FPA
FINANCIAL PLANNING ASSOCIATION
The Heart of Financial Planning™

Suite 201
1600 K Street
Washington, D.C. 20006
Voice: 202.449.6340
800.322.4237
Fax: 202.449.6350

E-mail: fpa@fpanet.org
Web site: www.fpanet.org

July 28, 2009

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

Re: Release No. IA-2876; File No. S7-09-09

Dear Ms. Murphy:

The Financial Planning Association ("FPA®)[1] appreciates the opportunity to comment on the proposed rule (the "proposal" or "rule") entitled "Custody of Funds or Securities of Clients by Investment Advisers." Financial planners are commonly regulated as investment advisers by the Securities and Exchange Commission ("SEC" or "Commission") and under state securities laws. As a strong advocate of a fiduciary standard for financial planning services,[2] FPA is supportive of rules that benefit the public and enhance investor protection, particularly in a time of financial crisis that has led to widespread loss of investor confidence in the capital markets. Our detailed comments follow below.

I. Introduction

For obvious reasons, custody of client assets has always been a primary concern of regulators. With respect to the billions of dollars in investor losses through Ponzi schemes that have come to light recently – most notably those involving Bernard Madoff and Allen Stanford – the Commission's renewed focus on custody is timely and appropriate. As noted in congressional hearings, however, many of these frauds were uncovered largely as a result of the severe market correction, not by regulators. This, then, becomes a question of how to revise current regulatory or enforcement priorities, including an analysis of available resources, to reduce future systemic fraud.

The crux of the matter was aptly summarized by a witness in a Senate Banking Committee hearing:

[1] The Financial Planning Association is the largest organization in the United States representing financial planners and affiliated firms, with more than 25,000 individual members. FPA members directly manage more than $1.75 trillion in assets with a combined client base of 3 million. Approximately 48 percent of FPA members are affiliated with SEC-registered investment adviser firms and 24 percent with firms registered on the state level. FPA is incorporated in Washington, D.C., with administrative headquarters in Denver.

[2] *See* FPA Standard of Care, at http://www.fpanet.org/AboutFPA/Organization/CoreBeliefs/.

> The tide has gone out on Wall Street, and in Warren Buffet's words, we are now finding out "who has been swimming naked." Sadly, it has been the recurrent pattern in Ponzi schemes and similar investment frauds, that they are revealed not by regulatory detection and enforcement, but by their own collapse under the pressure of investor demands for redemption when the market sours (and investors become belatedly anxious).[3]

This ebbing tide has led to questions from Congress about the efficacy of the current regulatory system. With more than 75 Ponzi frauds uncovered in the past two years,[4] Rule 206(4)-2 of the Investment Advisers Act of 1940, commonly known as the custody rule, is now under intensive analysis by the Commission.

In its comprehensive review[5] of the rule seven years ago, the SEC added a broad definition of "custody" and attempted to clear up the clutter of numerous staff interpretations built up over 40 years. FPA was generally supportive of the rule changes in 2002. Today, we strongly support continued review of the rule in light of these new, disturbing threats to investor protection. At the same time, the concerns that we expressed with the interpretation of "custody" under the 2002 rule, and in a more recent letter to the Commission regarding protections provided through independent custodians,[6] has led to what we believe is a major flaw in the current proposal. We address these concerns, and also review other actions that may be taken by the Commission to ultimately resolve the problem at hand.

In light of these possibilities, we believe adoption of the proposal is premature. The SEC should await review of the Inspector General's report on Madoff and subsequent oversight hearings of Congress prior to taking final action. For the same reasons, if the SEC moves forward to adopt the amendments as proposed, the rule should be temporary, given the likelihood of other reform measures to be passed by Congress affecting securities regulation and the custody rule. In the interim, we believe that 'down the chain' sweeps of custody activities of investment advisers should continue and this, along with other measures taken by the Commission, will help safeguard investor assets and restore confidence in the advisory profession while a more comprehensive solution is found.

