

CERTIFIED FINANCIAL PLANNER  
BOARD OF STANDARDS, INC.

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July 28, 2009

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

**Re: Custody of Funds or Securities of Clients by Investment Advisers; File No.  
S7-09-09**

Dear Ms. Murphy:

Certified Financial Planner Board of Standards, Inc. (CFP Board) appreciates the opportunity to comment on the proposed amendments to the custody rule under the Investment Advisers Act of 1940 (Advisers Act).<sup>1</sup> In the release proposing the amendments (Proposing Release), the Securities and Exchange Commission (SEC) indicated that in light of recent enforcement actions against investment advisers and broker-dealers alleging fraudulent conduct, including misappropriation or other misuse of investor assets, the SEC decided to propose changes to the investment adviser custody rule, Rule 206(4)-2 under the Advisers Act. The changes are designed to decrease the likelihood that client assets are misused, and to increase the likelihood that fraudulent activities are discovered earlier and client losses thereby reduced. While the SEC's concerns are legitimate, CFP Board believes that the surprise examination proposal, as described below, should be modified in the manner suggested in this letter so that it is appropriately tailored to address the SEC's concerns. The internal control report proposal should provide sufficient protection where use of an independent qualified custodian is not feasible.<sup>2</sup>

**Background on CFP Board**

CFP Board is a non-profit organization that acts in the public interest by fostering professional standards in personal financial planning through setting and enforcing education, examination, experience, and ethics standards for financial planner professionals who hold the CFP® certification. Our mission is to benefit the public by granting the CFP® certification and upholding it as the recognized standard of excellence for personal financial planning. We currently regulate nearly 60,000 CFP® professionals who agree on a voluntary basis to comply with our competency and ethical standards and subject themselves to the disciplinary oversight of CFP Board.

Financial planning professionals provide services that integrate knowledge and practices across the financial services industry. Financial planners work with their clients to determine whether and how they

<sup>1</sup> See Custody of Funds or Securities of Clients by Investment Advisers, 74 Fed. Reg. 25,354 (proposed May 27, 2009) (to be codified at 17 C.F.R. pts. 275, 279) [hereinafter Proposing Release].

<sup>2</sup> Our comments are limited to these two proposals, and we do not take a position with respect to other proposed amendments to the custody rule in the Proposing Release.



CERTIFIED FINANCIAL PLANNER™

CFP®

Certified Financial Planner Board of Standards Inc. owns these certification marks in the U.S., which it awards to individuals who successfully complete CFP Board's initial and ongoing certification requirements.

can meet their life goals through the proper management of their financial resources. Financial planning typically covers investment, income tax, education, insurance, retirement, and estate planning. As noted below, many CFP<sup>®</sup> professionals are registered investment advisers and could be subject to the changes proposed by the SEC.

### **Surprise Examination Proposal**

The SEC's proposed amendments to the custody rule would require all registered investment advisers with "custody" of client funds and securities to engage an independent public accountant to conduct an annual surprise examination to verify those client assets (Surprise Examination Proposal). Under proposed amendments to the custody rule, "custody" would continue to mean "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them," and would include arrangements in which a registered adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the adviser's instruction to the custodian.<sup>3</sup>

When the SEC adopted the custody rule in 1962, each adviser with custody of client securities or funds was required by Rule 206(4)-2 to engage an independent public accountant to conduct an annual surprise examination. In 2003, the SEC amended the rule to eliminate the annual surprise examination with respect to client accounts for which the adviser has a reasonable belief that a "qualified custodian," including a qualified custodian that is a related person, provides account statements directly to clients.<sup>4</sup> At that time, the SEC believed that direct delivery of account statements by qualified custodians would provide clients with the confidence that any erroneous or unauthorized transactions would be identifiable on the account statements and, as a result, the statement delivery would be sufficient to deter advisers from fraudulent activities. Thus, under the current rule, registered investment advisers who maintain client assets with qualified custodians, and who have a reasonable basis for believing that such custodians send account statements to clients at least quarterly, are not required to undergo an annual surprise examination.

