UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
INVESTMENT MANAGEMENT

June 5, 1996

Mr. John B. Kennedy
4930 Courville Avenue
Toledo, OH 53623

Dear Mr. Kennedy:

This will respond to your letter to Robert Plaze, in which you asked the staff of the Division of Investment Management to modify one of the conditions set forth in Investment Advisers Act Rel. No. 1000 (Dec. 3, 1985) ("Release No. 1000") under which an investment adviser that does not comply with Rule 206(4)-2 under the Investment Advisers Act of 1940 ("Advisers Act") may be paid its fees automatically from a client's account by presenting a bill to the client's custodian. 1/

Rule 206(4)-2 sets forth certain requirements for investment advisers that have custody of client assets. 2/ The staff generally takes the view that an adviser has custody if it directly or indirectly holds client assets, has any authority to obtain possession of them or has the ability to appropriate them. 3/ Accordingly, an adviser generally would be deemed to have custody if the adviser is paid automatically from a client's account upon presentation of a bill to the client's custodian. 4/ The staff has stated, however, that an investment adviser paid in this manner would not be subject to the requirements of Rule 206(4)-2 if: (1) the client provides written authorization permitting the

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1/ Release No. 1000 restated the staff's position articulated in prior no-action letters. See Lawwill Sena & Weller Inc. (pub. avail. Apr. 11, 1983); Investment Counsel Association of America, Inc. (pub. avail. July 9, 1982).

2/ The rule requires that an adviser (1) segregate client securities and hold them in safekeeping, (2) deposit client funds in bank accounts that contain only client funds and are maintained in the adviser's name as agent or trustee, (3) notify the client of the place and manner in which such funds and securities are maintained, (4) send the client at least quarterly an itemized statement showing the funds and securities in the adviser's custody, and (5) have the client's funds and securities verified annually by an independent public accountant on a surprise basis.

3/ Release No. 1000, at Part II. C., Question 5.

4/ Id.

adviser's fees to be paid directly from the client's account held by an independent custodian; (2) the adviser sends both the independent custodian and the client a bill showing the amount of the fee, the value of the client's assets upon which the fee was based, and the specific manner in which the fee was calculated; and (3) the independent custodian agrees to send the client, at least quarterly, a statement indicating all amounts disbursed from the account. 5/

You ask that the staff modify the second condition so that the adviser may send the custodian a bill indicating only the amount of the fee. Under your proposal, the adviser would continue to send the client a statement showing the amount of the fee, the value of the client's assets upon which the fee was based, and the specific manner in which the fee was calculated. In support of your proposal, you state that custodians rarely are obligated to verify the amount of an adviser's fees and that the primary protection against an adviser's overreaching results from the adviser providing the client with a statement showing the value of the client's assets and the manner in which the fee is calculated. You also state that when multiple custodians are involved, a single custodian cannot verify the accuracy of the fee calculation because it cannot verify the total value of the client's assets. Moreover, a client often may not want the total value of his or her assets disclosed to a custodian that does not hold all of those assets. Finally, because the client is in the best position to verify that fees are being properly calculated and deducted, you propose as part of the requested modification that the adviser's agreement with the client be required to disclose that it is the client's responsibility to verify the accuracy of each billing and that the custodian will not determine whether the fee is properly calculated.

We agree that, regardless of whether a client's assets are maintained by a single or multiple custodian(s), the client, rather than the custodian, is in the best position to ascertain whether an advisory fee has been calculated correctly. Thus, an adviser will not be deemed to have custody, and therefore does not have to comply with Rule 206(4)-2, if the adviser is paid its fees by presenting a bill to the client's custodian(s), and (1) sends a statement to the client showing the amount of the fee, the value of the client's assets upon which the fee was based, and the specific manner in which the fee was calculated, (2) discloses to clients that it is the client's responsibility to verify the accuracy of the fee calculation and that the custodian will not determine whether the fee is properly calculated, (3) sends a bill to the custodian indicating only the amount of the fee to be paid by the custodian, and (4) complies with conditions (1) and (3) set forth in Release No. 1000,

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5/ Id.

