CFA INSTITUTE | Centre for Financial Market Integrity

11 December 2009

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

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

Dear Ms. Murphy:

The CFA Institute Centre for Financial Market Integrity (the "CFA Institute Centre")[1] appreciates the opportunity to comment on the U.S. Securities and Exchange Commission's proposed amendments to the custody rule that would subject investment advisers to new regulations when they are deemed to have custody of client funds or securities. We believe that, on balance, the benefits of the proposed additional safeguards to investors whose assets are held in custodial accounts outweigh the costs to advisers.

Executive Summary

Annual surprise examination for all advisers with custody. We strongly support amendments that would make the annual surprise examination applicable to *all registered* advisers who are deemed to have custody of client funds or securities, even when those funds or securities are held through a "qualified custodian." We agree with the proposal that this requirement would replace the exception for surprise examinations currently afforded situations where a qualified custodian provides statements to clients directly or where a pooled investment vehicle is audited at least annually and distributes audited financial statements within 120 days after its fiscal year.[2]

When those client assets are held by the adviser itself or a "related person" of the adviser, we support the proposed requirement that the surprise examination be conducted by a public accountant that is registered with the PACOB, and who would also supply an internal controls report.

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[1] The CFA Institute Centre for Financial Market Integrity is part of CFA Institute, a global, not-for-profit professional association of 102,385 investment analysts, advisers, portfolio managers, and other investment professionals in 139 countries, of whom 89,666 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

[2] While the proposed rule amendments would subject pooled investment vehicles to the surprise examination requirement, the current exception for such vehicles from having their qualified custodian send account statements to clients would continue.

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***Reporting requirements*.** We support the proposed requirements that the SEC receive notification of discrepancies in such examinations within one business day, and notification of an accountant's termination, resignation or removal within four business days. However, we question the proposed 120-day time period for the accountant to report on the surprise examination. Instead, we suggest a reporting requirement of 45-60 days from the time of the surprise exam for non-pooled investment vehicles.

Privately offered securities. We support amendments that would bring privately offered securities under the surprise exam requirement. While they currently are exempted from the custody rule requirements, we believe that the surprise exam would provide added assurance of this proper safeguarding.

***Delivery of statements and notices to clients*.** We strongly support requirements that custodians deliver account statements directly to clients, rather than through the advisers. We also support proposed amendments that add language advising clients at the inception of their relationships with advisers to compare account statements they receive from their custodians with statements received from the advisers.

Discussion

Recent events have pointed to the need to reevaluate the existing regulations for the custody of client funds and securities. We support this reevaluation as a step in the right direction for providing added safeguards for investors.

We appreciate that in seeking to bolster the protections for investors whose cash and securities are held in custodial accounts, staff has provided two alternatives to advisers in an attempt to allow them to opt for the most cost-efficient option, rather than simply require that all advisers use independent custodians. This proposal differentiates in its requirements between arrangements when assets are held by a qualified independent custodian versus when they are held by the adviser itself or a related party.

Of most concern to us is whether the two options being proposed provide adequate and comparable protections. While we believe that use of an independent qualified custodian would ensure needed safeguards and streamline the process, we also appreciate the potential effect on smaller firms of requiring use of an outside custodian. Thus, on balance, we support use of the alternative approach as a means to offer options without sacrificing important investor protections.

I. Annual Surprise Exam

A. Applicable to All Advisers with Custody

We support the proposed revisions to Rule 206 (4)-2 that would require *all* advisers deemed to have custody of client funds or securities to engage an independent public accountant to conduct a surprise audit annually of client assets, whether or not the adviser maintains the assets with a "qualified custodian," or with an affiliated person. This requirement provides an added layer of security to the custodial process for investors by verifying that the clients' assets continue to exist and alerting accountants and regulators to any unsettling activities in the accounts.

We also support the shift in the scope of the current rule that provided a limited exemption from the annual surprise exam requirement for client accounts for which advisers had a reasonable belief that qualified custodians were providing account statements to clients, and thus excepting mutual fund shares and certain privately offered securities. We agree with the proposed amendments that would require a surprise exam, regardless of whether or not a qualified custodian supplies account statements directly to clients.. Thus, the reach of the surprise exam requirement would extend to privately offered securities, as well as to pooled investment vehicles, including mutual fund shares.

Similarly, we support the proposed scope of this rule that would require advisers registered as broker-dealers, and thus serving as qualified custodians for client assets, to be subject to the surprise exam requirement. As a corollary, we urge that advisers be required to segregate custodial duties from their advisory duties and create internal controls to protect client assets.

B. Reporting requirements

Under the proposal, a custodian would be required to contractually engage an independent accountant to conduct the examination and, in the case of material discrepancies, to notify the SEC within one business day. The proposal would also give the accountant who performs the exam 120 days from the time chosen by the accountant for the surprise exam to make the necessary filings with the SEC describing the examination and findings.

We question the substantial extension in time being proposed for making this filing with the SEC, from the 30-day requirement under the current rule. While we can appreciate the reason provided in the proposal that an adviser's surprise examination may continue for an extended time, we believe that tripling the allowed time is not advisable. We also understand that the proposal seeks to track the provision that gives an adviser to pooled investment vehicles that relies on the annual audit exception 120 days to distribute audited financial statements to those in the pool. For other than such pooled investment vehicles, we suggest that the accountant performing the exam be required to file Form ADV-E within 45 to 60 days from the completion of the surprise exam. We believe that this time frame provides a reasonable time within which to report the findings of an exam.