The SEC stated in the Proposing Release that it had decided to revisit the 2003 rulemaking in light of the significant enforcement actions it had recently brought alleging misappropriation of client assets. The SEC believes 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, the SEC believes that an independent public accountant may better identify adviser misuse of client assets, which would result in the earlier detection of fraudulent activities and reduce resulting client losses. Thus, under the Surprise Examination Proposal, all registered investment advisers with custody of client assets must undergo an annual surprise examination, including advisers who have custody solely because they have the authority to withdraw their fees from client accounts.

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<sup>3</sup> See Proposing Release, 74 Fed. Reg. at 25,375 (defining custody in proposed Rule 206(4)-2(c)(2)). The SEC is proposing to amend the current definition of "custody" to include arrangements in which a "related person" of the adviser holds client assets. Under proposed Rule 206(4)-2(c)(6), a "related person" is defined as "any person, directly or indirectly, controlling or controlled by [the adviser], and any person that is under common control with [the adviser]." *Id.*

<sup>4</sup> The SEC is not proposing to amend the current definition of "qualified custodian." Under proposed Rule 206(4)-2(c)(5), a "qualified custodian" would continue to mean a bank or savings association, a registered broker-dealer, a registered futures commission merchant, and a foreign financial institution that customarily holds financial assets for its customers. *Id.*

Many of our CFP<sup>®</sup> certificants are individual investment advisers with no custody of client assets other than the right to withdraw fees from client accounts. These advisers use independent qualified custodians (i.e., custodians that are not affiliates of the adviser) to hold all client assets with the exception that the adviser can instruct the custodian to send it fees owed by the client. These advisers are not subject to the annual surprise examination requirement in the current custody rule because they have the independent qualified custodians send account statements directly to their clients.

Our experience in overseeing such advisers as CFP<sup>®</sup> certificants has shown that they do not pose a risk of misappropriating client assets. This is not surprising given the safeguards that are in place to protect client assets managed by them. First, client assets are held by independent qualified custodians rather than by the adviser or a related person. Second, the adviser is only authorized to withdraw his or her fees from client accounts. This practice, coupled with the use of independent qualified custodians, greatly reduces the adviser's ability to misappropriate client assets. Finally, account statements are sent to clients by the independent qualified custodians rather than by the adviser. This practice prevents the adviser from manufacturing false account statements.

Our experience is supported by the enforcement actions cited by the SEC in the Proposing Release alleging misappropriation of client assets. A number of these enforcement actions involve advisers or related persons of advisers with custody of client assets.<sup>5</sup> None of these enforcement actions appear to involve advisers that used independent qualified custodians to hold all client assets and were deemed to have custody solely because they have the authority to withdraw fees from client accounts. Accordingly, these enforcement actions, which are the basis for the SEC's Surprise Examination Proposal, do not establish that these advisers pose a risk of misappropriating client assets. The true threat to client assets occurs where an adviser uses a qualified custodian that is a related person, which can result in the adviser causing the related person to send inaccurate or fraudulent account statements to the client. An adviser that uses an independent qualified custodian to hold all client assets has no such ability because he does not control the custodian.

An annual surprise examination would impose a significant increased cost on investment advisers that would be passed on to clients in the form of higher fees. A survey of CFP<sup>®</sup> certificants revealed that the average annual cost of the proposed surprise examination requirement would range from \$5,000 to \$10,000, which is in line with the SEC's cost estimate. Because advisers that use independent qualified custodians to hold all client assets and that have custody solely through their authority to withdraw fees from client accounts pose little or no risk of misappropriating client assets for the reasons set forth above, we believe that the costs imposed on such advisers by the proposed annual surprise examination requirement greatly outweigh the benefits that clients would receive from the examinations. We also believe that if the proposed annual surprise examination requirement is adopted in its current form, these costs will ultimately be born by clients in the form of higher fees.

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<sup>5</sup> See, e.g., SEC v. Bernard L. Madoff, Litigation Release No. 20889 (Feb. 9, 2009) (complaint alleges that Bernard L. Madoff and Bernard L. Madoff Investment Securities LLC committed a \$50 billion fraud); see also Proposing Release, 74 Fed. Reg. at 25,355 n.11.

