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July 24, 2009

VIA ELECTRONIC MAIL

Elizabeth M. Murphy, Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: SEC Release No. IA-2876; File No. S7-09-09
Custody of Funds or Securities of Clients by Investment Advisors

Dear Ms. Murphy:

TD AMERITRADE, Inc.[1] ("TD Ameritrade" or "the Firm") appreciates the opportunity to comment on the above referenced proposed rule by the Securities and Exchange Commission (the "SEC") under the Investment Advisers Act of 1940 (the "Advisers Act"). TD Ameritrade applauds the SEC's efforts to provide additional safeguards for client assets of registered investment advisors ("RIAs") and the thoughtful approach taken in the SEC's captioned release (the "Release"). At the same time, TD Ameritrade is concerned that the potential adverse economic impact of certain of the proposals, especially the surprise audit requirement on RIAs whose client assets are at independent custodians like TD Ameritrade but who have fee deduction authority, may outweigh any likely benefits. In this letter, TD Ameritrade will comment on the aspects of the Release most relevant both to its RIA clients and its activities as a broker-dealer qualified custodian for assets of RIA clients. The Firm also will make some alternative suggestions for achieving the very worthy objective of better protecting RIA client assets.

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1 TD Ameritrade is a wholly-owned broker-dealer subsidiary of TD AMERITRADE Holding Corporation ("TD Ameritrade Holding"). TD Ameritrade Holding has a 34 year history of providing financial services to self-directed investors. TD Ameritrade serves an investor base comprised of over 4.8 million funded client accounts with approximately $250 billion in assets. Through its Institutional division, TD Ameritrade provides custody services to approximately 4,000 RIAs who have entrusted it with over $80 billion of their clients' assets.

The Release proposes amendments to Rule 206 (4)-2 (the “Custody Rule”) under the Advisers Act, which governs custody arrangements for RIAs registered (or required to be registered) with the SEC. Under the proposed amendments, there are three key requirements. First, all RIAs deemed to have custody of client assets or securities must undergo an annual surprise examination by an independent public accountant (which must be certified by the Public Company Accounting Oversight Board (the “PCAOB”)) to verify client funds and securities. Importantly, the amendments continue to define “custody” as including an RIA’s power to deduct its fees from client accounts at a qualified custodian (whose use is required by the Custody Rule). Second, in addition to the surprise audit, RIAs maintaining client funds and securities with a qualified custodian which is either itself or a “related person” (like an affiliated broker-dealer) must obtain an annual written report (known as a SAS 70) from an independent public accounting firm that includes an opinion regarding the custodian’s controls as to custody of client assets. Third, each RIA deemed to have custody of client assets or securities must possess a reasonable belief that the qualified custodian of its clients’ assets or securities delivers account statements to the RIA’s clients directly at least quarterly. This eliminates the prior exception available under certain conditions that allowed RIAs to make their own delivery of client statements.

TD Ameritrade will provide detailed comments in this letter on the first proposal, focusing on the considerations most relevant to its RIA clients who would be deemed to have custody only because of their fee withdrawal authority. As to the second proposal, TD Ameritrade questions the need for both the surprise audit and the SAS 70 report and as to the third propoaal, TD Ameritrade completely supports the requirement that all RIAs must have a reasonable belief that the qualified custodian used for custody of their clients’ assets or securities delivers client account statements directly to their clients at least quarterly. We will not comment further as to either of those proposals.

SURPRISE AUDIT PROPOSAL

Currently, RIAs who custody their client assets at qualified custodians that directly provide account statements to the clients are not subject to the annual surprise audit requirement under the Custody Rule. That requirement, where applicable, entails having an independent public accountant (i) confirm with the custodian all cash and securities held by the custodian and reconcile all such cash and securities to the books and records of client accounts maintained by the advisor, (ii) verify the books and records of client accounts maintained by the advisor by examining the security records and transactions since the last examination and by confirming with clients all funds and securities in client accounts, and (iii) confirm with clients, on a test basis, closed accounts or securities or funds that have been returned since the last examination. The results of the examination must be reported by the accountant to the SEC. By rulemaking action in 2003, the SEC eliminated the annual surprise audit of RIAs with respect to client accounts for which the RIA had a reasonable belief that a qualified custodian provided account statements directly to the clients at least quarterly.

