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July 28, 2009

SUBMITTED ELECTRONICALLY VIA EMAIL

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

Re: File Number S7-09-09
Custody of Funds or Securities of Clients by Investment Advisers

Dear Ms. Murphy:

Charles Schwab & Co. Inc. ("Schwab") is pleased to take this opportunity to comment on the proposed amendments to Rule 206(4)-2 (the "Custody Rule").[1] Schwab is a dually registered broker-dealer and investment advisor with over $1 trillion in client assets and 7.5 million brokerage accounts. Schwab serves as a qualified custodian for over 1.8 million accounts served by some 6,000 independent registered investment advisors. Schwab also serves as advisor and custodian for approximately 190,000 accounts enrolled in non-discretionary advisory and mutual fund wrap programs. In addition, Schwab is the program sponsor for several separately managed account programs.

The Commission's focus on investor protection and adopting more effective ways to combat misappropriation or misuse of client assets are goals that Schwab shares and endorses. But as discussed below, except in clearly defined circumstances such as where an advisor with custody is not using a qualified custodian, or where the Commission has "cause" due to past client complaints or advisor infractions, Schwab does not believe that the surprise examination is the best way to achieve these mutual goals.

The Proposing Release asks whether there are alternatives the Commission should consider. We believe there are alternatives that responsible advisors and their qualified

[1] Custody of Funds or Securities of Clients by Investment Advisors, Release No. IA-2876 (May 20, 2009) (the "Proposing Release").

custodians can work on together with the Commission to meet legitimate investor protection concerns. With some of the alternatives we discuss below, a qualified custodian can accept additional responsibilities rather than advisors bearing the burden alone. We encourage the Commission to consider these alternatives, which we believe would be less burdensome to advisors overall but more effective in deterring and detecting fraud.

Based on the Commission's recent enforcement actions, and based on Schwab's own experience as one of the largest custodians for independent registered investment advisors, we believe that the biggest risks of potential misappropriation generally fall into three categories:

- Ineffective controls at certain custodians,
- Opportunity for misappropriation through unregistered pooled investment vehicles, and
- Potential for unauthorized disbursements from discretionary client accounts to third party accounts.

We address each of these risks below in Section II, with reference to the proposed amendments to the Custody Rule and our recommended alternatives. In Section I we first address the Commission's proposal to broadly apply the surprise examination requirement to over 9,500 advisors, even if the only way an advisor has custody is due to the ability to debit management fees from advisory accounts.

I. Annual Surprise Exam Requirement for Advisors Who Maintain Custody Only Because of Management Fee Debits Is Over-Broad and Would Not Be as Effective as Alternatives

The Proposing Release states that, in light of recent enforcement actions, a surprise exam by an independent public accountant would provide another set of eyes on client assets and additional protection against their misuse. None of the recent enforcement cases, however, appears to have involved misappropriation through management fee debits.[2]

Although it is difficult to argue that an annual surprise exam for virtually every advisor who maintains some discretionary authority over client accounts would not at some point in the future deter or detect an advisor misappropriation, we agree with the Commission's position in 2003 when it removed the exam as a broadly-applied requirement: "Advisers that intend to misuse client assets can fabricate client account statements and, because the surprise exam is performed only annually, many months may pass before the accountant has an opportunity to detect a fraud."[3]

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[2] *See id.* at footnote 11 (citing recent SEC enforcement cases).

[3] Custody of Funds or Securities of Clients by Investment Advisers, Release No. IA-2044 (July 25, 2002) (the "2002 Proposing Release"), text accompanying footnote 40.

Limited Scope and Effectiveness. The surprise examination only verifies that the securities held at a particular point in time are confirmed by the qualified custodian, reconciled to advisor records, and reported to clients on account statements. Such an exam likely would not be able to detect specific instances of fraud or a well-orchestrated scheme. The surprise examination component of the Custody Rule was developed over forty years ago when securities were physically held, and a "securities count" such as this made more sense.

High Costs and Burdens. The Commission must carefully assess the potential benefits of imposing this burden on over 9,500 advisors, most of them small businesses. The Proposing Release estimates a total cost to the industry of $77 million (an average cost of $8100 per advisor), with an additional 179,636 burden hours for facilitating the surprise exam (an average of 18.76 hours per advisor).[4] We believe that the actual cost and burden hours will be considerably higher.

