355 N.E. 5th Avenue
Delray Beach, FL 33483
Tel: 561-330-7645
Fax: 561-330-7648

July 10, 2009

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

RE: Custody of Funds or Securities of Clients by Investment Advisers
Release No. IA-2876
File No. S7-09-09

Dear Ms. Murphy:

National Compliance Services, Inc. ("NCS") appreciates the opportunity to express its views in response to the request by the Securities and Exchange Commission (the "Commission") for comments on the proposed amendments to Rule 206(4)-2 under the Investment Advisers Act of 1940 (the "Custody Rule").[1] NCS provides compliance consulting services to approximately 600 registered investment advisers ("RIAs"), many of which are deemed to have custody under Rule 206(4)-2. NCS commends the Commission for its review of the Custody Rule, as the safeguarding of client assets is of paramount concern to RIAs as well as advisory clients.

Based upon the feedback we have received from our clients in response to the proposed revisions to the Custody Rule, as well as our broad experience in dealing with day-to-day compliance issues, this letter addresses the Commission's proposal with respect to RIAs who are deemed to have custody solely as a result of deducting advisory fees from accounts held at independent qualified custodians ("Deemed Custody RIAs"). NCS believes that current safeguards afford advisory clients the ability sufficiently to identify and detect erroneous or fraudulent transactions and deter Deemed Custody RIAs from fraudulent conduct, and the proposed requirement of an annual surprise audit would provide advisory clients with minimal incremental protection. In addition, the costs associated with the proposed annual surprise audit would be unduly burdensome on Deemed Custody RIAs. Accordingly, we believe that an annual surprise audit of Deemed Custody RIAs is not warranted. We do, however, suggest a rule change to make custodians' account statements for Deemed Custody RIAs more meaningful and transparent.

Prior to the 2003 revisions to the Custody Rule, the Commission's staff took the position that an investment adviser may be deemed to have custody where the adviser is paid automatically from client

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

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funds upon presentation of a bill to the custodian of the client's account. However, the staff would take the position that the adviser was not deemed to have custody if several conditions were met, including that the custodian agreed to send to the client a statement, at least quarterly, indicating all amounts disbursed from the account including the amount of advisory fees paid directly to the adviser.[2] These conditions were designed primarily to reduce the potential for misappropriation of client funds by the adviser or its employees.[3]

When the Commission revised the Custody Rule in 2003, it strengthened the account delivery requirement, requiring that the adviser have a reasonable basis for believing that the qualified custodian sends an account statement, at least quarterly, to each of its clients for which the custodian maintains funds or securities, identifying the amount of funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period.[4] The Commission explained that this provision was designed to assure the integrity of those account statements and permit clients to identify any erroneous or unauthorized transactions or withdrawals by an adviser.[5] The prior no-action letters were withdrawn and Deemed Custody RIAs were deemed to have "custody," specifically so that clients would receive the quarterly account statements and be able to confirm that the adviser had not improperly withdrawn amounts in excess of its fees.[6] The Commission in the Proposing Release explained that it had believed that direct delivery of account statements by qualified custodians would provide clients confidence that any erroneous or unauthorized transactions would be reflected and, as a result, would be sufficient to deter advisers from fraudulent activities.[7]

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[2] Investment Advisers; Uniform Registration, Disclosure, and Reporting Requirements; Staff Interpretation, Release No. IA-1000 (Dec. 3, 1985), 50 Fed. Reg. 49835, 49838 (Dec. 5, 1985) ("1985 Interpretive Release"). The other conditions in this release were that (1) the client provides written authorization permitting the adviser's fees to be paid directly from the client's account held by an independent custodian and (2) the adviser sends to the client and the custodian at the same time, a bill showing the amount of the fee, the value of the client's assets on which the fee was based, and the specific manner in which the adviser's fee was calculated. Of these, the former presumably would be required by state law in any case, and the latter was subject to variation in later no-action letters. *See Securities America Advisers*, SEC No-Action Letter (Apr. 4, 1997); *John B. Kennedy*, SEC No-Action Letter (June 5, 1996).

[3] *Securities America Advisers*, SEC No-Action Letter (Apr. 4, 1997).

[4] The Custody Rule also provides an alternative, under which the adviser sends a quarterly account statement and an annual surprise examination is required. The Commission proposes to drop this alternative.

[5] Custody of Funds or Securities of Clients by Investment Advisers, Release No. IA-2176 (Sept. 25, 2003), 68 Fed. Reg. 56692, 56694 (Oct. 1, 2003).