We also support the proposed language that would require an independent public accountant to file a notice with the SEC within four business days in the case of the accountant's resignation, dismissal or termination relating to the surprise examination, accompanied by an explanation of the problems. This puts clients on timely notice that issues may have arisen with respect to the custody of their assets, and allows them to investigate further. It also allows SEC staff to evaluate the basis for any such actions. We strongly urge that this information be made publicly available.

C. Privately offered securities

We understand that under the current rule, privately offered securities are not subject to current custody requirements. Nevertheless, we support the proposal that they be subject to the surprise examination requirement. We agree that this would provide greater assurances that assets held in custody are better safeguarded.

II. When Adviser and Related Persons Have Custody

We support the proposed revisions to Rule 206 (4)-2 noted below that address when client securities are held by an adviser or when client funds are held directly or indirectly by a related person to the adviser, in connection with advisory services provided by the adviser with respect to its clients. The Commissions' proposals seek to extend the scope of protections under the rule where the adviser itself or related persons have custody (vs. a qualified custodian) in an attempt to close a gap that has become apparent through recent misuses of client assets. It also seeks to address an obvious area of potential conflict of interest. We appreciate the balance being struck by limiting the situations in which custody of the funds or securities is maintained by a related party only "in connection with the advisory services" that are being provided.

A. Custody by related persons

We support the SEC's definition of when an adviser has custody of client assets as when they are held directly or indirectly by a "related person" in connection with advisory services that are provided by an adviser to its clients. This formulation broadens the protections afforded client assets to instances when they are not being held by an independent custodian but instead by the adviser or one of its related persons. Deeming an adviser to have custody in such situations adds a degree of certainty in terms of applying the provisions of this rule.

B. Internal control report

We agree that maintaining client assets with someone other than an independent custodian presents added risks. Thus, we support the proposed requirement that an adviser or related person holding client assets be required to provide a written report on an annual basis that includes an opinion by an accountant registered with the PACOB as to internal controls. This "internal control report" would specifically opine on the adviser's (or the related person's) internal controls that are being used in connection with maintaining client assets, including a description of the controls in place and the results of the test of the operating effectiveness of the controls.

C. Surprise examination

Similarly, we support the requirement that surprise examinations be conducted not just by an independent public accountant, but by one that is also registered with the PCAOB. We agree with the SEC that this requirement provides added assurances in instances where there is an increased likelihood of conflicts of interest.

In response to a question raised in the release, we support use of both the internal control report and the surprise examination when client funds or securities are being held by the adviser or a related person. We believe that the combination of these requirements will go a long way to reinforcing investor protections.

III. Delivery of Statements and Notices to Clients

Under revisions to Rule 206 (4)-2, advisers must have a reasonable basis for believing that qualified custodians are delivering account statements to clients on at least a quarterly basis. Custodians holding clients assets would be required to deliver the custodial statements *directly* to clients instead of through the investment adviser. Moreover, the adviser would be obligated to conduct an inquiry sufficient for its reasonable belief that those account statements are sent after "due inquiry."

Additional rule amendments would require an adviser to provide language in the opening account statements that advises clients to compare the account statement they receive from the adviser with those that they receive from their custodians. This requirement is intended to alert the client to the possibility that there might be discrepancies or improprieties in the account transactions on an ongoing basis.

We support both of these requirements as providing added protections to investors and urge the SEC to adopt both provisions as proposed.

IV. Form ADV Amendments

We recognize that Form ADV serves a valuable purpose in providing clients and the SEC alike with meaningful information about the adviser and its practices. We generally support the proposed revisions that provide more complete information that informs clients about custody practices, while also alerting the SEC to potential risks.

We support the proposed amendment to Item 7 of Form ADV that will require, rather than permit, an adviser to supply the names of all related persons who are broker-dealers, and to identify those which serve as qualified custodians with respect to the adviser's assets. Similarly, we support the proposed amendment to Item 9 that requires an adviser with custody to report a number of additional pieces of information, including:

- whether a qualified custodian sends account statements on a quarterly basis to investors in pooled investment vehicles that are managed by the adviser;
- whether the financial statements of the pooled investment vehicles that are managed by the adviser are audited;
- whether the adviser's clients' assets are subject to a surprise examination; and
- whether an independent public accountant registered with the PACOB prepares the internal control report when the adviser or related persons serve as custodian.

Similarly, we support the proposed amendments to Form ADV that would require identifying information relating to the accountants that perform the surprise examinations and create the internal control reports. Inclusion of their names, the manner of their engagement and status of their reports is reasonable information for investors to have. We also support the proposal to include additional information about qualified custodians who are also related persons under the rule, including their names and whether they are a bank, futures commission merchant or foreign financial institution.

V. Form ADV-E Amendments

In light of our support of the proposed rule amendments, we also support the correlated form amendments that would require Form ADV-E and accountant's examination certificate to be filed electronically with the SEC. However, rather than within the 120 days being proposed, we recommend that this filing occur with 45-60 days, as discussed above. We do, however, favor the filing of Form ADV-E with a termination statement within the proposed four business days of the accountant's resignation, dismissal or removal.

Conclusion

We believe that the proposed revisions to Rule 206 (4)-2 present a balanced approach to increasing safeguards for custodial accounts, particularly with respect to those held by persons that are related to the adviser. Should you have any questions about our positions, please do not hesitate to contact Kurt N. Schacht, CFA at kurt.schacht@cfainstitute.org or 212.756.7728; or Linda L. Rittenhouse at linda.rittenhouse@cfainstitute.org or 434.951.5333.

Sincerely,

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