n.5 at n.7 ("Today, many consumers permit their mortgage companies, credit card companies, utilities and even athletic clubs to deduct fees directly from their checking accounts, in a manner similar to the adviser's deduction of fees. Few would deem these companies to have custody of the consumer's assets because they have received the authority or permission of the consumer to deduct the fees, just as the adviser has been granted authority by the client to deduct fees from the advisory account.")

[17] If the Proposal is adopted, advisers that are deemed to have custody solely because they deduct fees may decide to bill clients directly, even though, as noted above, clients typically ask to have fees automatically deducted as a matter of convenience. Billing clients directly would increase the costs and administrative burdens for advisers and clients, but would not result in greater client protection against fraudulent billing.

[18] Under the Proposal, advisers with custody of client assets would be required to have a reasonable basis for believing that the qualified custodian sends an account statement, at least quarterly, to clients and would no

transparency and have worked well to protect clients of advisers that have authority to deduct fees from client accounts. The IAA is not aware of any significant abuses due to fraudulent billing.[19] Indeed, because of the safeguards already in place, the risk that client assets will be misappropriated due to improper billing practices is minimal.

Furthermore, the surprise audit will not "substantially increase protections for investors who entrust their money to investment advisers"[20] and it will not provide any additional safeguards to clients of advisers that are deemed to have custody solely because they have the ability to deduct fees from client accounts. The surprise audit is solely intended to confirm and verify holdings (*i.e.* count securities). It is our understanding that the surprise audit does not cover review of fees assessed by advisers or paid by clients. Accordingly, there is no nexus between the proposed requirement and the activity the requirement seeks to address.

In addition, the Commission has significantly underestimated the cost of surprise audits. The Commission's estimate of $8,100 for a surprise audit is substantially the same estimate that was set forth in the 2002 Proposal. At an absolute minimum, that cost estimate should be adjusted to reflect price increases in the seven years since that estimate was published. Moreover, the Commission's cost estimate should be adjusted to account for factors that will have a significant impact on the cost of the surprise audit, including the size of the adviser and the complexity of the adviser's business, the number of clients an adviser has, the number of investment holdings, the number of custodians holding client assets, and the types of securities held by the clients.[21] Given those considerations, more realistically, it is our understanding that the surprise audits are likely to cost between $20,000 and $300,000. Also, because the overwhelming majority of advisers will have to negotiate new agreements with accountants for the surprise audits, that process will take far longer than the fifteen

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longer be able to send account statements directly to clients in exchange for undergoing an annual surprise audit. *See* Proposal *supra* n.2 at 29-32.

[19] The cases cited in the Proposal involve Ponzi schemes and other frauds, not misappropriation of client fees. We are aware of very few enforcement actions involving incorrect billing, and most of those actions appear to involve incorrect use of performance fees, as opposed to improper access to client assets. *See e.g*., *In the Matter of Bridgeway Capital Management, Inc.,* Rel. No. 2294 (Sept. 14, 2004); and *In the Matter of Renn Capital Group*, Rel. No. 2454 (Dec. 1, 2005). It is our understanding that the SEC recently filed an enforcement action against an adviser that allegedly misappropriated from client accounts advisory fees that were fraudulent, excessive, and unauthorized. *See SEC v. Jindra and Envision Investment Advisors, LLC,* (DC NE) (June 30, 2009). In that action, the alleged misappropriation was apparently discovered by the independent custodian and clients when they were reviewing account statements, reflecting the effectiveness of those safeguards.

[20] *See* SEC Custody Press Release *supra* n.6.

[21] For example, an audit involving privately issued securities is likely to be significantly more time-consuming and expensive than an audit involving common equity securities. Similarly, advisers may manage accounts custodied with regulated entities outside the United States, which will add significantly to the cost and complexity of the surprise audits, even though the foreign custodians are subject to regulatory and other oversight.

minutes estimated in the Proposal. The high costs and time spent implementing the requirements will have a disproportionate impact on smaller investment advisers.[22]

Given the high costs of surprise audits, the negligible benefits to clients of advisers that have authority to deduct client fees, and the substantial safeguards already in place for those clients, the surprise audit is not necessary for advisers that are considered to have custody solely because they have authority to deduct fees from client accounts.