Accordingly, we recommend that the SEC exempt from the Surprise Examination Proposal all advisers that use independent qualified custodians to hold all client assets, are deemed to have custody solely because they have the authority to withdraw fees from client accounts, and rely on the custodians to send account statements to clients.<sup>6</sup> As part of this recommendation, we suggest that the SEC require such advisers to send a statement to clients listing their annual fee, which could be expressed as a percentage, and itemizing the fees that they have deducted year-to-date. This will serve as an additional check on such advisers' activities, and will provide clients with the ability to compare custodian statements with their advisers' statements.

We also suggest that the SEC require such advisers to include in the statement a written notice telling clients to compare account statements received from the custodian with those received from the adviser. It is reasonable to expect clients to perform this minimal amount of due diligence on the safety of their assets. The responsibility of clients to undertake this easy review is preferable to the increased costs that would be passed on to them if the Surprise Examination Proposal is adopted in its current form.

### **Internal Control Report Proposal**

The SEC's proposed amendments to the custody rule also would require a registered investment adviser or a "related person" of the adviser who maintains custody of client assets to obtain a written internal control report from an independent public accountant registered with the Public Company Accounting Oversight Board (PCAOB) that includes an opinion regarding the controls relating to custody of client assets (Internal Control Report Proposal). As noted above, a "related person" would be defined as "any person, directly or indirectly, controlling or controlled by [the adviser], and any person that is under common control with [the adviser]."<sup>7</sup>

This proposal is designed to address the type of fraud that was perpetrated by Bernard L. Madoff (Madoff) and Bernard L. Madoff Investment Securities LLC (BMIS).<sup>8</sup> As we understand the facts in that case, BMIS was controlled by Madoff and was dually registered as an investment adviser and broker-dealer. Client assets of the adviser were held by BMIS. While BMIS had an accountant, this accountant was not registered with the PCAOB and did not appear to perform substantial audits of BMIS. This arrangement allegedly allowed Madoff to misappropriate the client assets of the adviser.

The SEC's Internal Control Report Proposal is designed to address this type of fraud by requiring advisers or related persons of advisers with custody of client assets to obtain a written internal control report from an independent public accountant registered with the PCAOB regarding custody controls. As the SEC noted in the Proposing Release, requiring the internal control report would provide an additional check on the safeguards relating to client assets held by advisers or related persons of advisers.

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<sup>6</sup> In making this recommendation, we recognize and support the SEC's proposal to require all registered investment advisers to have their qualified custodians send account statements to clients, thus eliminating the ability of investment advisers to send account statements to clients. Proposing Release, 74 Fed. Reg. at 25,361.

<sup>7</sup> *Id.* at 25,375.

<sup>8</sup> See *supra* note 5 and accompanying text.

We support the SEC's proposal to require advisers who maintain custody of client assets directly or through related persons to obtain a written internal control report from a PCAOB-registered independent public accountant. In light of the fact that the fraud in the Madoff case and other cases cited by the SEC in the Proposing Release was perpetrated by advisers or related persons of advisers with custody of client assets, the Internal Control Report Proposal is a reasonable requirement to provide the needed protection under these circumstances.

The SEC inquired, as an alternative, whether it should require that all advisers maintain custody of client assets with an independent custodian. Such a requirement would be consistent with the practice of the majority of CFP® professionals under the oversight of CFP Board because they generally maintain custody of client assets with independent qualified custodians. However, maintaining client assets with an independent custodian may not be feasible under all business models and circumstances. While many small registered investment advisers may not have an affiliated broker-dealer or other related person to serve as a custodian for client assets, larger financial services firms benefit from the economies of scale generated through the use of an affiliated broker-dealer or other related person as a custodian for client assets. These arrangements also allow larger financial services firms to provide additional services to their clients. Accordingly, we support the SEC's Internal Control Report Proposal because it would allow an adviser or related person to maintain custody of client funds where the use of an independent qualified custodian is not feasible or desirable, but at the same time provide needed protection for investors.

### **Conclusion**

CFP Board appreciates the opportunity to comment on the proposed amendments to the custody rule. If you should have any questions regarding CFP Board, the financial planners it certifies, or the CFP® marks, please contact Marilyn Mohrman-Gillis, Managing Director of Public Policy, at 202-379-2235, or visit CFP Board's Web site at [www.CFP.net](http://www.CFP.net).

Sincerely,

A handwritten signature in black ink that reads "Kevin R. Keller". The signature is written in a cursive, flowing style.

Kevin R. Keller, CAE  
Chief Executive Officer