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Via Electronic Filing

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: Proposed Rule Amendments: Custody of Funds or Securities of Clients by Investment Advisers, SEC File Number S7-09-09, Release No. IA-2876

Dear Ms. Murphy,

This comment letter is submitted on behalf of National Regulatory Services ("NRS"), a division of SourceMedia. NRS is the nation's leading compliance consulting firm founded in Lakeville, CT in 1983. NRS provides compliance-related consulting services, technology solutions, national conferences, seminars and the NRS Certified Compliance Professional certificate program to approximately 6,000 investment advisers, ranging from small state-registered advisers to the largest global investment management complexes and other financial firms. Substantially all of these advisers are deemed to have custody under the current custody rule.

The proposed rule amendments presented in IA Release IA- 2876 (the "Release"), address a very important aspect of the investment adviser business; one that represents a high risk area for investors, especially in these stressed times and markets, and traditionally a difficult and confusing area for investment advisers. NRS commends the Division of Investment Management of the

Securities and Exchange Commission ("Commission"), for again undertaking to address and bolster custody practices in an effort to provide additional safeguards for client funds and securities.

As a provider of compliance services and solutions for investment advisers, broker-dealers and other financial institutions, NRS, and our clients, place a premium on clarity and precision in the regulatory environment which promotes transparency regarding the expectations of the regulator as well as the obligations of the regulated.

NRS appreciates the opportunity to comment on the Commission's proposed amendments to Rule 206(4)-2 ("Custody Rule"), under the Investment Advisers Act. Our comments are presented with an objective of providing additional clarity, precision and practicality to any proposed rule amendments. Our comments are in the order as presented in the Release.

A. Annual Surprise Examination of Client Assets

1) Advisers directly debiting fees

The Commission cites a number of recent significant enforcement actions alleging misappropriation of client assets as the principal reason for its re-examination of the Custody Rule. Through the proposed rulemaking, as well as through its on-going investigations and examinations, the Commission seeks to prevent and decrease the likelihood that client assets will be misused or misappropriated, and increase the likelihood that fraudulent activities will be deterred and discovered earlier, thereby reducing client losses.

NRS commends the Commission for its efforts to seek out, thwart and severely sanction those who would so readily breach their clients' trust. On a daily basis, NRS works with its clients to help improve their compliance procedures and internal controls to prevent, where possible, or at least to detect promptly such practices. It is through these interactions that we have come to believe that the vast majority of investment advisers, large and small, take seriously their fiduciary responsibilities and compliance obligations. Nonetheless, the recent incidents have revealed weaknesses in the current system which must be corrected.

In the Proposing Release, the Commission proposes to address these weaknesses, in part, by requiring a surprise examination conducted by an independent public accountant who would provide "another set of eyes" on client assets. It is suggested that a surprise examination would serve to prevent the misuse of client assets and help to identify instances where misuse had not been noticed by the client.

Although NRS agrees that strong, affirmative steps should be taken, it is our view that the remedy proposed by the Commission will impose a heavy burden on a very large number of investment advisers, many of whom are small businesses. Recent experience has not shown the need for further regulation of these advisers and "another set of eyes" will simply add cost and administrative burden without providing any appreciable increase in client protection.

Although imperfect, NRS does not find that the current system needs to be drastically changed with respect to those advisers whose sole access to client funds is through their ability to have fees paid by a qualified custodian. Typically, these smaller advisers' accounts are held at large institutional custodians that provide an electronic platform through which the adviser establishes each account's fee schedule, and which provides a secure mechanism for efficient and automatic payment of the adviser's fees according to the terms agreed between the client and the adviser.

For larger clients and advisers, clients typically select their own independent custodian(s) and establish the term of the custodial relationships.