As an alternative, if the Commission is concerned about potential abuses from advisers that deduct fees, the Commission should consider adopting controls designed to address those potential abuses. Some controls to consider include requiring advisers to provide clients with documentation of the fee calculation, requiring advisers to provide duplicate copies of advisory bills to custodians and clients, requiring advisers to obtain written authorization from clients regarding the deduction of fees, or requiring advisers to obtain limited audits of advisory fees only.[23] The IAA would be pleased to work with the Commission to suggest reasonable alternatives to the surprise audit requirement for advisers that have authority to deduct fees from client accounts.

2. The Surprise Audit Will Not Benefit Clients of Advisers That Serve as Trustees to Client Accounts

The IAA also is concerned about the effects of imposing the surprise audit requirement on advisers whose client assets are maintained with third-party custodians and who are deemed to have custody because they or their employees serve as trustees to client trusts. Typically, because of the significant responsibilities involved, many advisers will agree to act as a trustee only for clients that they have known for a long time. Advisers are asked to serve in that trusted capacity because of longstanding relationships with their clients, because of their special expertise in investment matters, and/or because clients do not have any family members available to serve in that capacity.[24] Most advisers either do not charge a separate fee to act as trustee on a client account or charge a minimal fee to act in that capacity.

Requiring advisers that serve as trustees for client accounts to undergo an annual surprise audit will be more costly for clients because it will have the unintended effect of discouraging investment advisers from serving as trustees. This would force clients to appoint other trustees, at their own expense, who may not be as qualified or otherwise subject

[22] As of April 2009, more than half of investment advisers have fewer than five non-clerical employees, and more than nine in ten advisers have fewer than fifty such employees.

[23] The Commission should consider codifying the procedures established under certain no-action letters that were withdrawn upon the effectiveness of the 2003 amendments to the custody rule (*e.g., Investment Counsel Association of America, Inc.*, SEC Staff Letter (June 9, 1982): *John B. Kennedy,* SEC Staff Letter (June 5, 1996), and *Securities America Advisors Inc.*, SEC Staff Letter (Apr. 4, 1997). These conditions served as appropriate safeguards when the no-action letters were operative and provide more meaningful and focused protections than a surprise audit, which, as noted above, focuses on confirmation of securities.

[24] For similar reasons, advisers sometimes are asked to serve as executors of client estates.

to SEC jurisdiction (and who therefore would not be subject to the surprise audit requirements).[25] The IAA is not aware that there are greater concerns about registered investment advisers serving in a trustee capacity as opposed to other individuals serving in that capacity. Any concerns about the role of trustees in general should be addressed through trust law, not the Investment Advisers Act.

As an alternative, if the Commission is concerned about potential abuses by advisers that serve as trustees to client accounts, the Commission should consider requiring advisers to adopt controls to address those specific issues. Some controls to consider include requiring advisers that serve as trustees to: (1) use an independent third-party qualified custodian to hold client trust assets; (2) require the custodian to send quarterly statements to the trust beneficiaries; (3) require the custodian to send a trust accounting to the current and remainder beneficiaries of the trust; or (4) issue instructions to the custodian limiting its authority to deliver trust assets to the adviser other than fees, and limiting its authority to otherwise transfer trust assets.[26] These controls are reasonable alternatives to the surprise audit for advisers that serve as trustees to client trusts.[27]

3. The Surprise Audit Will Not Benefit Clients of Advisers to Pooled Investment Vehicles That Are Audited and That Distribute Financial Statements in Accordance with the Rule

The Proposal would continue to exempt advisers from the requirement to have a qualified custodian send quarterly account statements to investors with respect to assets held in pooled investment vehicles such as limited partnerships or limited liability companies if the pooled investment vehicle: (1) is audited at least annually by an independent public accountant; and (2) distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or other members or other beneficial owners) within 120 days of the pool's fiscal year end. Under the Proposal, however, pooled investment vehicles would be required to undergo a surprise audit in addition to the annual audit.