The main issues covered in our comments:

a. **Independent verification of client funds and securities.[7]** FPA believes that advisers deemed to hold custody solely by limited authority to deduct fees[8] should be excepted

[3] Testimony of John C. Coffee, Columbia University law professor, Jan. 27, 2009, before the U.S. Senate Committee on Banking, Housing and Urban Affairs, at 1.

[4] Testimony of SEC Commissioner Elisse B. Walter "Concerning Securities Law Enforcement in the Current Crisis," before the U.S. House Committee on Financial Services, March 20, 2009.

[5] Release No. IA-2044; File No. S7-28-02, "Custody of Funds or Securities of Clients by Investment Advisers," July 18, 2002.

[6] *See* letter regarding custody issues, from Daniel Barry, FPA Director of Government Relations, to SEC Chairman Mary L. Schapiro, Apr. 30, 2009, at 2.

[7] Release No. IA-2876; File No. S7-09-09, "Custody of Funds or Securities of Clients by Investment Advisers," May 20, 2009, proposed sec. 206(4)-2(a)(4).

[8] For ease of reference, we divide custody activities into two different categories: 1) 'technical custody,' meaning an adviser meets the SEC definition of custody solely by having authority to deduct fees; and 2) 'physical custody,' in which the adviser has actual possession of client assets.

from the proposed requirement. We provide cost estimates that question the SEC's assumption, and offer reasons why other actions of the Commission might do more in accomplishing the overall goal of curbing Ponzi fraud.

b. **Auditor integrity.** We review action taken by the SEC and Public Company Accounting Oversight Board ("PCAOB") since the Madoff scandal and suggest why strengthening the inspection requirements for PCAOB registrants, as well as requiring independent verification only for certain advisers that maintain *physical* custody of client assets, may be the most important actions undertaken by Congress and the SEC to mitigate this problem.

c. **Resources.** Congress and the SEC are in agreement that additional resources are needed for enforcement and may very well be the root cause of the problem. We urge the Commission to wait before adopting a final rule until after it has carefully examined the Inspector General's report on Madoff and then determined whether it is primarily an enforcement and resource – not rulemaking – issue.

II. Background.

a. Historically, the Commission has sought to avoid additional burdens on advisers deducting fees through custodial arrangements.

FPA encourages the SEC to maintain a consistent policy for advisers with technical custody absent systemic fraud or abuse.

Under the current Rule, an adviser is generally deemed to have custody of client assets when holding actual possession ("physical custody") or having the authority to obtain possession of some or all of the assets (e.g., by deducting advisory fees or withdrawing funds on behalf of the client – "technical custody"). During previous rulemakings, the Commission did not express much concern with technical custody in contemplating investor risk. In fact, for decades it allowed advisers to rely on several no-action letters to deduct fees in this manner without being subject to the surprise examination requirement. Had such activities posed significant risk to investors then, the Commission would have undoubtedly addressed this problem. Instead, as noted in the 2002 proposing release concerning deduction of fees, the Commission appropriately expressed concern with unnecessary compliance costs:

> We have designed the proposed rule so that these advisers would be able to comply with the rule without facing the burdens they previously sought to avoid.[9]

The final rule retained this semi-exclusion from the custody requirement. Perhaps initially puzzling to anyone who reviews the instructions to Form ADV, this 'semi-exclusion' comes from a requirement under Item 9, Part 1, that firms deducting fees in this manner <u>not</u> check the 'custody' box, even though the Commission believes fee deductions to be a custodial activity. This seemingly contrary instruction suggests

[9] Release No. IA-2044.

that the SEC has always viewed fee deductions as a low-risk activity, one not even requiring notification to clients on Part II of the form as a potential conflict of interest.[10]

b. Madoff and other publicized Ponzi schemes have caused the Commission to respond prematurely to demands for action.

FPA encourages the SEC to delay taking action until it has reviewed the Inspector General's report and considered subsequent recommendations by Congress.