In 2002 the Commission estimated the cost of the surprise exam to be on average $8,000 with approximately 335 burden hours per advisor to facilitate the exam.[5] The Commission at that time estimated the burden hours were 30 minutes for each account under management. It is unclear why the cost has only risen $100 over the last 7 years (less than inflation), and why the burden hours have been substantially reduced.[6] SIFMA, in contrast, has estimated that, for its members who would be subject to the surprise exam, it would cost on average over $200,000, while the Investment Adviser Association has estimated the cost likely would range from $20,000 to $300,000. Moreover, the Commission's burden estimate does not include the significant additional time and expense that would be imposed on qualified custodians to respond to advisors' and their accountants' requests to verify securities positions during the course of the surprise exam, and on clients who would be asked to respond to accountant inquiries as well.

The cost and burden hours are a function of asset types, the location(s) of securities, and the number of accounts and positions managed by the advisor. Even for the smallest advisor subject to Commission registration, we think the cost in terms of accountant's fees and person hours addressing the exam will be substantial relative to advisor size. This is time and money advisors (and their custodians) could better spend working with their clients or focusing on operational controls. Any excessive costs will be passed on, one way or the other, to the advisor's clients, the investors whose financial interest the Commission is trying to protect.

Sampling Techniques Should Be Allowed. If the Commission is set on requiring the surprise exam for any advisor who debits management fees, the Commission should

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[4] Proposing Release, text accompanying footnotes 87 and 102.

[5] 2002 Proposing Release, text accompanying footnote 72.

[6] It may be because many more and smaller advisors would be subject to the requirement under the proposal, but it is unclear to us.

modernize the exam requirement to allow a sampling approach, instead of verification of every account position with every client. Broker-dealer regulation has allowed for sampling procedures for decades, and we are unaware that the Commission staff has encountered any problems with sampling techniques in broker-dealer audits. In the very least the requirement to confirm "with clients all funds and securities in client accounts" should be eliminated or subject to sampling. As a practical matter, clients can merely only verify what the advisor and qualified custodian send to them on their account statements anyway.

Exceptions Should Continue to Apply. If the Commission does adopt the surprise exam requirement, non-discretionary accounts (including those maintained with related custodians), dual registrants, and wrap fee programs sponsored by dual registrants should be excepted from the rule.

With non-discretionary accounts, the risk of advisor misappropriation is substantially reduced because the client maintains all trading and disbursement authorities over the account. Such investors are much more involved in day-to-day activities in their accounts including active monitoring. This is true whether or not the custodian is a related broker-dealer or a dual registrant.

For broker-dealers who are related custodians, the surprise exam is duplicative and unnecessary, given the panoply of custodial protections and safeguards under the Securities Exchange Act of 1934. In addition to delivering trade confirmations and account statements, broker-dealers must:

- Control customer securities they hold (Exchange Act Rule 15c3-3(b)),
- Reconcile and "count" securities held each quarter (Exchange Act Rule 17a-13),
- Set aside money owed to customers with a special reserve bank account (Exchange Act Rule 15c3-3(e)),
- Send financial reports or statements to customers (Exchange Act Rule 17a-5(d)-(e)),
- Hire PCAOB accountants to conduct audits and file financial statements with the Commission (Exchange Act Rule 17a-5(f)),
- Supervise their business and personnel (e.g., FINRA Rule 3101(c)), and
- Maintain SIPC coverage against misappropriated or missing funds and securities (Securities Investor Protection Act of 1970).

In the typical wrap fee program sponsored by a dual registrant, a client's account is managed by a third party investment adviser with trading authority over the account (but no disbursement authority). To fulfill its responsibility to invest the assets in the account, the third party adviser has daily access to account information through electronic systems made available by the wrap program sponsor. The program sponsor debits the wrap fee from the account and pays the third party adviser. In this situation, where there are two advisers on the account owing fiduciary duties to the client, the possibility of fraudulent account activity is too remote to justify the expense of a surprise exam.

Alternatives Relating Directly to Management Fee Practices. The Proposing Release asks whether, instead of the surprise exam, the Commission should specify requirements or restrictions regarding withdrawing fees from client accounts. If the Commission sees the disbursement of funds to pay management fees as a real concern in terms of potential advisor fraud, then Schwab recommends that, in lieu of the surprise exam, the final rule enable enhanced fee disclosure procedures and controls as an alternative.

