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NASAA

By Email To: rule-comments@sec.gov

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

Re: File Number S7-09-09
NASAA Comment Letter on Proposed Amendments to the SEC's Custody Rule

Dear Ms. Murphy:

The North American Securities Administrators Association, Inc. (NASAA)1 appreciates the opportunity to comment on Release No. IA-2876, File No. S7-09-09, "Custody of Funds or Securities of Clients by Investment Advisers."

NASAA commends the Commission for proposing these changes to the rule. The amendments represent important steps toward clarifying custody requirements and strengthening investor protections. Some of these issues have been considered or addressed by state securities regulators and we welcome the opportunity to share our reasoning and experience with the Commission. Conversely, some of the proposed rule amendments, while only applying to SEC-registered advisers, can serve as important guides to state officials in their efforts to promote strong and uniform regulation.

SURPRISE EXAMINATIONS

Surprise examinations for all investment advisers with custody of client assets.

The Commission proposes to require that all registered investment advisers with custody of client assets must engage an independent public accountant to conduct a surprise examination on an annual basis, regardless of whether or not the adviser has a reasonable belief that "qualified custodians" provide account statements directly to clients. NASAA strongly supports the reinstatement of this requirement for all advisers with custody. In years past, the annual surprise examination requirement was an effective tool for monitoring advisers who had custody of client assets. The withdrawal of the surprise

1 The oldest international organization devoted to investor protection, the North American Securities Administrators, Inc. was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

exam requirement eliminated an important tool for detecting and deterring the mishandling of client assets. By restoring this important regulatory requirement, the proposed rule will enhance investor protection.

An exception for advisers who have custody merely because they have authority to withdraw advisory fees from client accounts.

With respect to investment advisers that have custody of client assets solely as a result of their authority to withdraw advisory fees from the client accounts, we believe these accounts are less likely to be subject to abuse and could reasonably be excluded from a program of annual surprise examinations by an independent CPA.

Clarifying references to "public" accountants.

The Release would require that surprise examinations be conducted by "independent public accountants." NASAA believes that this requirement should be clarified and strengthened. The rule should require surprise audits to be performed by "Certified Public Accountants." Expressly incorporating this higher professional standard in the audit requirement is warranted in light of both the complexities that may be involved in surprise audits and the public interest at stake—safeguarding investor assets. Certified Public Accountants provide a widely recognized and uniform standard of expertise that will reduce instances of possibly inferior audits. This approach is also consistent with the Commission's reporting requirements in general. For example, when the Commission requires a balance sheet as part of Schedule G, Form ADV-II, it must always be prepared in accordance with Generally Accepted Accounting Principles (GAAP) which have been developed by the American Institute of Certified Public Accountants (AICPA) and the Financial Accountant Standards Board (FASB). NASAA questions whether a public accountant that is not a member of the AICPA would have the ability to fully understand or apply the Generally Accepted Auditing Standards (GAAS) issued by the AICPA for its members.

Providing additional guidance regarding the conduct of surprise examinations.

NASAA strongly suggests that additional guidelines be provided to the independent CPAs performing surprise exams. For example, the Commission should provide more detailed methodologies for verifying information provided by the investment adviser, such as pricing of investments. In addition, that verification should include an appropriately large sample of direct contacts with the investment adviser's clients.

Enhanced reporting requirements relating to surprise examinations.

NASAA supports the Commission's proposals to strengthen the reporting requirements relating to surprise examinations. For example, requiring accountants to report material discrepancies discovered during the surprise exam within one business day is an essential requirement for ensuring that potential abuses in the handling of client funds are not only discovered, but also investigated by the Commission and acted upon in a timely fashion.

NASAA also agrees that the deadline for filing reports of surprise examinations should be changed. We support the Commission's proposal to calculate the deadline from the point the exam opens as opposed to the exam closing. NASAA recommends a further adjustment to the proposed rule: that the ADV-E filing deadline be "within 30 days of the completion of the exam or within 120 days of the start of the exam, whichever is sooner." Under this approach, exams that are completed in a shorter period of time would be reported sooner (for example, an exam taking 30 days would be reported in 60 days), while exams that may take longer to complete are still given a firm deadline for completion and submission of a report.

NASAA further believes that an accountant's resignation or dismissal in connection with engagements for surprise audits should be promptly reported to the Commission. However, we have concerns with placing this reporting requirement solely on the accountant and not the registrant. It may be more appropriate to place the burden directly on the registrant over which the Commission has clear jurisdiction to ensure that this filing occurs. Footnote 29 of the Release indicates that in two comparable regulations, the reporting burden is placed on the registrant and also requires a statement from the third party as to whether or not it agrees with the regulated entity's statement. NASAA recommends that a similar model be adopted in this situation.