Numerous Ponzi schemes were uncovered in the past year, even though such fraud has been perpetrated on the public for decades through various real estate and investment schemes. Of course, the sheer scope and size of the most recent ones have gripped the attention of the American public and Congress. As noted earlier, many appeared to have collapsed as a result of the market crisis rather than from vigilant enforcement activity. Most notable among these lapses, and the subject of extensive congressional review, is Madoff Securities.[11]

Clearly, Congress has placed pressure on the SEC to act decisively as a result of the Madoff case, even while not providing specific guidance. This is, of course, how congressional oversight works. It is ultimately up to the agency to revise policy if current programs fail. In several hearings this year on Madoff, most of the focus was on mistakes in enforcement, not regulatory gaps. Senate Banking Committee Chairman Christopher Dodd, in his opening statement at the initial Senate hearing, said:

> "…This much we know. Since Bernard L. Madoff Investment Securities LLC started in 1960, the firm has been subject to examination and oversight by the Securities and Exchange Commission and by the securities industry self-regulatory organization, the Financial Industry Regulatory Authority, or FINRA, and its predecessor, the NASD."
>
> "…How could regulators have missed so many warning signs? Did the examination staffs lack adequate expertise or numbers? Were they intimidated by Mr. Madoff's influence in the securities industry? Did they lack legal authority? *Or, as I suspect, are there deeper problems*?"[emphasis added][12]

Indeed, we believe the problems are much deeper, and we believe the Commission would agree that these problems cannot be resolved merely by recalibrating a single rule. The SEC, under Chairman Mary Schapiro's leadership, has responded with a number of initiatives, including more aggressive enforcement, elimination of pilot penalty programs, organizational restructuring, and strengthening its

---

10 Part 1 is essentially a data collection section of Form ADV and is not required to be offered or delivered to clients of an investment adviser. Part II is the standard disclosure section that is given to prospective clients.

11 *In the matter of Bernard L. Madoff and Bernard L. Madoff Investment Securities, L.L.C.,* 08 Civ. 10791 (LLA), (S.D.N.Y. 2008)

12 Opening statement of Senator Christopher Dodd, Jan. 27, 2009, hearing of the Senate Committee on Banking, Housing, and Urban Affairs.

oversight and consumer tips and complaints programs.[13] It is important to note that Congress did not specifically ask the Commission to target advisers who deduct fees through their custodians. Statements made in the relevant committees suggest a keen interest in reviewing the report from the Inspector General and in exploring a broad set of issues related to the inquiry. Consistent with this approach, we believe the SEC should consider, and continue to implement other, more tangible solutions before moving forward with a new requirement based on a vague nexus between advisers holding technical and physical custody.

III. Independent verification of client funds and securities.

FPA urges the Commission to except advisers from the surprise examination requirement solely as a result of authority to deduct fees.

As noted earlier, the SEC historically treated advisor accounts subject to technical custody, i.e., the adviser is able only to withdraw advisory fees, in a completely different manner than an investment adviser with physical custody (e.g., Madoff, Sanford). There are a number of valid public policy reasons why technical custody should be excepted from a surprise examination requirement.

a. Ponzi fraud requires physical custody, not fee deductions, to operate.

According to commonly accepted definitions,[14] a Ponzi scheme typically pays returns to investors out of money paid by subsequent investors rather than from profits. The system is destined to collapse because the earnings, if any, are less than the payments.[15]

In a classic Ponzi scheme, even with small-scale frauds, adequate cash inflow is required to cover payments to current investors. This may seem obvious, but in order to make the fraud worthwhile to the perpetrator, he must be able to siphon off substantial assets in addition to payments. If the fraud relies on fees that are deducted from the corpus over a long period of time, without immediate receipt of the entire investment, then such a scheme is far less appealing to the Ponzi artist. In summary, this kind of cash-flow arrangement would appear to leave little or no capital available for both distribution payments and theft.

The SEC this past spring testified before the House Committee on Financial Services and reported on enforcement activity related to Ponzi schemes.[16] To our knowledge, none of the public statements or reports of the Commission to-date have addressed the different risks between physical and technical custody, or abuses related to fee deductions. If fee deductions were a common artifice used to foment Ponzi schemes, we would expect the SEC to readily explain the connection.

---

[13] "Testimony Concerning SEC Oversight: Current State and Agenda," by Chairman Mary Schapiro, before the U.S. House of Representatives, Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises, July 14, 2009.