For example, the Commission could require that the advisor send an invoice to the client showing the amount of the fee, the value of the client's assets upon which the fee was based, and the specific manner in which the fee was calculated.[7] Contemporaneously, the advisor would be required to send the same fee amount to the qualified custodian for debit. The qualified custodian in turn would be required to send the client, at least quarterly, a statement indicating all amounts disbursed from the accounts, with clear labeling of the management fee. Both the account statement and the invoice should remind the client to check the invoice against the account statement for consistency and accuracy.[8]

Qualified custodians also could be prohibited from debiting management fees in excess of 2% of the assets held at that custodian for that client. Such a restriction would need to allow for single billing accounts which pay the fees for all accounts in a household at the custodian, and payment of fees for non-management services like financial planning.

As an additional measure, qualified custodians could be prohibited from debiting advisor management fees from an account held at the custodian for management services provided to clients on assets held at another custodian. Although admittedly a convenience for some advisors and their clients, this practice can render fee calculation and invoicing less transparent. Clients would still be free to direct the custodian through an express, separate authorization (e.g., a check) to disburse money from any account they own to pay their advisor fees no matter where their assets are held.[9]

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[7] Initially, of course, a client must provide authorization (as today) to the custodian to debit management fees from their account.

[8] This is similar to the no-action relief granted by the Commission staff in the 1980s and 1990s, with some differences. Mandating greater transparency of fee calculations would deter or detect "fee draining" misconduct. The qualified custodian, however, should not be placed in a position of having to police the fee calculation and agreement between individual advisors and their clients.

[9] The Commission asked for comment on another alternative to the surprise examination, which would have the chief compliance officer ("CCO") of an advisor submit a periodic certification to the Commission that all client assets are properly protected and accounted for. Schwab does not believe that the CCO should be placed in the role of an accountant. A CCO's role should be to make sure that the advisor's compliance procedures relating to custody are reasonably designed and functioning properly. Although a certification would not be as effective as the alternatives we put forth in this letter, if the Commission were to decide on a certification approach it would be more appropriate to have that certification come from the president (or equivalent) of the advisor.

II. Alternatives to Surprise Exam Would Address More Effectively Risks at Issue in Recent Advisor Fraud Cases

A. Related Custodians: Annual Internal Control Report Focused on Custody, with More Guidance on Control Objectives Should Be Effective without Unnecessary Additional Annual Surprise Exam

The Proposing Release includes a new provision that would require an advisor who uses a related custodian to obtain a written internal control report once a year that includes an opinion from an independent public accountant registered with the PCAOB with respect to the related custodian's controls over custody of client assets. In light of several of the Commission's enforcement actions involving complicity or participation by the custodian, Schwab would support a variation of that requirement, if it were in lieu of the surprise examination.[10] Schwab, as a related custodian for its retail advisory programs, would be subject to this requirement.

The Proposing Release notes that a Type II Statement of Accounting Standards (SAS) 70 Report would be sufficient. SAS 70 defines the professional standards used by a service auditor to assess the internal controls of a service organization and to issue an auditor's report. A Type II report would include the auditor's opinion on the fairness of the presentation of the custodian's description of operational controls and the appropriateness of the controls' design to achieve specified control objectives. The auditor also gives an opinion, after testing, whether the specific controls were operating effectively over a period of time. This is a significant advantage over the point-in-time surprise examination.

Clear Control Objectives Necessary for Custodians. Instead of a general requirement for an internal controls audit report, a final Commission rule should narrowly define the audit engagement with clear control objectives to warrant the extra time and expense beyond the current Rule 17a-5 broker-dealer annual audit. The custody controls audit could be a supplement to that existing audit for broker-dealers. The SAS 70 standard does not specify a pre-determined set of control objectives or control activities that service organizations must achieve. Accordingly, to ensure consistency across the industry of control activities and related auditor attestations there is a need for more guidance from the Commission – with input from the industry, AICPA, and PCAOB – to articulate critical and common control objectives specifically focused on custody operations for the safekeeping of assets. The key is to define control objectives at a general level to assure consistency and confidence across the industry, while still allowing individual firm

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[10] For the reasons already stated above, Schwab is opposed to adding the surprise exam on top of a related broker-dealer / custodian's current Exchange Act Rule 17a-5 audit and on top of any supplemental internal controls custody audit that might be imposed on custodians. Instead of the surprise exam, time and resources in the industry would be much better spent on control objectives, controls assessment, and control effectiveness testing.

flexibility. This approach will enable appropriate management assertions about firm controls and better facilitate auditor testing.