Question No. 5, relating to the client's authorization of the fee-paying arrangement and the custodian's obligation to send out statements to the client no less frequently than quarterly.

Sincerely,

Jana M. Cayne

Jana M. Cayne
Attorney
Office of the Chief Counsel

John B. Kennedy
4930 Courville Avenue
Toledo, Ohio 43623

December 6, 1995

Investment Advisers Act of 1940
Rule 206(4)-2
Request for No-Action Response

Mr. Robert E. Plaze, Chief
Office of Disclosure and Investment Adviser Regulation
United States Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Mr. Plaze:

I am writing with respect to an issue arising under Rule 206(4)-2 under the Investment Advisers Act of 1940 (the "Act"). As an investment adviser registered under the Act, I currently manage portfolios for fourteen clients on a fee-only basis. Clients are accepted only by referral -- I have no marketing activity what-so-ever.

During a recent Securities and Exchange Commission ("SEC") audit it was alleged that I have constructive custody over my client's accounts due to my use of an advisory fee deduction service provided by an investment company. Based on research conducted since the audit, I am now using a service with a different investment company which improves on the conditions specified in the SEC staff's no-action relief granted to the Investment Counsel Association of America, Incorporated ("ICAA") on June 9, 1982 (*See* Investment Counsel Association of America, Inc., SEC No-Action Letter (June 9, 1982)). I request that no-action relief to Rule 206 (4)-2 under the Investment Advisers Act of 1940, as amended, be granted to my new activity with the advisory fee deduction program of the new investment company.

Background

The SEC staff has taken the position that an investment adviser who has the authority to deduct advisory fee payments directly from client assets has custody of such assets, and therefore is subject to the requirements of Rule 206(4)-2. However, the SEC staff has held that an advisory fee deduction program will not cause the requirements of Rule 206(4)-2 to apply if the following conditions are met: (i) the client authorizes the adviser in writing to receive fee payments directly from the client's account being held by an independent custodian; (ii) the adviser sends the independent custodian and the client a bill showing the amount of the fee, the value of the client's assets upon which the fee was based and the specific manner in which the fee was calculated; and (iii) the independent custodian agrees to send the client, at least quarterly, a statement indicating all amounts disbursed from the account. (*See* Investment Advisers Act Release No. IA-1000 (December 3, 1985) ("Release IA-1000"))

Proposed Arrangement

The new service which I am using requires written client authorization to have fees deducted from client accounts held by an independent custodian ("custodian"). The service has additional features not described in prior ICAA / SEC correspondence and designed to address flaws in the current system. Some of the main features are:

1. The custodian requires two separate independent written agreements: one between the client and itself; one between the adviser and itself.

2. The adviser must agree to furnish the client with a bill that shows (i) the dollar amount of the fee, (ii) the specific account where the deduction will be made, (iii) the basis for the calculation (e.g. total portfolio amount), and (iv) how the fee is specifically calculated. The adviser also agrees that the client shall verify the accuracy of the bill and notify the custodian of any errors. The adviser agrees to furnish the custodian only (i) and (ii) above at the same time, and thereby keeps confidential the total amount of the client's portfolio total. Note that this last requirement is a modification of the response outlined in Release IA-1000.

3. The agreement with the client emphasizes that it is the responsibility of the client to verify the accuracy of each billing; that the adviser will concurrently give the client the bill described above in order to do so; and that the custodian will not perform any accuracy or appropriateness testing. The adviser is required to sign this agreement to indicate concurrence. The responsibility for error detection is accordingly clearly shown to rest solely with the client who is the natural, appropriate, and only party capable of detecting overbilling, fraudulent or otherwise.

4. The custodian sends 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. The fees paid are explicitly and easily distinguished as such.

5. Fees deducted must be deposited to an account with the custodian which is registered to the advisory firm. This "Fee Account" provides a superior permanent audit trail of all adviser fee activity.

Basis for Request

The justification for this proposed arrangement is based on six areas as follows:

1. While the no-action relief granted the ICAA in 1982 was a positive step, it unfortunately requires two conditions of questionable value. They are that the custodian be furnished:

a.) the value of the client's assets on which the fee was based, and

b.) the specific manner in which the adviser's fee was calculated.