[14] *See, e.g., <u>http://en.m.wikipedia.com/wiki?search=ponzi+scheme</u>; http://dictionary.reference.com/browse/Ponzi%20scheme.*

[15] Wikipedia.

[16] Testimony of Elisse Walter, March 20, 2009.

Regrettably, the Commission has not made a convincing argument in the rulemaking or other public statements to justify applying a blanket requirement to advisers who maintain some form of custody. Instead, the proposing release simply states that "investment advisers typically do not maintain *physical custody* [emphasis added] of client funds or securities but rather *may* [emphasis] have custody because they have the authority to obtain client assets, such as by deducting fees from a client account…"[17] Later, it notes that "the surprise examination requirement of the rule may deter fraudulent activities by advisers,"[18] but it again fails to explain what it means by "misuse" of client funds, and why a costly new requirement is needed for advisers without physical custody.

In practical, not technical terms, there is a clear difference. Physical custody means the ability to walk away with most of the funds. Technical custody, as we define it, means that in practice, a dishonest adviser may walk away with 3 percent of the client's funds per year, if he overcharges for his services. There are safeguards in place that we discuss, limiting the ability to do even that.

We can only conjecture that, given the intense congressional scrutiny of the Commission's enforcement activity, the SEC has determined to respond with a sweeping regulatory response to assure Congress it is serious. However, absent any abusive or fraudulent practices in the area of technical custody, we urge the SEC to maintain the current exception while continuing to look at other, more effective programs that demonstrate a renewed commitment to investor protection.

b. Protections are already in place with fee deduction practices.

Although not required by rule, most advisers that automatically deduct fees send invoices directly to clients with a cost breakdown of various services provided. In offering financial planning services in addition to portfolio management, the investment adviser may break out the additional costs in the billing statement if such services are not offset by the asset management fee. The client is then able to compare the adviser's statement and billing costs deducted from assets with the statement from the custodian. Statements are typically distributed monthly or quarterly. In either event, the client has an opportunity to spot discrepancies more often than would happen with an annual accounting review.

c. Qualified custodians offer additional protections for fee deduction accounts.

Third-party custodians typically have control procedures in place to detect unusual fee deductions by the investment adviser. Like independent advisers using third-party custodians, individual advisers affiliated with broker-dealers that serve as qualified custodians, who may be considered higher risks by regulators since the individual may operate in a branch office hundreds of miles from the corporate office, are subject to similar controls. In both instances, the qualified custodian generally would have copies of the client-adviser agreement that outline compensation arrangements and the power of attorney that permits fee distributions by the custodian.

---

[17] Release No. IA-2876, at 3-4.

[18] *Id.* at 71.

More importantly, the custodian also typically maintains control procedures to identify unusual activity, such as excessive fee deductions or more frequent billings. Unusual activity in the billing account would trigger an exception report that requires a manual override by the custodian before processing the new fee deduction. Typically third-party custodians will impose a 3 percent maximum cap on fees that may be charged by the adviser per billing cycle, raising another warning flag if the adviser attempts to exceed that amount.

In this manner, abusive practices are mitigated by internal controls of the custodian, separate from the periodic statements that enable the client to review any billing or other discrepancies.

d. Questions around the estimated cost of a surprise examination.

The proposing release relies heavily on a 2002 cost estimate of $8,000 per firm[19] in concluding that the average surprise examination today would cost about the same. The 2002 analysis was based on the average firm having 670 clients subject to the exam. The current proposal, however, estimates 978 clients in today's typical firm, yet the estimated exam fee is only slightly higher.[20] Nor does the current proposal build in an increase for inflation. These assumptions are at odds with what accounting firms tell us about current costs. As a general rule, the greater the number of client accounts that need to be inspected, the more expensive the billing or fee arrangement. Such an exam is not scalable based on size.

The proposing release also states that the SEC consulted with "a few accounting firms" to confirm that the old costs were consistent with the new requirements. In discussions with a number of firms, however, FPA questions the accuracy of those estimates. Indeed, we believe that the true cost of the average examination could be up to three times higher than the SEC's finding, or a minimum range of $15,000 to $24,000 in average costs.

