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Pamela K. Ziermann, CSCP
Dougherty Financial Group LLC

July 28, 2009

VIA E-MAIL

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

Re: Proposed Amendments to Investment Advisers Act Custody Rule RIN 3235-AK32

File No. S7-09-09

Dear Ms. Murphy:

I am writing this letter on behalf of the National Society of Compliance Professionals, Inc. ("NSCP"). NSCP is the largest nonprofit membership organization dedicated to serving and supporting compliance officials in the securities industry, with a membership of more than 1,700. NSCP's membership includes professionals from broker-dealers, investment advisers, banks, insurance companies, registered investment companies, advisers to hedge funds, accounting firms and law firms. NSCP's mission is to serve compliance professionals exclusively, including through education, the Certified Securities Compliance Professional® certification, publications, consultation forums, and regulatory advocacy.

NSCP appreciates the opportunity to comment on the Securities and Exchange Commission's ("SEC") proposed amendments to the custody rule ("Proposed Rule") under the Investment Advisers Act of 1940, as amended, as set forth in Release No. IA-2876 (May 20, 2009) ("Proposing Release").

Because NSCP's membership consists overwhelmingly of compliance professionals, it understands the need for a robust regulatory regime designed to protect investors as well as the soundness of our financial system and markets. As compliance professionals who must interpret and implement the SEC's rules, they are also vitally interested in encouraging the adoption of regulations that are carefully considered, appropriately tailored, and accompanied by clear direction and guidance. These comments are intended to offer constructive observations from the perspective of the compliance professionals who make up NSCP's membership.

The proposed amendments are intended to strengthen the custodian requirements of Rule 206(4)-2 (the "Custody Rule"). In this connection, the Proposing Release asks for comments on a number of proposed changes and possible alternatives. NSCP supports the basic concept of the Custody Rule, which requires funds and securities of advisers' clients to be held by custodians. However, as discussed below, NSCP strongly objects to certain proposed changes that would impose significant and unnecessary burdens and costs on many advisers.

DIRECT BILLING OF CLIENT ACCOUNTS AS CUSTODIANS

The Custody Rule provides that it is a fraudulent, deceptive or manipulative act, practice or course of business for a registered investment adviser to have custody of client funds or securities unless they are maintained by a "qualified custodian." In 2003, the SEC adopted amendments to the Custody Rule ("2003 Amendments") that, among other things, added the following definition of custody: "holding, directly or indirectly, client funds or securities, or having authority to obtain possession of them." Although the Custody Rule did not define custody prior to the 2003 Amendments, the SEC staff, for many years both before and after 2003, interpreted it expansively to include situations where clients authorized their custodians to remit fees to their advisers.

Notwithstanding the SEC's broad interpretations, staff no-action letters permitted custodians to debit client accounts for advisory fees without subjecting advisers to the Custody Rule requirements if the following conditions were met: (1) the client provided written authorization to the custodian to pay the adviser's fees directly from the client's account; (2) the adviser simultaneously sent the client and the custodian bills 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 fee was calculated; and (3) the custodian or trustee sent 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.[1]

These no-action letters were withdrawn when the 2003 Amendments became effective.[2] The withdrawal was of little practical importance to advisers at the time, however, because the only consequence for an adviser having custody based on the ability of a custodian to debit client accounts for custody fees was the requirement that a qualified custodian be used to hold the client's funds and securities. This was not burdensome for advisers.

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[1] Investment Counsel Association of America, Inc. SEC No-Action Letter (avail. July 9, 1982); The Institute of Certified Financial Planners, SEC No-Action Letter (avail. Aug. 15, 1990). *Cf.* John B. Kennedy, SEC No-Action Letter (avail. June 5, 1996) in which the Staff modified the second condition so that the adviser could send the custodian a bill only indicating the amount of the fee as long as the client received a complete statement from the adviser showing the fee, the amount of assets on which the fee was based and the specific method by which the fee was calculated.

[2] SEC Rel. No. IA-2176, footnote 11.

The Proposed Rule, however, would significantly change the current regulatory landscape by requiring advisers who do not have custody of client assets in the traditional, commonly understood sense of the word but who can be paid directly from client accounts by the client's custodians to engage an independent auditor to conduct annual surprise audits of client assets even though the client assets are held at a qualified custodian. While these more stringent requirements may make sense when applied to more conventional custodial activities, they will add significant costs with no apparent improvement in customer protection when applied to advisers who are deemed to have custody only because a qualified custodian may debit client accounts for advisory fees.