An annual audit provides protection against the misuse of client assets. Surprise audits do not add substantial value to annual audits, particularly in circumstances in which the assets of the pooled investment vehicle are maintained by an independent third-party

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[25] Because investment advisers typically either charge a minimal fee or do not charge an extra fee for serving as a trustee to client accounts or as an executor to client estates, the fees associated with the surprise audit will likely be passed directly to the trust or the beneficiaries.

[26] *See e.g. Blum Shapiro Financial Services, Inc.* , SEC Staff Letter (Apr. 16, 1993); *Clifford Associates*, SEC Staff Letter (Sept. 22, 1992); and *Wallington Asset Management*, SEC Staff Letter (Nov. 20, 1990). These conditions served as appropriate safeguards when the no-action letters were operative.

[27] Because of the expense of surprise audits, many advisers may decide to not serve as a trustee for client accounts if the Proposal is enacted. In that case, at a minimum, advisers that serve in a trustee capacity for existing client accounts should be grandfathered in or otherwise exempted from the surprise audit requirement for those accounts.

custodian. Requiring a surprise audit in addition to an annual audit would be disruptive, time intensive, and costly, while adding only minimal increased protections to investors in pooled vehicles. Advisers to pooled investment vehicles that undergo financial audits at least annually, that distribute audited financial statements in accordance with the rule, and that maintain client assets with independent third-party custodians should not be required to also undergo a surprise audit.[28]

Furthermore, the Commission should restore the rule provision that indicates that a fund of funds has 180 days to distribute audited financial statements. When the hedge fund registration rule was adopted several years ago, the Commission added a provision to the custody rule allowing fund of funds 180 days from the pool's fiscal year end to distribute audited financial statements to all limited partners.[29] According to the Commission staff, "the amendment was designed to address the practical difficulties faced by advisers to funds of funds in obtaining completion of their final fund audits prior to completion of the audits for the underlying funds in which they invest."[30] After the hedge fund registration rule was vacated, the staff clarified that an adviser to a fund of funds can continue to rely on the "annual audit exception" as long as the fund of fund's audited financial statements are distributed to its investors within 180 days of its fiscal year end.[31] The Proposal, however, does not include any reference to the provision for fund of funds.

Given that the practical difficulties faced by advisers to fund of funds seeking to complete their final fund audits prior to completion of the audits for the underlying funds in which they invest have been compounded by the recent market crisis, we recommend that the Commission include the fund of funds provision in the final rule.

Finally, the Commission staff has recognized that pooled investment vehicles often fail to distribute their financial statements within the prescribed time period because of unforeseen events. The staff has advised that failure to meet the deadline would not result in an enforcement action if the adviser "reasonably believed that the pool's audited financial statements would be distributed within the 120-day deadline.[32] We recommend incorporating this relief into the final rule.

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[28] As an alternative, the Commission could consider requiring enhancements to the annual audit that would include supplemental audit procedures that could help to verify each client's proportionate share of the pooled vehicle's assets. The IAA would be pleased to work with the Commission to suggest alternatives to the surprise audit requirement for advisers to pooled investment vehicles.

[29] Under that provision, a "fund of funds" is defined as a "limited partnership (or limited liability company, or another type of pooled investment vehicle) that invests 10 percent or more of its total assets in other pooled investment vehicles that are not, and are not advised by, a related person (as defined in Form ADV), of the limited partnership, its general partner, or its adviser."

[30] *See American Bar Association,* SEC Staff Letter (Aug. 10, 2006).

[31] *Id*.

[32] *Staff Responses to Questions About Amended Custody Rule,* Question VI.9 (updated Jan. 10, 2005), available at http://www.sec.gov/divisions/investment/custody_faq.htm.