Given these discrepancies, we believe the SEC should review the disparity and consider why the most critical factor in cost – the increase in client numbers from 670 to 978, or nearly 50 percent – does not change the overall cost of the surprise examination.

Secondly, neither the 2002 or 2009 analysis appears to take into account significant variables that can affect the overall cost of the examination. Key variables include multiple accounts for each client, type of investment that must be counted individually (e.g. securities versus mutual funds), and number of custodians.

Using our own membership data in combination with IARD data for comparison, FPA came up with different costs. Each individual FPA member, for example, has an average of 200 clients. Using the SEC's estimate from IARD data that 85 percent of a firm's clients have discretionary accounts in which fee deductions are made, each FPA member would have 170 clients subject to the surprise examination. (85% X 200 = 170.) To this we added three accounts per

[19] Release No. IA-2044, footnote 72.

[20] Release No. IA-2876, at 42.

client, or a total of 510 accounts that must be inspected.[21] Although firm demographics vary considerably, on average each FPA firm has only one principal maintaining client relationships. Therefore we treated each planner as a firm. This resulted in a client base only about one-fifth the size of the average SEC firm. (170 X 928 divided by 100 = 18.3 %.)

One might initially conclude that the examination cost for each FPA firm would be substantially less than the SEC average. Based on this assumption, an FPA firm audit would cost about $1,500, compared to the $8,100 SEC average (18.3% X $8,100 = $1,482.30). However, our accounting firms rejected this assumption as far too low. One believed there would be a minimum floor, or base cost of approximately $4-5,000 for *any* surprise examination -- even if the adviser had only four or five clients. The reasons cited were different technical requirements related to a surprise examination: applicable attestation standards of the American Institute of Certified Public Accountants, each firm's quality control procedures, and any future requirements instituted by the SEC, PCAOB, or any other governing body.

This explanation, we believe, also contrasts with another cost assumption from the 2002 proposing release – that a surprise examination of 1 percent of a firm's clients would cost only $1,000.[22]

Using a client base of 170 clients for one adviser and other assumptions cited above, one of our practitioners received the following estimates[23] from three accounting firms located in North Carolina:

- $18-20,000 (an estimate from a CPA firm used by the adviser)
- $10-12,000 (by an auditor of non-profit organizations)
- $15,000 (by another CPA firm)

Taking the average of the three, the cost per examination of a financial planner with 170 clients would be $15,000. ($19,000 + $11,000 + $15,000 by 3 = $15,000.)

---

[21] We believe this to be a conservative estimate. FPA's volunteer committee of practitioners suggested that their clients often have five and sometimes up to 10 accounts for which the planner charges a consolidated management fee. One example was for a married couple with two traditional and two Roth IRAs, two 401(k) plan accounts, a joint brokerage and a joint trust, the sum total being eight accounts for one client.

[22] *See* 2009 proposing release at 64: "[Under the current rule]…11 advisers were subject to the surprise examination with respect to 100 percent of their clients and spent $8,000 each annually, on average, and 193 advisers were subject to the surprise examination with respect to only 1 percent of their clients and spent $1,000 each annually, on average.

[23] The scope of the examination provided to accounting firms was based on the SEC's criteria described in the proposing release on page 6: 1) Confirm with the custodian all cash and securities held by the custodian, including physical examination of securities if applicable; 2) Reconcile all cash and securities to the books and records maintained by the adviser; 3) Verify books and records of the adviser for these accounts by reviewing all transactions since the last examination; 4) Confirm with clients all funds and securities in the accounts; and 5) Confirm with clients, on a test basis, closed accounts or assets returned to them since the last examination.

FPA also discussed the examination cost with a Cleveland accounting firm (registered with and inspected by the PCAOB) that conducts audits and examinations of broker-dealers, mutual funds, and small advisers. Its estimate was much higher than the other firms. In this instance, the Cleveland firm cited a real example – a small adviser with 100 clients, of whom there were about 150 accounts spread out among 10 different custodians. The Cleveland firm charged a fixed engagement fee of $12,000, although it subsequently found it had underestimated the true cost. In billable hours, the real cost would have been closer to $20,000. This was due to, among other things, limited cooperation and lack of confirmation responses received from the custodians and clients; the volume of routine reconciling items noted (i.e., trade date vs. settlement date) which must be investigated; and changes in the volume of investments held within each client account from the time the fee quote was provided to the date of the surprise examination.