Although abuse of the authority to withdraw fees may provide a theoretical means for advisers to misappropriate client funds, it is our sense that this has not been borne out by experience, and abuse of this authority has not been a material source of adviser defalcations or enforcement proceedings. To the extent such cases have arisen, we are not aware that they have occurred with sufficient frequency to warrant subjecting a large majority of advisers to the substantial direct and indirect costs related to surprise examinations and the inevitable increase in related recordkeeping.

NRS suggests that the lack of cases involving misappropriation through abuse of the authority to withdraw fees indicates that advisers bent on misconduct are, at the least, aware that outright withdrawal of funds will be duly noted by custodians on their quarterly statements, and easily detected by clients (or regulators) through even a cursory review of their statements.

The protections offered through the use of qualified custodians and statements sent directly to clients are essential elements of the regulatory scheme embodied in the 2003 amendments of the Custody Rule. These protections seem to be working reasonably well at preventing misuse by these advisers of their fee authority.

Under prior SEC No-action letters, (John B. Kennedy, publicly available 6/5/1996), the Commission provided guidance for those advisers deemed to have custody as a result of direct debiting of advisory fees. The guidelines were sound and required among other things, client authorizations, adviser invoices providing the fee calculation to clients, reporting of fee deductions on custodian reports and disclosures to clients to verify fee calculations. These guidelines and safeguards worked well in the past. NRS has noted that a number of advisers no longer provide client invoices with fee calculations or verification disclosures under the current Custody Rule.

NRS believes these were, and should again be considered by the Commission as additional adviser and client custody safeguards and consistent with best business and industry practices for advisers, which are deemed to have custody solely because of the direct debiting of fees.

NRS urges caution against any expansive remedy that would tend to lull clients into a false sense of security and the appearance of protection offered by yet "another set of eyes," and work to decrease clients' active participation in protecting their accounts. Clients certainly deserve protection against the misdeeds of those to whom they have entrusted their assets, but they should not be encouraged to reduce their own vigilance.

For these reasons, NRS most strongly urges the Commission not to require the annual surprise examination of advisers whose only access to client funds is through the direct debiting of advisory fees.

Should the Commission find that further client protection is warranted, NRS suggests consideration of solutions which avoid the costs, time and recordkeeping of surprise examinations, and yet provide meaningful protection, through helping firms and clients to identify when funds have been withdrawn through abuse of an adviser's authority.

2) Advisers other than those directly debiting fees

There are currently three examples provided in the custody definition in the Custody Rule, which may result in an adviser being deemed to have custody. The current Custody Rule, when adopted in 2003, withdrew certain prior SEC No-Action letters, except for Crocker Investment Management Corp. (SEC No-Action Letter, publicly available 4/14/1978) covering custody maintained by affiliates or "related persons" of the adviser. These prior no-action letters were relied on by advisers for years to avoid undergoing an annual surprise examination prior to the current Custody Rule. For most advisers, these prior no-action letters were difficult to find and confusing, so the current Custody Rule clarified custody to a large extent for advisers.

While NRS does not support reinstating the prior no-action letters, the Commission should consider certain of the principles and requirements underlying the prior no-action letters, which, for example, added independent checks, disclosures or reporting as safeguards.

For example, those advisers which are deemed to have custody for acting as trustees, executors, etc., represent a much smaller number of advisers, and again, typically include smaller firms with limited resources. For these smaller firms, the cost and burden of a surprise annual examination would be difficult with very limited benefit. These custody situations arise because clients request their advisers, typically their portfolio manager, to act as trustee because of the personal nature of the relationship and the expertise of their adviser.

NRS again strongly recommends that the Commission not require annual surprise examinations for advisers deemed to have custody under these circumstances. NRS suggests that the Commission consider some of the concepts and safeguards that were in place under prior no-action letters (Blum Shapiro Financial Services, Inc., publicly available 4/16/1994). These conditions included written instructions to custodians and restrictions on transfers of funds or securities.