[6] *Id.*, at 56693.

[7] Proposing Release, *supra* note 1, 74 Fed. Reg. at 25356.

In the Proposing Release, the Commission states that it has decided to revisit the 2003 rulemaking in light of the significant enforcement actions it has recently brought alleging misappropriation of client assets.[8] The cited enforcement actions, however, do not relate to Deemed Custody RIAs, but instead pertain only to RIAs having custody of client assets directly or through related entities, typically through pooled investment vehicles or, as in the Madoff and Stanford cases, through entities that are themselves qualified custodians under the Custody Rule. There has been no evidence to suggest that the Custody Rule in its present form has been ineffective at preventing fraudulent misappropriations of client funds by Deemed Custody RIAs. At a minimum, the lack of enforcement actions against Deemed Custody RIAs (who comprise the large majority of RIAs), at a time of notable enforcement activity against other RIAs, is an indication that custody resulting solely from an RIA's authority to deduct advisory fees does not appear to be a high-risk area of abuse.

Furthermore, requiring Deemed Custody RIAs to undergo annual surprise audits would not significantly enhance current safeguards mandated by the Custody Rule. The surprise audit could occur at any time during a given year, and in most cases a finalized audit would not uncover or remedy fraudulent activity any sooner than the receipt of quarterly statement by clients. A surprise audit would also be just a one-time annual event. A fraudster Deemed Custody RIA, however, would have to worry that every defrauded client could have files of fraudulent but transparent statements that could be used to prove his fraud at any time in the future.

NCS also believes that a careful analysis of the costs and benefits of the proposed amendments to individual Deemed Custody RIAs and to the industry as a whole dictates that the costs of an annual surprise audit outweigh the limited benefits. Based on the Commission's estimates, RIAs that would be subject to the surprise examination requirement would pay an accounting fee, on average, of $8,100.[9] Such an expense would financially impair the operations of small and medium size RIAs, and the costs associated with the audit would likely be passed on to advisory clients in the form of higher advisory fees. This burdensome expense seems particularly difficult to justify when the surprise examination is directed primarily at verifying client funds and securities. That verification of client funds and securities is unnecessary when there is an independent qualified custodian and will do nothing to address the Commission's central concern: whether the Deemed Custody RIA has improperly withdrawn amounts in excess of its stated fees.

Our extensive experience as a compliance consultant has taught us that the application of overly broad compliance requirements can have a deleterious effect on compliance, because they detract attention from areas of real risk and result in lower respect from participants, who rightly perceive that they are forced to engage in unnecessary and expensive busywork. We believe that applying the annual surprise audit requirement to Deemed Custody RIAs not only would be unnecessary and unduly expensive, but it would actually be harmful to compliance efforts.

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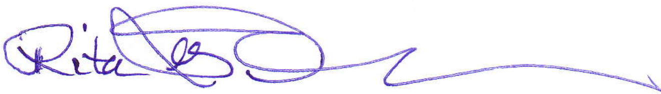
[8] *Id.* at 25355 & n. 11, 25356.

[9] *Id.* at 25365.

While, for these reasons, we do not believe that it is necessary or desirable to subject Deemed Custody RIAs to an annual surprise audit examination, we do believe that qualified custodian account statements should be explicitly required to provide additional information with respect to any fee deductions reflected on the statement. Specifically, any account statement that is provided by a qualified custodian to clients of a Deemed Custody RIA, and that reflects any deduction of client assets to pay an advisory fee, should show the amount of the fee, the value of the client's assets on which the fee was based, and the specific manner in which the adviser's fee was calculated. Although the 1985 Interpretive Release required this disclosure to be provided by the adviser in a separate bill,[10] we believe this information will be most useful to clients if it appears on the same statement that reflects the deduction. We would contemplate that a Deemed Custody RIA would be required to provide this information to the qualified custodian not later than the time it deducts its advisory fee from the client's account. We would also recommend that such statements bear a legend instructing clients to contact their investment adviser if they do not fully understand the statement.

We thank the Commission for its consideration of our comments and the opportunity to provide input regarding this important matter. Please do not hesitate to call me at (561) 330-7645, or our counsel, John Baker of Stradley Ronon Stevens & Young, LLP, at (202) 419-8413, if you would like to discuss these comments further.

Sincerely,



Rita G. Dew, President
National Compliance Services, Inc.

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[10] *See supra* note 2.