Indeed, in the proposing release for the 2003 Amendments, the SEC recognized the limited utility of surprise audits and thus replaced that requirement with the requirement that a qualified custodian send account statements directly to clients. Referring to the surprise audit requirement of the then-current custody rule, the SEC commented, "Moreover, experience has shown that the current rule has limited deterrent effect. Advisers that intend to misuse client assets can fabricate client account statements and, because the surprise examination is performed only annually, many months may pass before an accountant has an opportunity to detect a fraud."

This method of collecting fees is a long-time, standard industry practice and a key component of the business models of most advisers. Many clients not only prefer but insist upon automatic fee deductions rather than sending checks to the advisers after receiving invoices. In many cases, advisory clients believe that this is one of the responsibilities that their custodians are hired to perform.

Imposing the new surprise audit requirement on advisers simply because they are paid directly by the clients' custodians is not a remedy that is proportionate to the regulatory risk that the SEC is attempting to address, and therefore will be an unfair burden and expense. The Proposing Release lists (at footnote 11) a number of SEC "enforcement actions against investment advisers and broker-dealers alleging fraudulent conduct, including misappropriation or other misuse of investor assets." However, misappropriation cases against advisers are rare and generally appear to be part of much larger cases that do not involve remittance of management fees. Indeed, our research has not uncovered any enforcement actions revolving around intentional overcharging of fees by advisers simply because clients had authorized their custodians to automatically deduct and remit advisory fees.

In order to avoid being deemed to have custody and the associated burdens and costs of complying with the new requirements, advisers would be forced to invoice each client for each fee period, and each client would be forced to send payment by check or specific written authorization to his or her custodian to pay the invoice. These measures would be required for every invoice. This inevitably will cause a large percentage of advisory fees to be paid late and some not to be paid at all due to the administrative difficulty of following up with clients as to their payments by check or by written authorization. Collection costs could be cost-prohibitive for investment advisers with a small revenue base and limited personnel. Moreover, increased

collection costs will inevitably be passed on to clients, again with little or no meaningful customer benefit to them.

Estimated Cost. One justification given by the Proposing Release for such a broad new regulatory burden is the estimate by the SEC that the cost will be relatively low. The Proposing Release states that the SEC estimates that 9,575 advisers will be subject to the annual surprise audit requirement and that the audits will take a total of 179,636 hours, or less than 20 hours to audit the client accounts of each adviser. The SEC estimates that the average cost to an adviser for employee time would be $1,230; and the average total cost would be $8,000.

NSCP believes the SEC should recognize that, even if this estimate is accurate, $8,000 in increased regulatory costs is significant for many small advisers. More importantly, we believe that the SEC's estimate is far too low, both as a general matter for advisers subject to the surprise audit obligation and as specifically applied to advisers who become subject to it because their fees are automatically deducted by a custodian. Our own members have received preliminary estimates from their independent auditors as high as $25,000 for each annual surprise audit. In the event that different clients of an adviser have assets custodied at more than one custodian, the costs of these annual surprise audits would be multiplied accordingly.

Of course, the cost will depend on the extent of the work that is required to be performed. The Proposed Rule and Proposing Release are unclear as to the scope of the audit engagement. Additionally, certain of our members have been advised by their auditing firms that there have been indications that some SEC staff members believe that sampling of client accounts will not be permissible. In other words, every security in each client's account may need to be verified. Many advisers have thousands of accounts, particularly advisers with retail clients. While each retail client account usually has substantially smaller assets than institutional accounts, the total number of retail accounts can easily dwarf the number of accounts managed by institutional advisers.[3] If sampling is not permitted, the cost would be prohibitive. Furthermore, many advisers manage international assets that can only be verified through sub-custodian acknowledgement. If all 9,575 advisers are required to have annual surprise audits, the cost inevitably will rise as the demand rises and accounting firms try to fit the new engagements into their schedules. For these reasons, the average cost for the industry could be substantially higher than $25,000.

Wrap Fee Advisers. The Proposed Rule also fails to recognize or take into account the situation of advisers that sponsor or subadvise wrap fee arrangements. Wrap fee accounts take

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[3] Nearly 64% of registered advisers provide advisory services to "retail" (*i.e.*, non-high net worth) individuals. Furthermore, advisers with between $25 million AUM and $100 million AUM had a median of 140 accounts with an average value of $237,000, and advisers with between $100 million AUM and $1 billion AUM had a median of 225 accounts with an average value of $600,000 per account. In comparison, advisers with between $1 and $5 billion, $5 and $10 billion, and $10 and $50 billion AUM had a median number of accounts of 48, 63, and 112, respectively, and average account values of $544,000, $1.2 million, and $2.4 million, respectively. *Investment Adviser Association & National Regulatory Services, Evolution Revolution 2009* (forthcoming August 2009).

numerous forms, but virtually all involve some combination of adviser advice, discretionary management, execution and custody. In wrap fee arrangements, the custodian might be a broker-dealer, bank or other qualified custodian. In many cases, the custodian is an affiliate of the adviser. The Proposed Rule would needlessly subject thousands of wrap fee accounts to the surprise audit and other requirements simply because the custodian is authorized to deduct the wrap fee from client accounts.