For those advisers which act as a general partner of an investment fund, NRS believes that the exception for advisers from providing reports to investors should not be changed provided the investment funds are audited by an independent accounting firm and audited financials are provided to the investors timely and as currently required. While NRS does not believe there have been cases of falsified audited financials, the Commission could consider having the independent accounting

firm forward the audited financials directly to the investors, as done by qualified custodians. NRS submits that requiring the adviser, as general partner, managing member, etc. and investment manager of the investment fund to undergo a separate surprise annual examination in addition to the independent audit of the investors' funds in the pooled fund, would be expensive, burdensome and accomplish little in the way of additional custody safeguards for investors.

One of the remaining very small categories of advisers with custody is those advisers who do maintain custody, i.e., self custody, client funds and securities. The Commission notes in the Custody Proposal that the dual registrant firms (i.e., firms registered both as a broker-dealer and an investment adviser) must already undergo an annual surprise examination as a broker-dealer which does provide "another set of eyes" as safeguards for the broker-dealer and advisory client accounts and assets.

The final very small category of advisers who do self custody and are not also registered broker-dealers are higher risk firms where the Commission's proposal for annual surprise examinations does provide additional safeguards, checks and balances and the other set of eyes. This is the only category of advisers that NRS believes should be subject to the proposed annual surprise examination.

In view of the substantial increase in fraud and misappropriation cases and other schemes which have been detected and unraveled in these difficult economic and market conditions, NRS recommends that the Commission may consider the following additional safeguards in this currently very high risk area:

a) Form ADV Part 1 disclosures

As noted below, NRS submits that additional Form ADV Part 1 disclosures about an adviser's custody circumstances (e.g., direct debiting, trustee relationships, etc.), would allow the Commission and clients to better identify those advisers with high risk custody profiles. Such additional disclosures would not be burdensome or costly for advisers.

b) Form ADV Part II disclosures

In the proposal for Amendments to Form ADV (Part 2) Release No. IA-2711, 3/3/2008, the Commission proposed narrative and plain English disclosures for the client disclosure brochure on numerous topics, including custody. NRS commented and supported additional Form ADV Part 2 disclosures on custody in 2008 and again supports additional custody disclosures about an adviser's custody practices, risks, policies and controls. As part of this comment, NRS also encourages the Commission to proceed with the review and adoption of new Form ADV Part 2.

c) Prior No-action letters

As summarized above, the Commission should reconsider and adopt certain of the prior Commission no-action letter guidelines and safeguards as part of any Custody Rule amendments, which were effective, reasonable and not burdensome or costly as annual surprise examinations would be for advisers and the industry.

d) Enhanced SEC scrutiny

The Commission should consider enhanced scrutiny of advisers having custody and deemed to have custody based on the Commission's risk profiling methodology. NRS suggests that with expanded Form ADV custody disclosures, the Commission and the examination staff can target those higher risk advisers with custody profiles for examination and more rigorous examination of the firm's custody practices, policies and controls.

The commission may require additional resources, staffing and examiner training to assist its more focused regulatory responsibility and oversight of this current critical area.

e) Annual Reviews of Custody Policies

Currently, advisers must now include safeguarding and custody as one of the policies required at a minimum under the Compliance Programs Rule Release No. IA-2204, 12/17/2003. NRS suggests that this can be an area of increased SEC examination scrutiny.

The Chief Compliance Officer ("CCO") has the overall responsibility for implementation and administration of the firm's compliance program, including custody policies and procedures. NRS opposes the Commission's suggestion of making the CCO responsible for any sort of certification process for custody practices of typically independent custodians. CCO's and management currently have oversight responsibility for the firm's compliance program and testing its adequacy and effectiveness annually.

f) Custody Compliance Review

NRS strongly believes that only those investment advisers who act as actual custodians of client assets pose any substantive risk to clients and the public. The proposed rulemaking is warranted for those advisers which self custody assets, but is overly burdensome, costly and unnecessary for those advisers deemed to have custody by other indirect reasons (e.g., direct debiting of advisory fees).