Internal Control Report Should be Required of All Custodians. Because qualified custodians play a critical role in the industry generally and to assure the effectiveness of the Commission's Custody Rule in particular, Schwab believes the Commission should require an internal control report for **any custodian** to be considered "qualified," whether related to an advisor or not. This would provide advisors and their clients with additional assurances regarding the safekeeping of their assets.

Prohibiting Related Custodians in All Circumstances Would Frustrate Investor Choice. In the Proposing Release the Commission asked whether the Custody Rule should mandate an independent custodian, and whether that would impose a loss of services or inefficiencies. Schwab does not believe it would further investor interests and protection to ban the use of related qualified custodians, except in certain high risk, well-defined situations.

Clients who have enrolled in a Schwab retail advisory program have selected Schwab both to provide advice on their accounts and to serve as custodian to safeguard their assets. Although for many investors it may be a wise choice to select an advisor independent from their custodian, it would be contrary to investor choice to require that every investor do so. Prohibiting a related custodian and mandating the separation of custody from advisory services would interfere with wrap fee accounts and could even lead to the cessation of certain services to those accounts. In the very least it would result in a time-consuming and expensive migration to another custodian or advisor, frustrating the very investor interests the Commission is seeking to protect. Instead of an arbitrary rule generally prohibiting related custodians, the Commission should reiterate that where there is a related custodian, the advisor's ADV Part II disclosure should make very clear the relationship and any potential conflicts of interest.

One area where an independent custodian should be considered, however, is where an advisor serves as manager of an unregistered pooled investment vehicle and has discretion over individual investor accounts that may purchase interests in those funds. A related custodian for the fund under those facts can create sufficient additional risk to warrant an independent custodian requirement for the fund.

B. Preventing Potential Fraud Related to Pooled Investment Vehicles

Recent Commission enforcement actions illustrate the potential conflicts of interest that arise in the context of unregistered pooled investment vehicles ("Unregistered Funds").[11]

[11] *SEC v. Donald Anthony Young, et al.*, Litigation Release No. 21006 (April 20, 2009) (principal of registered investment adviser misappropriated $23 million from investors in limited partnership that he advised and controlled by converting checks written for investment in the limited partnership, withdrawing funds from the capital accounts of investors and depositing them into personal accounts, and providing false account statements); *SEC v. The Nutmeg Group, LLC, et al.*, Litigation Release No. 20972 (Mar. 25, 2009) (registered investment advisor to 15 unregistered funds misappropriated in excess of $4 million of client assets by transferring them to third parties); *SEC v. WG Trading Investors, L.P., et al.*, Litigation

An advisor who controls an Unregistered Fund either as general partner of a limited partnership or managing member of a limited liability company generally has discretion to determine valuations, request withdrawals and disbursements of fund assets from custodians, and determine the level of transparency into fund assets available to investors. The advisor typically will allocate interests in its Unregistered Fund to individual investor accounts that the advisor also manages.

For these Unregistered Funds, Schwab endorses independent verification of fund assets, which would provide important assurances to maintain confidence in these unregistered securities that fill a portfolio need for certain investors. This would be an independent accountant's audit or examination also covering controls over fund valuations and disbursements, in addition to the annual financial statements audit that many pooled investment vehicles currently undergo.[12]

An independent examination, however, should not be the exclusive way for advisors of Unregistered Funds to meet their Custody Rule obligations. There is an increasing trend among Unregistered Funds to retain independent administrators who on a continuous basis verify positions with custodians against the books of the Unregistered Fund and provide independent valuations. Under this alternative approach, the independent administrator (rather than the advisor) could be subject to audit oversight. An advisor could choose which of the two approaches to take, a verification audit or an independent administrator subject to audit.[13]

The pending legislation written and endorsed by the Obama Administration, the "Private Fund Investment Advisers Registration Act of 2009" that would require advisors to register with the Commission if they have at least $30 million under management regardless whether they have fewer than 15 clients or only manage private pools of money or hedge funds, would provide an opportunity for the Commission to adopt specific guidelines relating to pooled investment vehicles. A review of disclosure, supervisory, and other compliance program requirements for the management of pooled investment vehicles - no matter their size - would be an important method to mitigate the risk of fraud.[14] This could include guidance to managers of pooled investment vehicles covering:

Release No. 20912 (Feb. 25, 2009) (misappropriation fraud perpetrated in part through an unregistered investment vehicle).