NSCP Recommended Exception. NSCP believes that the requirement of a surprise audit does not appear to be tailored in a direct and measured way to address the concern that advisers might abuse the fee-deduction process and collect inflated fees directly from client accounts. NSCP believes that the following requirements, with which many advisers already comply, would effectively achieve the SEC's objectives with respect to advisers whose only indicia of "custody" is automatic fee deduction in a way that is significantly less costly to advisers than subjecting them to the Proposed Rule.

1. Client funds and securities are held by a "qualified custodian."
2. The client and the adviser agree on a fee schedule in writing that includes all relevant information for the calculation of fees.
3. The written advisory agreement provides for direct payment of fees by the client's custodian.
4. The written fee schedule is sent to the custodian or any independent representative of the client for its reference before payment of any advisory fees is remitted from a client's account and again prior to any subsequent changes in fee calculations.
5. The client receives a statement at least quarterly directly from the adviser or custodian that specifies the manner of calculation and identifies the advisory fees paid from the client's account (or, in the case of a hedge fund, the client receives annual audited financial statements), and the value of the assets on which the fee was calculated.
6. The client receives a statement directly from the custodian at least quarterly that identifies the amount of funds and each security in the client account at the end of the period and sets forth all transactions in the account during that period.
7. The client retains authority to dispute any adviser invoice whether the client is paying invoices by automatic deduction or other means.
8. The adviser retains records of all fee calculations.

The possibility of asset misappropriation is extremely remote as a result of the limited "custody" access that comes from automatic fee deduction. NSCP believes that clients can be protected efficiently and cost-effectively through the steps outlined above rather than through the much more complex and expensive surprise audit process and recommends that the SEC exempt from the surprise audit requirement advisers who meet these conditions, including wrap fee sponsors and subadvisers.

ADVISERS THAT USE REGISTERED BROKER-DEALER CUSTODIANS

The Proposed Rule fails to recognize or take into account registered advisers that use broker-dealers registered under the Securities Exchange Act of 1934 ("1934 Act") for custody services. Registered broker-dealers are subject to annual audits under Section 17(e) and related Rule 17a-5(a)(2) under the 1934 Act. Many advisers already custody client assets with registered broker-dealers. There are numerous arrangements, some of which are described below, under which registered broker-dealers act as custodian for assets of advisers' clients. In some cases, the advisers themselves are dual registrants, in others, the advisers are affiliated with registered broker-dealers and in others there is no relationship between the advisers and the broker-dealers providing custody to their client's assets. However, in each case, the Proposed Rule would needlessly subject advisers who custody assets with registered broker-dealers to an adviser surprise audit even though the broker-dealers themselves are already subject to annual audits. We believe this is redundant and unnecessary where the adviser itself is deemed to have custody solely because it is authorized to automatically deduct its fees. Moreover, we believe that surprise audits for dual registrants are completely redundant since those entities are already subject to annual audits under the 1934 Act. Some of the other types of arrangements between advisers and broker-dealers may help clarify our concerns about redundant regulation.

Advisers with Introducing Broker Arrangements. While most institutional advisers allow their clients to open brokerage and custodial accounts with any firm they choose, some advisers, often smaller firms, utilize introducing brokers that retain clearing broker-dealers to execute and clear transactions, and to custody securities and cash. The advisers recommend, and in some cases require, that their clients establish brokerage accounts at the introducing broker-dealers and custody their accounts at the clearing firms in order to achieve economies of scale and to obtain certain reporting or other service benefits from the broker-dealers.

In these arrangements, the clearing broker handles the transactions and back-office functions for the introducing broker, including mailing directly to clients their brokerage account statements and transaction confirmations. Under the Proposed Rule, advisers who automatically deduct fees are subject to surprise audits even though the only real custodians in these types of arrangements are the clearing firms, not the advisers, and the advisers' clients are protected by the 1934 Act audits applicable to broker-dealers qualified to hold custody of customer assets.

Other Adviser Arrangements. Other types of adviser arrangements in which custody is maintained by a registered broker-dealer include, for example, small advisers who use unaffiliated subadvisers with separate agreements with an independent clearing firm. The advisers may or may not execute through the clearing firm. The agreements cover advisory fees of the outside manager or managers, custodial fees, and the fee to the introducing broker's investment adviser. In these situations, there is an additional agreement between the client and the outside adviser further detailing the advisory arrangement, including the fees to be charged.