In the event the Commission concludes, despite all comments and arguments to the contrary submitted in this and many comment letters, that advisers deemed to have custody indirectly be subject to enhanced measures to protect investors from fraudulent activities, NRS proposes that the Commission consider whether these advisers should be required to establish a "Custody Compliance Program" in lieu of an annual surprise examination. A Custody Compliance Program would be reasonably designed to prevent and detect custody-related fraudulent activities. The Custody Compliance Program should require that appropriate policies and internal controls be developed and that the firm perform an annual, independent test and review of its Custody Compliance Program. Furthermore, independence should be defined to allow reviews by qualified independent third parties that need not be accountants. Also, allowances should be made for the firm to perform its own annual custody review as long as the responsible party is not responsible for any custody related policy, controls or operations.

During the annual custody review, the independent party should be required to test a sampling of accounts that represent a cross section of clients, advisory programs and custodians. The testing should be designed to verify the consistency of advisory and custodial statements and should include an appropriate level of

validation with client records. This alternative suggestion would be a more moderate and effective protocol that is analogous to what is required for broker-dealers under NASD Rule 3011, Anti-Money Laundering Compliance Program and the annual AML reviews.

B. Custody by Adviser and its Related Persons

The Commission proposes to limit custody of advisory client assets by an adviser's related persons to those assets held "in connection with advisory services you provide to clients."

NRS agrees with the Commission that an adviser should be deemed to have custody if its related persons hold assets in connection with the adviser's advisory services. NRS also agrees that there are circumstances where a related person's custody of client assets should not be imputed to the adviser. The tests articulated under Crocker Investment Management Corp., (SEC Staff No-Action Letter publicly available Apr.14, 1978), however, have often proved unwieldy in that they often require an adviser to be deemed to have custody for assets having nothing to do with advisory services.

As compliance consultants, NRS often consults with and visits advisers who are required to comply with the custody rules as the result of non-advisory services provided to advisory clients by the adviser's related persons. For example, an adviser may manage a $5 million dollar account for a client with no authority to obtain possession of that $5 million. If, however, that adviser has an affiliated accounting firm that offers a bill-paying service in which the accounting firm has the authority to sign checks from a client's $5,000 checking account, under the current rules that adviser may well be deemed to have custody.

By making the definition of custody hinge on the provision of advisory services to custodied assets, the Commission will greatly increase its ability to identify those advisers that may need enhanced scrutiny, and at the same time will ease the regulatory burden on advisers whose services do not impact the custodial services provided by their related persons.

That said, NRS is concerned that the phrase "in connection with advisory services you provide to your clients" is vague and subject to different interpretations. NRS believes that

clarification of this phrase will eliminate the need for a rebuttable presumption that an adviser has custody if any of its related persons has custody of advisory client assets.

Many advisers provide services that go beyond advice about securities and include budgeting, credit counseling, and more. If, for example, an investment adviser recommended, as part of an effort to help a client impose spending discipline on herself and her family, that all her credit cards be locked in a drawer at an affiliated accounting firm and that all household bills be forwarded to a related accounting firm for review and payment, would that bill-paying service be considered "in connection with advisory services?"

NRS does not think that the above scenario should be sufficient to impose custody requirements on the adviser. While abuse in this situation is possible, it does not have the potentially grave consequences that can undermine public confidence in the securities markets. Rather, we suggest that the phrase "advisory services" be clarified to include only advice about securities as described in SEC Release IA-1092 (Oct. 16, 1987) and subsequent interpretations.

Further, and as noted above, it is NRS' understanding that the Crocker Investment Management Corp. No-action letter is still in effect and was not withdrawn by the Commission in 2003. The Commission has provided guidance about access to a client's assets by the adviser, among others. NRS recommends that the Commission consider clarifying and adopting these Crocker guidelines as safeguards for custody relationships with related persons.