[12] Rule 17f-1 under the Investment Company Act could serve as a model, although for smaller unregistered funds the examination could take place on an annual basis.

[13] The Commission, of course, may not have direct jurisdiction over an independent administrator. But the Commission could establish these requirements through its regulation of advisors who manage Unregistered Funds.

[14] Basic standards and controls should not vary depending on the size of the fund as, unfortunately, fraud has occurred in smaller pools as well.

- a uniform, substantiated and documented process for valuing the holdings of Unregistered Funds and reporting the value of those funds to clients and qualified custodians,
- documentation to reflect reconciliation of individual capital accounts to the fund's accounts, and
- a reasonable system of supervision and controls over Unregistered Funds.

C. Deterring and Detecting Unauthorized Disbursements from Discretionary Client Accounts

Across the industry, there are hundreds of thousands of routine disbursements out of investment advisor accounts each year. A tiny fraction of those disbursements, by a small number of advisors, may facilitate misappropriation of client assets. An annual accountant's surprise exam is not designed to detect or prevent this relatively isolated misconduct. It is searching for the proverbial needle in a haystack.

For discretionary accounts,[15] the best safeguard is to require timely and clear notice to the client directly from the qualified custodian that a disbursement has taken place to a third party account. The client ultimately is the best set of "eyes" to assure that he or she has authorized or requested a disbursement to a third party.

Instead of an expensive surprise examination that focuses on counting securities, the Commission should consider additional measures to enhance the ability of clients to review disbursements of funds from their account and to call their qualified custodians if something seems amiss. The final rule could provide that, as an alternative to the surprise exam, an advisor's qualified custodian must send directly to the client a transaction confirmation of each disbursement to a third party account that includes, at a minimum, the date and amount of the transfer, identification of the third party account to which the funds were sent by the custodian, and the phone number of the custodian with a request to call the custodian directly if there are any questions or concerns.

We note that, under FINRA Rule 3012, broker-dealers who serve as qualified custodians are required to have policies and procedures in place that include a documented method of customer confirmation or notification of any transmittal of funds or securities to third parties. Any qualified custodian -- whether a member of FINRA or not – should be required to provided a written confirmation with the specific enhancements noted above.

In Schwab's experience, the type of disbursement most subject to potential misappropriation risk is a wire transfer from a discretionary account to a third party account. If the Commission does not deem the additional transparency of a full written transaction confirmation - including identification of the third party account - to be sufficient in higher risk areas, a qualified custodian could be required to go a step further

[15] This is not an issue for non-discretionary accounts, because the client by definition is more engaged in the day-to-day account activity.

and confirm the wire disbursement directly with the client by phone, through email, or over the Web through internet access to the account.

In considering these alternatives, confirmations generally should be permitted to take place immediately after processing the client's disbursement request which may come by form, letter, or facsimile.[16] This will avoid unnecessary delays (i.e., the client is temporarily unreachable) in processing what are often time-sensitive payments to third parties, an important client interest to uphold. It is also important that the client be able to elect the type, method and frequency of disbursement confirmation communications from their custodian. For example, a client who has a need for recurring wires to third party accounts should be able to verify them one-time, without repeated phone calls from the custodian.

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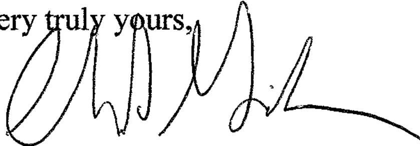
The Commission's recent enforcement actions and the proposed amendments to the Custody Rule raise critical issues for the Commission and our industry. Schwab, as one of the largest qualified custodians under the Commission's jurisdiction, would be pleased to work with the Commission and its staff to address these important matters and to consider in more depth the alternatives suggested in our letter.

Very truly yours,



Christopher Gilkerson

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

[16] Pre-disbursement verification, of course, might still occur consistent with the particular custodian's internal controls relating to fraud prevention and risk management.