When asked what the firm would charge based on the SEC's average client based of 928, the Cleveland firm indicated at least $24,000, or nearly three times the SEC's estimate.

Separately, two compliance firms that work with advisory clients around the country, one with offices on both coasts, the other in the Midwest, provided similar estimates of $10-20,000 for a surprise examination.

Another factor not addressed by the proposing release is the effect on supply and demand for accounting work generated by Sarbanes-Oxley after the 2002 custody rule amendments were adopted. With the SEC estimating an additional 9,385 advisory firms suddenly required to undergo surprise examinations, accounting firms may charge even higher prices due to the increased demand.

In summary, it is clear that costs for surprise examinations of this sort will vary considerably, depending upon a variety of factors. While FPA's survey was limited in scope, so were the estimates in the proposing release. At an absolute minimum, we believe more extensive work must be done by the Commission in estimating a realistic average cost per firm. However, based on our own analysis and other comments we've seen filed by individual practitioners on the rulemaking,[24] we believe that the true costs are likely to be significantly higher than the SEC's original estimates.

Taking into account all of the above factors, we believe that the SEC's average estimate is too low: possibly by half or more.

e. Accounting firms not readily accessible in rural areas.

Although many investment advisers are located in metropolitan areas where their clients live, some advisers live and work in rural areas. Related to our concerns with the examination costs enumerated above, we would add to this list fees charged for 'drive' or travel time of the accountant. We note that this concern has also been raised by other commenters.

[24] *See*, e.g., comments of Jeffrey W. McClure to the SEC, June 22, 2009, $15-20,000 estimate; Dennis Vogt, July 2, 2009, $10-12,000 estimate.

f. The rule will ultimately affect state-registered investment advisers.

While this rulemaking would directly affect only federally registered investment advisers, we are aware that the SEC has worked cooperatively with state securities regulators and others over the years to harmonize rules and enforcement activity. We believe that a final rule would ultimately impact state-registered investment advisers ("RIA"), as well.

After adoption of the 2002 amendments to the SEC Rule, the North American Securities Administrators Association ("NASAA") proceeded to make similar amendments to its model rule.[25] We believe that the states would again follow the SEC's lead if the current proposal were adopted.

The fiscal impact on state RIAs would be even more severe, since state RIAs typically have a smaller asset base and less diversified income stream.

g. Proposed independent examination is anti-competitive.

Finally, the rulemaking does not distinguish between the proportionately higher compliance costs for smaller advisory firms, e.g., those with assets under management of $25 million to $100 million, and those with billions under management. It is certainly much easier to absorb compliance costs for larger firms. Yet under the Regulatory Flexibility Act, the SEC does not analyze the disadvantage for smaller advisers with the exception of a handful of firms allowed to register with the SEC having less than $25 million in assets under management.[26] The proposing release simply states that "…no more than 8 of these [small] advisers or their related persons would serve as a qualified custodian for client funds or securities under the proposed rule…" The Commission also rejected easing compliance requirements for smaller firms[27] and did not comment on the relative costs to smaller firms in terms of effects on competition, other than to state that "we believe that the proposed amendment would not materially increase the compliance burden on advisers..."[28]

We disagree. Based on FPA's own internal study,[29] eight in 10 planning firms with less than $50 million under management generated less than $500,000 in gross

---

[25] *See* "NASAA Custody Requirements for Investment Advisers, Model Rule 102(e)(1)-1," *Adopted April 3, 2000, Amended 4/18/04, 9/11/0,* http://www.nasaa.org/content/Files/IACustodyRules.pdf.

[26] Release No. IA-2876, at 73.

[27] "We do not believe that differing compliance or reporting requirements or an exemption from coverage of the rule amendments…would be appropriate or consistent with investor protection." *Id.*at 75.

[28] *Id. at 78.*

[29] *Source:* "2009 FPA Financial Planner and Staff Salary Survey." Data below shows assets under management and correlation to annual gross revenue.