C. Delivery of Account Statements and Notice to Clients

NRS supports the Commission's decision to eliminate the ability for an adviser to send account statements to clients if it undergoes a surprise annual examination by an independent public accountant. We believe advisers should be required to have a reasonable basis for believing that the independent qualified custodian sends an account statement, at least quarterly, to each client or client's representative for whom the qualified custodian maintains funds or securities. NRS believes that direct delivery of client statements from the client's independent custodian on a quarterly basis should be one strong mitigant to an adviser misappropriating client assets.

NRS understands that some advisers did not want to disclose the names of their clients to custodians for privacy reasons. We believe, however, that the privacy issue could be addressed as part of the sharing of client information for providing the advisory services or in a confidentiality agreement between the adviser and custodian to restrict the custodian's use of the information.

NRS supports the Commission's decision to obligate the adviser to conduct a "due inquiry" to form a reasonable belief that the qualified custodians are sending statements to clients at least quarterly. NRS recommends that such a due inquiry consist of the qualified custodian providing the adviser with a copy of the account statement that was delivered to the client. NRS believes that most advisers are currently engaged in such confirmation as a best practice. Receipt of such statements by an adviser allows for an additional layer of internal controls and testing, with the firm having an enhanced and routine ability to reconcile its own internal records with the information reported by the custodian.

NRS also believes that requiring advisers to revise the content of the notice advisers send to clients at the time the custodial account is opened, will highlight the importance of clients verifying activity in their account. NRS recommends that the notice include a statement urging clients to verify the accuracy of the account information received from the custodian. Since advisers are not required by the Investment Advisers Act of 1940 or rules to send their own account statements to clients, NRS does not recommend that the required notice urge clients to compare their custodial account statements with those they receive from the adviser. However, if advisers elect to send account statements to clients, the required notice should urge such a comparison.

NRS does not believe that requiring all advisers to send their own account statements to clients would materially enhance investor protection because the client already has the opportunity to verify the account information provided directly by the custodian.

D. Amendments to Form ADV

NRS supports the Commission's decision to amend several sections of Form ADV. To further the Commission's goal of establishing an appropriate risk profile based on the adviser's reason for having custody, NRS recommends that Item 9 of Part 1A be amended to include a new subsection with various reasons why an adviser has custody. For example, Item 9 could include an

option for an adviser that has custody because it directly debits advisory fees from client accounts, or it acts as general partner of a limited partnership, or it acts as trustee for an advisory client trust.

Amending Schedule D of Form ADV by adding items to require additional details relevant to an adviser's response to Item 9 would allow the Commission to better assess the compliance and custody risks of an adviser. These amendments would require advisers to explain the reason why they have custody if such a reason is not included in Item 9. Furthermore, NRS believes that the currently proposed custody disclosures in Form ADV, Part 2 would not only assist the Commission in better monitoring compliance with the requirements of rule 206(4)-2, but also assist advisory clients in understanding an adviser's custody practices, safeguards and controls. NRS believes that requiring advisers to disclose in plain English that they have custody and to explain the risks that clients will face as a result is another custody safeguard for clients, prospective clients and the public (Release No. IA-2711).

NRS does not recommend that advisers be required to report the amount of client assets and number of clients of which it or its related person has custody. We believe that this would place an undue reporting burden on advisers and will not provide meaningful information to the Commission. Many of these reported assets would be a result of advisers having custody for reasons, such as direct debiting of advisory fees, that do not pose high risk to the safety of their client assets. Furthermore, this requirement would make it more difficult for the Commission to determine the true dollar amount of client assets reported that is subject to higher risk forms of custody.

Conclusion

NRS again appreciates the opportunity to comment and offer suggestions for clarifying and strengthening the safeguards for protection of client funds and securities. While certainly now a high priority risk area, any rule amendments need to be effective and clear and not overly broad, expensive or burdensome for advisers.

If we may assist further or provide additional information or background on our comments, please let us know. We at NRS would certainly look forward to assisting the Commission in this very important area affecting the entire industry.

Sincerely,

/s/ John E. Gebauer Jr.

John E. Gebauer Jr.

Managing Director