III. The Definition of Custody Should Be Amended to Allow for the Consideration of Crocker Factors Regarding Whether an Adviser Has Custody Because its Related Person Has Custody

Under the current rule, if an affiliate of an adviser has access to or authority to obtain client assets, the adviser generally would not be considered to have custody of client assets unless the adviser or its personnel has access to those client assets through the affiliate.[33] In a no-action letter, the Commission staff set forth factors used to determine whether an adviser has indirect custody of client assets because its related person has custody.[34] Those factors include: (1) whether clients' property in the custody of the affiliate might be subject, under any reasonably foreseeable circumstances, to the claims of the adviser's creditors; (2) whether advisory personnel have the opportunity to misappropriate clients' property; (3) whether advisory personnel ever have custody or possession of or direct or indirect access to clients' property or the power to control disposition of such property for the benefit of the adviser or its affiliates; (4) whether advisory personnel and relevant personnel of the affiliated company are under common supervision; and (5) whether advisory personnel hold any position with the custodian or share premises with the custodian and, if so, whether they have access to or control over clients' property.[35]

The Proposal unconditionally provides that an investment adviser has custody of any client assets that are directly or indirectly held by a "related person" in connection with advisory services provided by the adviser to its clients. There are no proposed exceptions. A "related person" is defined as a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser. "Control" is 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. According to the Commission, the "in connection with" limitation of the Proposal is designed to prevent an adviser from being deemed to have custody of client assets held by a related person broker-dealer (or other qualified custodian) with respect to which the adviser does not provide advice.[36]

Although the IAA supports the Commission's goal to minimize opportunities for an adviser to have indirect access to client funds and securities through a relationship with an affiliate, the proposed standard is too broad and does not take into consideration different relationships advisers may have with their affiliated entities or the fact that affiliated entities may operate entirely independently from a related adviser. Not all arrangements in which a related person has custody of client assets result in the same level of risk to advisory clients.

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[33] *See* 2003 Custody Release *supra* n.4 at n.4.

[34] *Crocker Investment Management Corp.*, SEC Staff Letter (Dec. 5, 1977) ("Crocker").

[35] *Id.*

[36] *See* Proposal *supra* n.2 at 19.

In addition, the proposed standard could have unintended implications for foreign affiliates of advisers that operate separately from the adviser.

Furthermore, the Proposal presumes that advisers choose the custodian for clients. As noted above, more typically, particularly for institutional clients, the custodian is chosen by the client. In those situations, the client may choose a related person of the adviser to serve as a qualified custodian without prior consultation with the adviser or without the adviser's knowledge.

Accordingly, the Commission should retain and codify the current standard, as set forth in the Crocker no-action letter, and consider factors, including creditor claims, misappropriation, access, supervision, and shared personnel/location, used to determine whether an adviser has indirect custody of client assets because its related person has custody.[37] At a minimum, the rule should contain a rebuttable presumption that the adviser has custody if any of its related persons has custody. Advisers could then consider the factors outlined above and if they choose to rebut the presumption, they could be required to document their reasons for doing so and maintain such documentation under the books and records rule.

IV. Appropriately Tailored Disclosure and Controls Provide Additional Safeguards to Clients

1. PCAOB Registered Accountants Should be Required Only for Advisers that Self-Custody Client Assets

The IAA supports the use of PCAOB registered and inspected independent accountants to conduct internal control exams and surprise audits of investment advisers that self-custody client assets. The Commission requested comment regarding whether it should require *all* surprise audits under the rule to be conducted by independent public accountants registered with, and subject to regular inspection by, the PCAOB. We do not recommend the adoption of that requirement. Because most advisers (and the vast majority of smaller advisers) do not self-custody client assets, the risk of misappropriation is much lower. Thus, such a requirement would make it difficult and cost-prohibitive for small advisers to find accountants qualified to conduct surprise audits, while providing little added benefit to investors.[38] Furthermore, if any concerns arise regarding particular accountants, those accountants can be tracked through the proposed enhanced Form ADV reporting requirements. Accordingly, although the PCAOB requirements may be warranted for advisers that physically hold client assets, they are not necessary for advisers that are deemed to have custody, but that use independent third-party custodians to hold client assets.[39]

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[37] *See* Crocker *supra* n.34.