Assets Under Management	**Percentage of FPA firms with >$500,000 revenue**
$0-$49.9 million	83.9%
$50-$99.9 million	33.4%
$100-$249.9 million	6.4%
$250-$999.9 million	2.9%
$1 billion or more	0%

annual revenue, which must cover overhead, salary and benefits, debt, and other expenses. Similar income levels are reported by one out of three firms with $50-100 million under management. According to IARD data, about half of all SEC-registered advisers manage less than $100 million in assets,[30] therefore it can be assumed that 4,000 or more SEC-registered advisers would be faced with significantly higher compliance costs. Not surprisingly, the disparity in income between these smaller firms and those with $100 million or more assets under management places the smaller firms at a significant competitive disadvantage.

h. Alternatives.

FPA opposes the inspection requirement of advisers with technical custody as costly and unnecessary. We offer other alternatives below.

In lieu of a surprise exam, we believe other alternatives would meet the Commission's goal of strengthening custody rules.

First, it may consider imposing a requirement that all advisers provide clients with a user-friendly breakdown of fees in advance of the custodial statement. This would work well with the proposed notice that advisers encourage clients to compare statements.

Second, the Commission may want to require that advisers with fee deductions provide the qualified custodian with a copy of the client compensation arrangement, so it is aware of how fees are charged.

However, FPA is opposed to fee caps as a method of internal control. We believe a rigid cap on overall compensation would not work as intended, particularly if there were performance fee compensation arrangements. Other internal controls discussed above would be preferable.

Finally, and notwithstanding what we believe are compelling reasons for the SEC to except advisers with technical custody from surprise examinations, if the Commission proceeds with this requirement, we ask that it consider reducing the requirement for verification of <u>all</u> accounts to <u>random</u> verification.

By limiting random audits to 10 percent of an advisory firm's clients (about 93 clients),[31] and perhaps a floor of 25 clients for firms that fall below that percentage, we believe that the SEC could still accomplish its objective without compromising on its overall goal of establishing independent verification. The accountant should be left with the discretion to single out higher risk accounts for inspection, including some of the largest accounts and accounts recently closed.

IV. Auditor Integrity.

FPA believes strengthening rules and authority of PCAOB would enhance investor protection more than any other regulatory initiative.

---

[30] *See* "Evolution Revolution 2008, A Profile of the Investment Adviser Profession," by National Regulatory Services and Investment Adviser Association, chart C6, at 5.

[31] 10% X 928 = 92.8.

Madoff Securities in 2006 became a registered investment adviser allegedly holding physical custody of client assets. As such, he was subject to a surprise examination under the custody rule. When entering his guilty plea, Madoff admitted that he "intentionally and falsely certified" that his advisory firm had custody of client assets. Subsequent investigation by federal authorities revealed that the accounting firm retained by Madoff for the annual surprise examination was nothing more than a shell company. The SEC's complaint alleged that Madoff's accounting firm, Friehling and Horowitz, accepted millions of dollars in fees and other payments while both exploited a loophole that exempted it from registration or inspection by the PCAOB. This loophole was created by a series of orders issued by the Commission in 2003, 2004, and 2005[32] that exempted privately-held broker-dealers like Madoff's firm from the requirement to use a registered public accounting firm.

By shutting down this registration loophole after Madoff confessed, the Commission may discourage future accounting frauds. However, registration alone is not sufficient. By only closing the registration loophole, it is conceivable that the Madoff scheme could still be going on today had the market not crashed. This is because registration with PCAOB does not automatically allow it to <u>inspect</u> all of its registrants, unless the firm is involved in examining public companies. However, this problem is about to be addressed legislatively. As we understand it, the Commission is in fact working closely with Congress to expand PCAOB's authority to not only register, but also to inspect accounting firms that were previously exempt. We applaud this effort. It is hoped that legislation such as H.R. 1212 will provide PCAOB with the tools it needs to carefully examine all accounting firms within a three-year cycle and help avoid the kind of phony surprise examination that Madoff used to avoid regulatory scrutiny.

V. Resources.

FPA supports greater enforcement resources for the SEC.

