MARKETCOUNSEL®

July 28, 2009

VIA INTERNET COMMENT FORM

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

RE: U.S. Securities and Exchange Commission's Proposed Rule Regarding Custody of Funds or Securities of Clients by Investment Advisers

Dear Ms. Murphy:

Please accept our comments to the U.S. Securities and Exchange Commission's (the "Commission's") proposed rule regarding Custody of Funds or Securities of Clients by Investment Advisers. MarketCounsel applauds the Commission's attempts to strengthen protection of investor's but we oppose the Rule as proposed by the Commission.

MarketCounsel is a business and regulatory compliance consulting firm to some of the country's preeminent entrepreneurial investment advisers. In addition, or affiliated law firm, the Hamburger Law Firm, renders coordinated legal services to a similar but more expansive universe of clients. All told, we render professional services to more than 700 investment advisers that would be affected by the proposed rule. We host an outsourced compliance platform for registered investment advisers ranging from start-ups with little or no assets under management to firms managing billions of dollars. All of our members utilize the services of third-party, independent account custodians for their clients' assets. While some of our clients have commented directly on the Rule, many have asked us to comment on their behalf.

ANNUAL SURPRISE EXAMINATION OF CLIENT ASSETS

Effectiveness of the Examination

MarketCounsel finds the blanket requirement that all registered investment advisers with custody of client assets engage an independent public accountant to conduct an annual surprise examination of client assets to be overly broad and unduly burdensome. This is especially true where the investment adviser maintains client assets with an independent account custodian.

Under the current draft of the proposal, custody is broadly defined to include investment advisers who withdraw fees directly from their clients' accounts. The definition also includes investment advisers who engage in bill paying services for their clients or act as a trustee on client accounts. Currently, advisers that have custody due to these activities maintain compliance with Rule 206(4)-2 of the Investment Advisers Act of 1940 (the "Advisers Act") by utilizing a "qualified custodian" (as defined in the rule) to maintain their clients' assets.

As acknowledged in the proposal, the Rule 206(4)-2 was amended in 2003 to eliminate an annual surprise examination requirement where an adviser with custody has a reasonable belief that a "qualified custodian" provides account statements directly to clients. The Commission is now seeking to reinstate that examination requirement under the theory that "another set of eyes" may help prevent the type of frauds and schemes appearing in recent headlines.

MarketCounsel is strongly opposed to the proposed surprise examination upon investment advisers where the investment adviser utilizes an independent third-party custodian. We feel that the marginal benefit investors will receive from this examination is strongly outweighed by the burden this presents to investment advisers.

For those investment advisers utilizing an independent third-party custodian, the statements sent to clients are generated and sent directly by the custodian. This direct delivery to clients ensures that the investment adviser does not have the opportunity to manipulate the statements prior to receipt by the client. The client that receives a statement directly from the independent custodian is able to review that statement for inaccuracies and discrepancies. The client, not an independent auditor, is in the best position to determine if something is amiss in their own account.

We would be pleased to see a proposal where clients and investment advisers benefit from the independent examination. We do not see, however, how the proposed surprise examination will provide any benefit to anyone but third party service providers.

In 1966, the Commission set forth the criteria and standards that independent accountants should apply when performing these surprise examinations. Under the 1966 guidance, the accountant is charged with obtaining confirmation of the funds on deposit in banks and should reconcile that information with the adviser's own books. The accountant should also verify the transactions done by the adviser since the last examination by obtaining from the clients written confirmation of the funds and security in the client's accounts as of the date of the physical examination. While at first glance this concept appears to have merit, it ultimately provides no benefit to the client. The client is going to obtain the information about recent transactions directly from the custodian; the adviser is going to pull the same information from the custodian. The accountant's review would serve no functional purpose as it would be comparing data from the same source.

In the Commission's 2003 release revising the rule to eliminate the annual surprise examination requirement for investment advisers utilizing independent custodians, the Commission stated that "[r]eceiving quarterly account statements directly from the qualified custodians will enable advisory clients to identify questionable transactions early and allow them to move more swiftly than relying on an annual surprise examination." This justification continues to hold true today. The client is in the best position to identify any discrepancies rather than waiting a year for a surprise examination that is less likely to detect discrepancies.

Virtually all frauds that did include self-custody involved improper disbursements of assets. For example, where an investment adviser has the authority to debit fees from a client account and they abuse that authority by debiting more than they contractually agreed to debit. The examination proposed would not stop this type of fraud as it appears that the examination would only confirm that the assets reported are actually with the custodian.

As such, MarketCounsel respectfully submits that the surprise examination requirement should not be applicable to advisers utilizing independent third-party custodians to maintain client accounts. The examination will not help identify the frauds that the Commission seeks to stop.