[38] Such a requirement would be even more difficult and cost-prohibitive for small advisers if the Commission does not adopt our recommendations regarding the scope of the surprise audit requirement, as set forth herein.

[39] Similarly, auditors to pooled investment vehicles with client assets maintained by independent third-party custodians should not be required to be registered with, and subject to regular inspection by, the PCAOB.

2. Advisers That Self-Custody Client Assets Should Be Required to Provide An Internal Control Report, Subject to an Appropriate Transition Period

Pursuant to the Proposal, an adviser (or related person) that serves as a qualified custodian for client assets must obtain a written report (referred to as an internal control report or SAS-70 report) at least once a year from an independent public accountant registered with, and subject to regular inspection by, the PCAOB, with respect to the adviser's or (related person's) controls relating to the custody of client assets. The internal control report includes the accountant's opinion "with respect to the description of controls placed in operation relating to custodial services, including the safeguarding of cash and securities" held by the adviser or a related person on behalf of clients, as well as tests for operating effectiveness. According to the SEC, control objectives relevant to custodial operations might include: safeguarding physical securities from loss or misappropriation; timely and accurate reconciliation of cash and security positions among the custodian, depositories and accounting systems; proper authorization and complete and accurate recording of client-initiated trades; timely and accurate processing of securities income and corporate action transactions; accurate performance of net settlement procedures; complete and accurate documentation of the account opening process; and accurate recording of valuations obtained from outside pricing sources.[40]

The proposed requirements with respect to the internal control report appear to directly address concerns raised by the Madoff fraud. The report, as well as the requirement that accountants preparing the report must be registered with and subject to regular inspection by the PCAOB,[41] will help to provide for the safekeeping of assets held by investment advisers that also serve as qualified custodians of those assets.[42]

The internal control report will be comprehensive and time consuming to prepare. Because the written report will have to include the accountant's opinion regarding the description of controls in place during the audit period, investment advisers will need ample time to establish the controls and to have those controls in place for the full audit period. Accordingly, we suggest a transition period of at least 18 months to enable investment advisers to institute appropriate controls before the audit is conducted.

Because many pooled vehicles are organized as partnerships, such a requirement would impose significant costs directly on the partners of the pool, while providing little added benefit to those investors.

[40] Proposal *supra* n.2 at 23.

[41] We have concerns, however, about indirectly converting advisers into guarantors of their accountants' status. *See* subsection 5, *infra*.

[42] The IAA supports the proposed internal control report requirements for advisers deemed to have custody because a related person holds client assets only to the extent that this concept incorporates consideration of the factors set forth in Crocker. The proposed requirements are overbroad, however, if the definition of custody is not amended to allow for consideration of such factors.

3. The Form ADV-E Filing Deadline Should be Extended and Portions of Form ADV-E Should Not be Made Publicly Available

The Proposal requires advisers to enter into a written agreement with an independent public accountant to conduct the surprise audit. The accountant is required to notify the Commission within one business day of finding any material discrepancies, and the accountant is required to electronically submit Form ADV-E to the Commission accompanied by a certificate within 120 days of the time chosen by the accountant for the surprise audit (as opposed to 30 days from the completion of the exam, under the current rule), stating that it has examined the funds and securities and describing the nature and extent of the examination. Advisers would be required to retain the written agreements pursuant to the investment adviser recordkeeping requirements.