As noted recently by SEC Chairman Schapiro in congressional testimony,[33] the agency is in great need of increased resources. Since fiscal year 2005, the SEC has faced three consecutive years of flat or declining budgets, resulting in an overall 10 percent reduction in its workforce. During the same period, the investment adviser registrations have increased nearly 30 percent, and since 1999, by 78 percent.[34]

According to reports, Madoff was only examined once after registering as an adviser in 2007. It is clear that the SEC needs more resources to do its job and get back to the annual audit goal of once every five years for each adviser.

VI. Other Issues.

FPA greatly appreciates the questions posed by the Commission on a number of different matters. We touch on many of the key questions in our previous comments. Additionally, we offer comment on other issues of concern to financial planners.

---

[32] Securities Exchange Act Release No. 34-54920 (2006).

[33] Testimony of SEC Chairman Mary L. Schapiro, July 14, 2009.

[34] *Id.* and *Evolution Revolution, 2008.*

a. Should [the SEC] require advisers to adopt compliance policies and procedures administered by a chief compliance officer, and to submit a certification to the agency on a periodic basis that all client assets are properly protected?

No. FPA believes certification would not enhance investor protection, primarily because if a firm were intent on committing fraud, it would fabricate its certification. In practical terms, it would be difficult or impossible to certify assets held by a third-party custodian unless it undertook its own verification procedures that essentially replicated aspects of the surprise examination.

b. Should [the SEC] deem an adviser to have custody if its related persons hold assets in connection with the adviser's advisory services?

The Commission proposes amending the rule to provide that an adviser has custody if client assets are held by a 'related person.' A related person is a person directly or indirectly controlling or controlled by the adviser, or under common control.[35] FPA has concerns with the technical definition of 'related persons.' We are concerned that some financial planners, having organized state-chartered trust companies to hold client assets, might come under the definition. In all instances, their respective ownership in the trust company is typically less than 7 percent. Some principals in the advisory firms, however, may serve as an office of the Board of Directors of the trust company. Unofficial staff guidance from the SEC suggests such activities, assuming a Director did not hold more than 25 percent of voting rights, would not be deemed to control the entity. FPA wants to confirm that the proposal would not inadvertently trigger such a requirement.

Second, with respect to related persons such as broker-dealers, we agree that for purposes of custody, the dually registered adviser and broker-dealer ("dual registrant") should be deemed to hold physical custody.

c. Would the requirement of an internal control report by advisers with physical custody provide additional protections for clients?

We believe an internal control report should not be required for dual registrants or for advisers affiliated with bank and trust companies that maintain physical custody. Broker-dealers and banking institutions are already subject to extensive regulation and oversight with respect to protection of customer assets.

d. Does it make sense to require both an internal control report and a surprise examination?

We believe both should be required only if the adviser holds physical custody and is not a related person of a qualified custodian. Independent advisers using a third-party custodian to deduct fees are not subject to the internal controls requirement in the proposal and we believe should continue to be exempt. In addition, FPA believes that dual registrants should not be excepted from the surprise

[35] Release IA-2876, at 18.

examination requirement if such a requirement were imposed on independent advisers that use third-party custodians.

e. Should we simply amend rule 206(4)-2 to require that an independent qualified custodian hold client assets?

No. FPA believes there are adequate safeguards in place for affiliated qualified custodians. To make it a requirement for affiliates of an adviser to maintain custody with a third party would significantly increase costs significantly for clients and raise a host of other privacy and compliance issues.

f. Delivery of account statements and notice to clients.

FPA supports the proposed amendments to require advisers with technical or physical custody of client assets to have a “reasonable belief” through appropriate due diligence to ensure that clients or their representatives are receiving account statements from the qualified custodian.

Further, FPA supports the revisions to Part 1 of Form ADV to include a statement to clients urging them to compare account statements that they receive from the custodian with those from the adviser.

VII. Conclusion

FPA appreciates this opportunity to provide comment on the critical investor protection issues raised by this proposal. Please contact the undersigned at 202-449-6341 for any questions or comment.

Very truly yours,

Duane R. Thompson

Duane Thompson
Managing Director, Washington Office