Rationale for Proposed Surprise Audit Amendments

The proposed Custody Rule amendments would reverse the SEC's 2003 rulemaking. The SEC states in the Release:

> We have decided to revisit the 2003 rulemaking in light of the significant enforcement actions we have recently brought alleging misappropriation of client assets. We believe that a surprise examination by an independent public accountant would provide "another set of eyes" on client assets, and thus additional protection against their misuse. Moreover, an independent public accountant may identify misuse that clients have not, which would result in earlier detection of fraudulent activities and reduce resulting client losses. Therefore, we propose to require all registered investment advisers with custody of client assets to obtain an annual surprise examination regardless of whether a qualified custodian directly provides statements to clients…

As part of this reversal, the Release indicates that the SEC wishes to include in the ambit of RIAs subject to the surprise audit requirement those that are deemed to have custody of client assets only by virtue of their authority to withdraw advisory fees from client accounts. The Release also proposes additional audit advisor and accountant reporting requirements beyond those currently specified.

Key SEC Questions as to Surprise Audit Proposal

We note that the SEC specifically asks in the Release "Would an annual surprise examination increase protections afforded to advisory clients…? Should we except from the surprise examination requirement advisors that have custody of client funds or securities solely as a result of their authority to withdraw advisory fees from client accounts?" These are very appropriate and important questions.

Would Surprise Audits Increase Protections?

As to the question of whether an annual surprise examination would increase protections afforded to advisory clients, we will focus on the case where the RIA's client assets or securities are held at an independent qualified custodian such as TD Ameritrade and the RIA is deemed to have custody only because of fee withdrawal authority. In this case, as discussed in detail below, we believe that the benefits of surprise audits of RIAs would be minimal at best, since the RIAs do not have true custody, but the costs would be substantial. Accordingly, we oppose the surprise audit proposal in the Release in the context of RIAs using independent qualified custodians for their clients' assets or securities who are only deemed to have custody because they have fee withdrawal authority. Instead, we suggest that alternative approaches be taken to enhance the protection of client assets in the fee withdrawal context.

An important factor in our view here is the nature of a qualified custodian. A "qualified custodian" is defined in Rule 206(4)-2(c)(3) to include banks, registered broker-dealers, and registered futures commission merchants. The Release notes the Custody Rule "…requires advisers that have custody…to maintain client funds or securities with a "qualified custodian." After noting the above types of entities, the Release states "These institutions' custodial activities are subject to extensive regulation and oversight." As TD Ameritrade is a registered broker-dealer, our position will focus on this type of custodian. We note that, as stated in the Release at page 12:

> Under the Exchange Act, a broker-dealer's financial statements must be audited annually by a registered public accounting firm. This audit must include a review of the broker-dealer's procedures for safeguarding securities. The scope of this review must be sufficient for the auditor to provide reasonable assurance that material inadequacies do not exist in a broker-dealer's procedures for safeguarding securities.

In the case where the RIA client assets are held at independent broker-dealer qualified custodians and the RIA is deemed to have custody only because of fee withdrawal authority (which has been estimated to involve approximately 6,000 RIAs), it is difficult to assess any significant amount of increased protection resulting from a surprise RIA audit requirement. That is because the RIA in this circumstance does not have custody of the client assets in the sense that the RIA could withdraw all assets of the client without that being noticed by the independent custodian. Rather, the RIA's access to the assets is limited to its ability to withdraw fees. Hence, the likelihood of significant RIA client asset misappropriation is low. In that regard, we suggest that separate protections be established as set forth below.

We note that in all cases a broker-dealer custodian separately is subject to the annual audit requirements performed by PCAOB auditors. This is a major source of protection of RIA client assets. In addition, as a practical matter RIAs often will look to the broker-dealer records as to client asset details. Accordingly, we could support an alternative approach to enhancing RIA client protection as follows: (i) require RIAs to provide clients with detailed written notice of fee deductions being made through their qualified independent custodian, (ii) have the SEC issue clear guidance as to a maximum permissible fee rate that RIAs can withdraw from client accounts through their qualified independent custodians, (iii) increase the frequency of SEC inspections with more focus on custody matters, and (iv) require the Chief Compliance Officers of RIAs to conduct an annual custody review and certify such to the SEC. More details as to those recommendations are set out below.

<u>Should RIAs Only Having Fee Withdrawal Authority Be Excepted?</u>

In our view, RIAs whose only connection to client assets held at qualified custodians is the ability to withdraw advisory fees do not have true custody. It is not clear that RIA fee deduction authority played any role in the situations that led to the enforcement actions by the

SEC referenced above or other recent advisor custody incidents. In short, the fee deduction test is an unnecessary regulatory stretch that would adversely affect about 6,000 of the approximately 11,000 SEC registered advisors (as estimated at a recent SEC open meeting) in a manner disproportionate to any benefit that may be derived.