The IAA supports the Form ADV-E filing requirements. The 120 day deadline for filing form ADV-E, however, could be problematic under certain circumstances, such as with respect to audits of advisers whose client assets include privately offered securities, and audits of very large and complex investment advisers.[43] Accordingly, we encourage the Commission to extend the filing deadline for such audits to 180 days from the time chosen by the accountant for the surprise audit.[44]

The Proposal also requires the accountant to submit Form ADV-E to the Commission within four business days of its resignation, dismissal from, or other termination, of the engagement, or upon removing itself or being removed from consideration for being reappointed, accompanied by a statement that includes (i) the date of such resignation, dismissal, removal, or other termination, and the name, address, and contact information of the accountant, and (ii) an explanation of any problems relating to examination scope or procedure that contributed to such resignation, dismissal, removal, or other termination.

The electronic filing of Form ADV-E could enhance the Commission's ability to identify potential custodial risks. The required disclosure will provide the Commission with timely information regarding any problems concerning the surprise audit. We support the public disclosure of the provision of Form ADV-E regarding an accountant's description of the nature and extent of the examination; however, we do not support the public disclosure of the portion of Form ADV-E reflecting the termination of the accountant's engagement. Advisers may be required to change accountants for non-regulatory reasons. Making the form

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[43] As noted above, we recommend that the Commission eliminate the surprise audit requirement for investment advisers to pooled investment vehicles that use an independent third-party custodian. If the Commission chooses not to eliminate that requirement, at a minimum the Commission would need to extend the Form ADV-E filing requirement for advisers to fund of funds to 180 days. The practical difficulties faced by advisers to fund of funds seeking to complete their final fund audits prior to completion of the audits for the underlying funds in which they invest will also be encountered by accountants seeking to submit Form ADV-E to the Commission within the 120 day deadline set forth in the Proposal.

[44] We recommend adding a provision to Form ADV-E to allow auditors to indicate the circumstances that led a particular audit to exceed 120 days. We would appreciate the opportunity to work with the Commission to draft appropriate language for that disclosure.

publicly available could have the unintended effect of making it more difficult for advisers to change accountants and making advisers captive to accountants that may not be providing optimal services. Furthermore, any change in the adviser's accountant would be reflected on Schedule D of Form ADV.

4. The Proposed Amendments Related to Notice and Delivery of Account Statements Provide Safeguards to Clients

The current rule requires advisers with custody of client assets to have a reasonable belief that a qualified custodian delivers account statements to advisory clients. Alternatively, the adviser can send account statements if it undergoes a surprise examination. The Commission now proposes to eliminate the latter alternative in order to provide "greater assurance of the integrity of those account statements."[45] We support this proposal. We agree that the overwhelming majority of advisers do not use this alternative, and those that do can address confidentiality concerns by contract or other means. We also agree that involvement of an independent third-party in sending account statements directly to the client would make it more difficult for an adviser to create false account statements.

The Proposal also makes explicit the implicit requirement that advisers form their reasonable belief that the qualified custodian is sending client account statements after "due inquiry." Our understanding is that most investment advisers form their reasonable belief by having the qualified custodian provide a copy of the account statement that was delivered to the client. The Proposal confirms that this is an appropriate way to satisfy the "due inquiry" requirement, but indicates that other means could be used as well.[46]

In addition, the Proposal requires advisers to include a statement in the notice they are required to send clients upon opening a custodial account on their behalf that urges clients to compare the account statements they receive from the custodian with those they receive from the adviser. We support this requirement with the modification that the statement be required only if the adviser sends its own account statements. The adviser is not required to send its own statements, and including the statement in those instances may be confusing to clients.

5. Form ADV Should Include Enhanced Disclosure Regarding Custodial Controls, with Certain Modifications

The Commission has proposed substantial additional disclosure in Form ADV, Part 1 regarding custody practices. As we stated in our March 2009 Letter, enhanced disclosure in Form ADV will greatly improve the SEC staff's ability to gather information about firms that self-custody client assets and to conduct appropriate inquiries, inspections, and other activities

[45] Proposal *supra* n.2 at 30.