Another common model for small dual registrants is to utilize the investment advisory platforms of their clearing broker-dealers. In these cases, the clearing firms' advisers have

agreements with the clients of the introducing brokers that cover custody of assets, calculation of advisory fees and debiting of fees. A portion of the fee is passed on to the introducing brokers' advisers. The clearing firms' advisers are compensated through the advisory fee, not transaction charges.

As noted above, in all of these situations, there is at least one audit covering the clients' assets which occurs at the level of the broker-dealer acting as custodian under the 1934 Act. There is no public policy justification for subjecting advisers whose clients' accounts are custodied with registered broker-dealers to an additional surprise audit when the only way in which the advisers may be considered to have custody is as a result of automatic deduction of fees.

In this connection, we also note that FINRA Proposed Rule 2231 retains the NASD requirement that brokerage statements include a notice advising customers to report promptly any inaccuracy or discrepancy. In all of these situations, the SEC might consider requiring advisers to do the same on statements they send to clients.

FORM ADV DISCLOSURE

The current Form ADV disclosure is inconsistent and confusing. As noted above, the Custody Rule currently provides that an adviser has "custody" if it has any arrangement (including a general power of attorney) under which it is authorized to withdraw client funds or securities from the custodian. An adviser authorized to deduct advisory fees or other expenses directly from the client's account is deemed to have custody for purposes of the Custody Rule.

The 2003 Amendments revised the instruction to Item 9 of Part 1A of Form ADV, which asks whether the adviser has custody of client funds or securities. Prior to the 2003 Amendments, many advisers who deducted their fees from client accounts answered "no" to Item 9 in reliance on the previous SEC no-action letters cited above. As noted above, in connection with the adoption of the amended rule, the SEC withdrew those letters. The 2003 Amendments, however, instructed advisers that they may still answer "no" to Item 9 if they are treated as having custody only because clients' custodians are permitted to remit fees. There is no way to distinguish between advisers who check "no" because they do not have custody in any case under the rules, and those who check "no" because the instruction permits them to do so if they are deemed to have custody solely because clients authorize custodians to debit their accounts for the adviser's fee.

It is illogical and confusing for regulations to require that advisers disclose both that they do and do not have custody of assets. NSCP recommends that the SEC make it clear in Form ADV that advisers are not treated as having custody if the only reason they are considered to have custody is because they permit clients to instruct their custodians to pay the advisory fees in accordance with the conditions listed above.

SURPRISE AUDITS FOR HEDGE FUNDS

Hedge funds typically have their financial statements audited. However, the Proposed Rule would require hedge fund advisers to engage an independent auditor and have a second annual audit. NSCP appreciates the issues that have arisen as a result of a number of recently discovered possible Ponzi schemes involving hedge funds. However, we question whether it is necessary for the SEC to subject hedge fund advisers to a second audit.

There are considerable expenses associated with a surprise audit, in addition to the annual audit requirement for hedge funds. As part of the annual audit, a fund's auditor should already be confirming the existence of client funds, particularly where the custodian and adviser are affiliated. NSCP questions the benefits and whether it is appropriate for investors in a hedge fund to effectively pay for the services of an audit firm twice (once in connection with the annual audit and once again with a surprise audit), when separate account clients would only be subjected to one level of verification. NSCP requests that the Proposed Rule be revised to exempt from the annual surprise audit requirement hedge fund accounts that are already audited.

AUDITED FINANCIAL STATEMENT DEADLINE FOR FUNDS OF FUNDS

The Proposed Rule would no longer permit funds of funds to furnish audited financial statements within 180 days after the end of a fiscal year. The SEC added the 180-day provision in 2003 in response to numerous comments from the hedge fund industry. The deletion of this provision was incorporated into the Proposing Release without any mention or explanation.

Funds of hedge funds cannot issue their financial statements until they receive financial statements from the underlying hedge funds. If the underlying funds provide financial statements on or about the 120th day, which is the typical practice, it is not possible for the adviser to the fund of funds to comply with the 120-day requirement. Because of this, the extra 60 days is critical to permit funds of funds to comply with the Custody Rule. NSCP recommends that the SEC retain paragraphs (b)(3) and (c)(4) of the Custody Rule.

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NSCP would be pleased to discuss the issues we have addressed in this letter with the SEC staff, and we would be happy to arrange a dialogue between the SEC staff and NSCP members from a cross-section of firms if that would be helpful. Please contact me at 860.672.0843 with any questions. Thank you.

Sincerely,

Joan Hinchman
Executive Director, President and CEO