The SEC estimates in the Release an average surprise audit cost of $8,100 to an RIA. This figure seems very low; however, even accepting that figure, the estimated 6,000 SEC registered advisors deemed to have custody only because of fee withdrawal authority would incur total aggregated annual costs of about $48,600,000 ($8,100 x 6,000) to comply with the surprise audit requirement. That represents a very high cost to cover a situation which is arguably a strained interpretation of “custody”. In short, the low risk of wrongdoing in this limited circumstance coupled with the audit requirements already in place for independent qualified custodians makes this cost unwarranted. Moreover, in reality the cost is likely to be much greater than the SEC estimate.

With respect to the estimated $8,100 average audit fee, the Release indicates that the SEC “consulted with a few accounting firms before reaching these estimates”. We doubt that the Release estimate reflects the “friction” that will come into play in dealing with the thousands of small RIA businesses affected by the proposal. According to Cerulli Associates, a leading investment advisor consulting firm, RIAs on average employ about seven people, including professional and administrative staff. It is doubtful that the $8,100 estimate factors in such costs as those associated with an auditor showing up for a surprise audit and finding only one or two administrative assistants in the office because the principals are out of town for the rest of the week. (For example, they might be visiting current and prospective clients around the country, attending a conference or meeting with company managements.) It also is doubtful that the $8,100 reflects the risk premium calculations that auditors would make in assessing their fees for these audits, as the auditors no doubt would be sensitive to their potential liability exposure.

The SEC’s commentary indicates that its cost estimates were keyed to the number of RIA client accounts (with an assumption that on average they would total 928). This in turn leads to an indicated SEC belief that the actual audit costs for small RIAs would be much less than $8,100. The SEC’s related statement in the Release is as follows:

> Most small advisers that would be subject to the surprise examination have less than 6 accounts that would be included in the surprise examination. Thus the accounting fees for surprise examination conducted on small advisers would likely be much lower than our estimated average cost. As a result, the potential impact of the amendments on small entities due to the surprise examination requirement should not be significant.

We don’t agree with the logic of this analysis. It appears the SEC arrived at this calculation by focusing on the 177 SEC registered RIAs in the IARD as of February 2009 which fit the “small adviser” test by having (i) less than $25 million of assets under management,

(ii) less than $5 million of assets of its own, and (iii) not being in a control relationship with a party meeting either of the first two tests. Since the most common basis for SEC registration is having more than $25 million of assets under management, it appears likely that the 177 SEC registered advisors referenced either have relatively unusual types of advisory business, such as perhaps a few pooled vehicles or newsletters, or are winding down their business.

Based on information from Cerulli Associates, we estimate that the average number of client accounts serviced by RIAs with total assets under management of between $10 and $25 million is 90. Even if 50% of those accounts were not subject to a surprise audit (which we doubt), the remaining 45 accounts would be more than seven times the SEC's estimate of 6 accounts. In addition, while the 177 figure as to the number of SEC registered small advisors may be technically correct, it does not reflect that a large portion of the SEC registered advisors managing more than $25 million are very small businesses. For example, Cerulli Associates indicates that RIAs with less than $50 million in assets under management have an average of about three employees. Also, as to test (ii) in the above paragraph, we doubt very many of these RIAs have assets of their own of $5 million or more.

Further, it should be noted that the above annual total cost estimate of $48,600,000 for surprise audits of RIAs with fee deduction authority only relates to SEC registered advisors. There also are numerous state registered advisors, estimated to be about as many as the 11,272 SEC registered advisors noted in the Release. By definition, pursuant to the National Securities Markets Improvement Act of 1996, these RIAs typically have less than $25 million in assets under management. If the SEC surprise audit proposal were adopted, it is very likely the states would adopt similar requirements. That scenario likely would more than double the effective total annual cost of the proposal to more than $100 million. In the Release, the SEC notes that under the Small Business Regulatory Enforcement Fairness Act of 1996, the SEC is required to notify Office of Management and Budget of regulations constituting a "major" rule. The tests for such a rule are stated to be:

> if adopted, it results in or is likely to result in: (1) an annual effect on the economy of $100 million or more; (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse impacts on competition, investment or innovation.