[46] We suggest that the Commission identify other ways to satisfy the due inquiry requirement, such as by having the custodian inform the adviser at least annually that it provides such account statements or by requiring the custody agreement to include a provision requiring the custodian to send such statements to the client on a regular basis.

based on that information.[47] We also noted that this information could provide more transparency to clients and prospective clients, as well as to other regulators, about firms that self-custody.[48] Accordingly, the IAA supports additional disclosure in Part 1 of Form ADV, with the following modifications:

1. The questions should be revised to reflect our comments outlined above regarding the Proposal; if the Commission does not adopt our recommendations, the form instructions are not clear, particularly with respect to advisers that deduct fees;

2. If the Commission does not modify the related person provision of the custody definition in response to our comments, Item 9 will be somewhat confusing in its use of the terms "you" and "your related persons." Pursuant to the custody definition as proposed, "you" have custody if your related person has custody. The distinctions between Item 9A and 9B are therefore unclear. In addition, the custody definition limits imputed custody to situations where "your related persons" have custody "in connection with advisory services you provide to clients." Items 9B and 9C do not include this "in connection with" component.

3. Item 9C(1) is out of place in Form ADV. Form ADV is a disclosure document, not a vehicle for advisers to verify compliance with each aspect of the rule. Furthermore, advisers cannot guarantee that a third-party, the qualified custodian, sends account statements. They can only, as proposed, form a reasonable belief after due inquiry that the qualified custodian sends such statements.

4. Similarly, advisers should not be required to guarantee accountant PCAOB inspection and registration status; instead, investment advisers should be able to rely on accountants' representations regarding that status. Accordingly, Section 9(c)(3) and 9(c)(4) of Schedule D should be revised as follows:
   - (3) Has the independent public accountant confirmed registration with the Public Company Accounting Oversight Board?
   - (4) If yes to (3) above, has the independent public accountant confirmed that it is subject to regular inspection by the Public Company Accounting Oversight Board in accordance with its rules?

5. The custody disclosure should be amended to make it easier for the investing public to understand, since the disclosure is publicly available. For example,

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[47] March 2009 Letter, *supra* n.11. *See also* September 2002 Letter *supra* n.5 (suggesting that Form ADV distinguish between advisers that actually hold client assets and those that are merely deemed to have custody, in order to eliminate client confusion and provide more meaningful data to the Commission).

[48] March 2009 Letter, *supra* n.11.

> although some of the terms are defined, it might be helpful at the outset to clarify the distinction between when an adviser is deemed to have "custody" and when it acts a qualified custodian.

In addition, amendments to Form ADV, Part 2, the plain English brochure that provides clients with key information about an adviser's business practices, are currently pending. We recommend that the Commission update its proposed amendments to Form ADV, Part 2 (proposed Item 15) to require firms to include information about advisory assets maintained by dual registrants or an affiliate, including information about the firm's controls reasonably designed to mitigate any risks involved in self-custody arrangements. The Commission could also require disclosure designed to elicit whether self-custody arrangements are an integral or substantial aspect of the firm's business model and use this information to better focus inspection staff attention in these areas. We also take this opportunity to continue to urge the Commission to move expeditiously to adopt amendments to Form ADV, Part 2 in light of the compelling investor protection benefits the new plain English brochure would achieve.

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We appreciate the opportunity to comment on the Commission's proposed revisions to the custody rule. The IAA commends the Commission's efforts to strengthen the safeguards imposed by independent third-party involvement with respect to the surprise audit and internal control requirements for advisers that self-custody client assets. We urge the Commission to tailor the Proposal more appropriately to focus on the risks posed by self-custody. Please do not hesitate to contact us if we may provide additional information or clarification to the Commission or its staff regarding these matters.

Sincerely,

/s/ Valerie Baruch

Valerie Baruch
Assistant General Counsel

cc:

The Honorable Mary L. Schapiro, Chairman
The Honorable Kathleen L. Casey, Commissioner
The Honorable Elisse B. Walter, Commissioner
The Honorable Luis A. Aguilar, Commissioner
The Honorable Troy A. Paredes, Commissioner

Andrew J. Donohue, Director, Division of Investment Management
Mr. Robert E. Plaze, Associate Director, Division of Investment Management