Alternatively, if the Commission is not convinced that the current protections are adequate, MarketCounsel respectfully submits that implementing certain of the criteria in the custody no-action guidance prior to the 2003 custody rule would be more beneficial to clients than the proposed surprise examination. Those no-action letters required an adviser that withdrew its fees from client accounts to send an invoice to clients at the same time that it withdrew its fees. The invoice was to include the amount of the management fee, the value of the client's assets on which the fee was based, and the specific manner in which the adviser's management fee was calculated. If the Commission feels that this is a better solution than the proposed surprise examination, we suggest that the invoice should be able to be delivered in paper or electronic form, separate or combined with other reports issued by the adviser. In addition, the information should be allowed to be delivered directly by the account custodian. While we do not believe that this invoice should be required, we do feel that it better addresses the risks that the Commission is seeking to protect against.

Expense

In addition to the ineffectiveness discussed above, MarketCounsel feels that the expense burden outweighs any limited benefit that may be gained by requiring the surprise examination. We think the Commission's estimate of $8,100 in accounting fees for firms that utilize a qualified custodian is very conservative. When surprise examinations were required prior to the 2003 revisions, advisers had difficulty finding accountants that understood or were willing to assume the responsibilities set forth by the rule. In addition, we expect that service providers will charge a risk premium due to the perceived liability in the requirement to notify the Commission of any discrepancies as well as filing Form ADV-E with the Commission within 120 days of the examination. With a limited pool of service providers and a tremendous increase in the number of firms demanding those services, we believe that costs will be significantly higher than the Commission anticipates.

The costs associated with the proposed surprise examination are likely to alter the economics of the industry, dealing the most significant blow to non-high net worth investors and smaller investment advisers. Costs will either be passed on to clients through higher fees, increased minimum portfolio sizes, or absorbed by advisers who are already feeling the effects of lower revenue due to recent market conditions. We respectfully submit that the benefit received is so minimal as to make the expenses unduly burdensome and the effects devastating.

Privately Offered Securities

The proposed rule also includes a provision to make privately offered securities that investment advisers hold on behalf of their clients subject to the surprise examination requirement. The proposal fails to illuminate how independent accountants would be able to make this verification, when the very definition of privately offered securities (as defined by Rule 206(4)-2(b)(2) and adopted in this proposal), includes the fact that these are uncertified and ownership is recorded only on the books of the issuer or its transfer agent. If the Commission were to adopt this rule, it would have to provide guidance on how an independent verification of these assets should be conducted.

CUSTODY BY ADVISERS AND ITS RELATED PERSONS

Delivery of Account Statements and Notice to Clients

We agree that many clients, unfortunately, do not review their account statements. MarketCounsel understands the Commission's desire to inform clients that they should review their account statements received from the custodian. The proposal requests comments on the concept of revising the content of the notice advisers are currently required to send to clients upon opening a custodial account on their behalf. The proposal includes a provision to include a statement in the notice urging clients to compare the account statements they receive from the custodian with those they receive from their adviser, if any. We would not be opposed to such a requirement as we believe it comes closer to meeting the Commission's goal of fraud protection.

The Commission also requested opinions on whether it would be helpful to require advisers to send their own account statements to the clients. The burden of requiring advisers to issue account statements to clients substantially outweighs the marginal benefit it may produce. As in the case of the surprise examination by an accountant (discussed above), advisers will generally download the information required to produce the account statements directly from the account custodian, which is the same source the clients will be getting the information from directly. Sending the duplicate statement alone will not produce any benefit to the client, nor will it help the client detect possible fraud. Furthermore, requiring the delivery of statements by the adviser would add costs which, as described above, would be passed on to clients, or negatively impact the economics of smaller, entrepreneurial investment advisers.

Amendments to Form ADV

The proposal includes a provision to amend Item 9 of Form ADV Part 1, which asks whether the adviser or a related person has custody of client assets. The proposal includes a provision that requires advisers or their related persons who have custody of client funds or securities to provide information about their custodial practices. This would include requiring the adviser to report the amount of client assets and number of clients for which it or its related person has custody and whether it or its related person serves as qualified custodian with respect to the clients' funds or securities. The revision would also require disclosure of the information regarding the use of qualified custodians, information about audits of pooled investment vehicles, whether funds are subject to surprise examination, and information about PCAOB audits. The Form ADV would also require an update during the firm's annual updating amendment to state the month that the last audit took place.

While the benefit that clients would receive from this enhanced disclosure is minimal, we do not feel that the disclosure is a large burden to investment advisers. We would, however, request that if changes to the Form ADV are going to be made, the Commission take the opportunity to finally revise its Part 2. The current Form ADV Part II is partially redundant and conflicting with the current Part 1. Many of the check-the-box responses on Form ADV Part II are antiquated to the point of no longer being relevant.

Conclusion

We feel very strongly that requiring investment advisers that utilize an independent third-party custodian to engage an independent public accountant to conduct an annual surprise examination of client assets to be overly broad and unduly burdensome. In addition, we do not feel that the requirement would properly address the risk that the Commission is trying to reduce. We believe that the risk is better reduced through adviser disclosure, client diligence and the Commission's regular examination process.

We hope that our comments, made on behalf of us and our entrepreneurial, closely held investment adviser clients are beneficial to this process. Thank you for the opportunity to provide input and should you have any questions or require any additional information regarding any of the foregoing, we remain available at your convenience.

Best regards,
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