We believe that, as set forth above, the ultimate economic impact of the proposed rule could exceed the $100 million threshold and is likely to meet each of the other two tests. First, it would be unrealistic to assume that additional costs flowing from the rule proposal would not be passed on to consumers (investors) in whole or in part. Second, it also would be entirely likely that any additional costs not passed on (as well as the related burdens associated with the audit exercise) would lead some small RIAs to exit the business, merge with larger ones or divert attention and resources from investment or innovation.

For all of the above reasons, we strongly recommend that the proposed surprise audit requirement stemming only from RIA fee withdrawal authority be withdrawn. We note that our concerns about the relative costs and benefits of audits in this case appear to be shared by SEC Commissioners Kathleen Casey and Troy Paredes, based on questions they have raised. The concerns very clearly are shared by numerous RIAs who have submitted comments on the Release.

Finally, we recommend that the definition of custody in the Custody Rule be revised to eliminate the fee deduction test as a basis for an advisor being deemed to have custody. We note the ambiguity that has surrounded this topic since the SEC's 2003 rulemaking. This is exemplified by the anomalous result of the SEC taking the position that RIAs with fee deduction authority are deemed to have custody and yet can disclaim having custody on their Form ADV, Part I filings. Footnote 18 in the Release indicates the SEC's intention to continue with that approach. We think the better approach would be to remove the fee deduction test as determinative of whether an RIA is deemed to have custody over client assets or securities and in its stead, consider adopting certain alternative Custody Rule enhancements such as the four suggested below.

Alternative Suggestions to Achieve the SEC's Goal

We very much support the SEC's indicated goal of providing better protection of RIA client assets through Custody Rule enhancements. But as to the surprise audit proposal, for the reasons stated above, we take strong exception to subjecting an additional 6,000 or so RIAs to the expense and distraction of a surprise audit requirement merely because they have the ability to cause their independent custodian to withdraw their advisory fees. In lieu of that proposal, we suggest the following:

1. RIA Written Fee Notification. We suggest that RIAs who want to withdraw fees from their clients' accounts at independent qualified custodians be required to provide written notice to clients each time fees are deducted from their accounts, including a detailed fee calculation, at or about the time of the deduction. This effectively would reinstate a disclosure requirement stemming from SEC staff no-action letters that the SEC chose to eliminate in connection with its 2003 rulemaking.

2. Clear SEC Fee Guidance. We think the SEC should provide clear guidance as to the maximum permissible advisory fee rate that an RIA can deduct from client assets through an independent qualified custodian.

3. More Frequent SEC Inspections of RIAs. SEC oversight through inspections is an effective tool that should be more frequently utilized. Rather than looking to RIAs and their clients to bear the costs of surprise audits, the SEC should be enlarging its staff and greatly increasing the frequency of its RIA inspections, with a greater focus on client asset custody matters.

4. Expanded RIA Chief Compliance Officer Role. The Chief Compliance Officer ("CCO") at each RIA should be required to do an annual certified review and listing as to the RIA's client assets and securities. The list would include account names, account numbers and the positions maintained at the respective custodians for the individual clients. It also would include details as to the RIA's advisory fee withdrawals during the year under review. The CCO would be required to provide a written certification of the information to the SEC.

CONCLUSION

We greatly appreciate the extensive and intensive work of the SEC in re-considering the Custody Rule and issuing the Release. We believe that extending the Custody Rule's annual surprise audit examination to the approximately 6,000 RIAs deemed to have custody only because of their ability to withdraw fees from client accounts through their independent qualified custodians would entail relatively high costs to advisors and relatively little benefit to investors. Accordingly, we recommend that the new surprise audit requirement for those RIAs be withdrawn. We also recommend that a new four-pronged approach be taken entailing: (i) fee deduction notices by RIAs to their clients at or about the time of each fee deduction being made through independent qualified custodians, (ii) clear SEC guidance as to the maximum permissible advisory fee rate that RIAs can deduct from client accounts through independent qualified custodians, (iii) more frequent SEC inspections of RIAs with more focus on custody matters, and (iv) expanded responsibilities for RIA Chief Compliance Officers as to an annual custody review and related certification to the SEC. If the above or a similar approach is taken to enhance the Custody Rule, we further recommend that the Custody Rule be revised to eliminate the fee deduction authority test as a basis for establishing advisor custody.

If you have any questions regarding the Firm's comments, please contact Gilbert Ott, a Deputy General Counsel in our Legal Department, at 201-369-8559.

Very truly yours,

J. Thomas Bradley Jr.

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