This information is redundant, since it is provided to the client and corrective action, if necessary, need only be initiated by one party. In addition, my research of major investment companies shows that they universally neither desire this information nor take any action on it if the information is furnished. Thus, no additional benefit to the client is provided by furnishing this information already received by the client to a custodian who does nothing with it.

2. Providing the above information to the custodian, when known by the client, creates an illusion in the client's mind that the custodian requires the data to perform a valuation, verification, audit, and/or some other task (even though the custodian has no ability to verify amounts in a portfolio held by other custodians). In turn, this creates a false reliance by the client on the custodian, that the custodian can be counted on to do something which is not done, is not capable of being done, and is not desired to be done by that custodian. The presence of this false reliance is a harm to clients which should be eliminated as should the illusion which creates it.

3. Furnishing the above information to any custodian who provides a fee deduction service, where advisers utilize multiple custodians for the investments of clients (the usual case), violates the privacy of clients and as such is contrary to acceptable fiduciary relationships. This violation occurs in 100% of the cases involving multiple custodians and should be eliminated.

4. ICAA correspondence with the SEC on March 19, 1982, (*See* 1982 WL 29371 S.E.C.) leading to the June 9, 1982 no-action relief (*supra*), established that valuation was not the issue in requiring the above information (1.); rather it was fraud via overbilling. I concur with the concept that the client is the one with the greatest interest in not being overbilled and thus the most natural and appropriate person to check for any "deliberate .. and gross .. overbill(ing)." Furthermore, when multiple custodians are involved in one portfolio, it is quite beyond any reason to think the servicing custodian has the capability to verify the base on which fees are calculated. Only the client, with independently furnished statements from multiple custodians, can do so. Therefore, reliance for this detection should be clearly emphasized as a client responsibility.

5. Fraud in this area appears non-existent and therefore not a substantive issue. If ever present it is covered under Sections 206(1) or (2) of the Act. Prior to the 1982 no-action relief letter, no evidence of fraud in this area had been uncovered. My electronic search of the literature since 1982, showed significant fraud in the health care industry, and to a lesser extent in some other industries, that involved billing. Fraud was also present in the investment industry in areas other than billing. Of the thousands of fraud situations searched, none were uncovered which involved fraud in the investor billing area. In addition, my personal contact showed that none of the four custodians, with whom I do business and who also provide a fee deduction service, have received any complaints from clients concerning the overbilling concern expressed in the ICAA / SEC correspondence. It seems safe to conclude that the extent of any fraud which was of concern in the past to the SEC has disappeared, and in the future its potential can be adequately observed by clients. This is just not an area of focus for fraud; fraud in this area appears to be a theoretical possibility as contrasted with the 100% actual violation of privacy presently encouraged.

6. The administrative and accounting costs for my small practice would explode and have to be passed on to my clients if I were to continue good fiduciary standards by respecting their privacy, and simultaneously complying with SEC requirements for redundant audits and filings. I cannot represent to my clients that these requirements will benefit them. In fact, their net worth will be decreased by their *pro-rata* share of the cost. All of my clients are satisfied with past as well as new fee deduction services. None of my clients want the above information (1.) furnished to the servicing custodian.

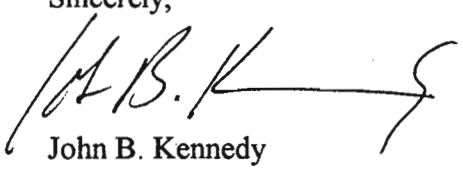
Conclusion

In summary, the granting of my request for no-action relief will eliminate redundant reporting, auditing, and associated costs; eliminate illusory safeguards and false reliance; insure client privacy; promote desirable fiduciary relationships; continue sanctions against fraud; improve the chance for detection of fraud and/or error detection; serve to discourage fraud; and inject a good measure of common sense into a long-standing practice which will be welcomed by both the industry and, more importantly, the investing public.

All the above can be effected without changing any SEC rules: only the staff interpretation need be slightly modified.

I look forward to working with you to achieve a satisfactory outcome as described above and having you grant the no-action relief requested. Please advise how I may do so.

Sincerely,



John B. Kennedy