The exception with respect to client assets held in pooled vehicles that are audited at least annually.

NASAA agrees with the Commission's proposal to apply the surprise examination requirement to advisers that have custody as a result of serving as a general partner (or in some other capacity) of a limited partnership or other form of pooled investment, even though they may utilize a qualified custodian, are annually audited, and distribute the annual audited financial statements to its limited partners (or other investors) within 120 days of the end of its fiscal year.

However, we disagree with the Commission's proposal to except the custodian and the adviser from the requirement to send account statements to its investors. The delivery of such account statements vastly increases the level of transparency for investors regarding the total assets of the pooled investment vehicle, at a very minimal cost to the pooled investment vehicle or the advisers. NASAA would support a requirement that all investors in such pools receive a quarterly statement showing the total amount of any additions or withdrawals from the pool and the total value of the pool at the end of the quarter based on the custodian's records of activity. The statement would not have to include individual transactions or portfolio holdings.

Safeguards for advisers using pooled investment vehicles.

NASAA would also like to take this opportunity to encourage the Commission to consider applying the safeguards that the Commission once supported in no-action letters. *See* SEC No Action Letter No. 91-476-CC, Pims Inc., File No. 801-19641; and SEC No

Action Letter No. 89-816-CC, Bennett Management Co., File No. 801-32236. These letters established an "independent representative" as a gatekeeper with regard to distributions of assets and monitoring of activity in pooled investment vehicles, using information from both the custodian and the adviser. The independent representative role was understood by industry and provided a high degree of protection against misappropriation and misuse of investor funds. NASAA has incorporated these elements in its Model Rules, in 102(e)(1)-1 of the 1956 Act Rules and 411(f)-1 of the USA 2002 Rules. Incorporating these elements in the Commission's custody rules would promote uniformity and investor protection at a relatively low cost to the adviser or pool. More importantly, it would provide an element of protection to the investors on a "before the fact" basis not yet included within the Commission's proposals.

Electronic filing of Form ADV-E.

NASAA believes it would be beneficial to file Form ADV-E electronically on the IARD. Further, NASAA believes it is absolutely necessary to ensure that states have access to the information filed on the ADV-E.

Surprise examinations with respect to privately offered securities.

NASAA agrees with the Commission's proposal to subject privately offered securities to the surprise examination requirement. This step will help safeguard investor assets of all types, and promote transparency.

CUSTODIAL INDEPENDENCE

Should all custodians be independent?

The Release raises two alternative solutions to the important challenges raised whenever a "related person" of an adviser has custody of client assets. NASAA strongly endorses a requirement that all custodians holding client assets be independent. This strong and simple approach will increase investor protections without unduly interfering with the prevailing business models that IAs use.

NASAA has followed this approach in the development of its own IA model rules. NASAA adopted most of the provisions of the original custody rule enacted by the Commission, but in 2005, it modified its model rule definition of "custodian." NASAA took the position that the potential problem of advisers having the ability to control both the advisory side and the custody side created too great a danger to investors. We have seen advisers attempt to avoid custodial safeguards by setting up their own ostensibly separate companies to act as custodians while using employees of the adviser to actually administer the custodian. Similarly, related person custodianships are more problematic than an independent qualified custodianship for the participants in pooled investment vehicles. NASAA's model rule addressed this type of conflict in its definition of "custodian" by including the following language: "'Qualified custodian' means the following independent institutions or entities that are not affiliated with the adviser by

any direct or indirect common control and have not had a material business relationship with the adviser in the previous two years."

Requiring all custodians to be independent will not interfere with IA business models. Wrap fee programs have for years used outside, unaffiliated investment advisers to manage assets held in brokerage accounts. The reverse of this—the broker-dealer affiliated investment adviser seeking an unaffiliated custodian—should pose no greater problems. In the final analysis, protecting investors takes precedence over minimizing regulatory costs to advisers.

Requiring internal control reports where advisers or their related persons serve as qualified custodians.

If the Commission decides not to require all custodians to be independent, then it certainly should adopt the alternative safeguards proposed in the Release. Specifically, advisers that serve, or have related persons that serve, as qualified custodians for client assets should be required to obtain or receive an internal control report from an independent public accountant. The absence of an independent custodian increases both the opportunity for an adviser and its employees to misappropriate client funds or securities and the likelihood that any misappropriation will not be detected in a timely manner. Given these inherent risks, NASAA believes that the internal control report requirement is necessary. It will ensure that an independent public accountant performs an assessment of whether the adviser has in place internal controls that are reasonably designed to detect and prevent any misappropriation of client funds/securities and, perhaps more importantly, whether those internal controls are effectively being implemented by the adviser's employees.

Requiring the independent public accountants that prepare internal control reports be registered with the PCAOB.

NASAA also supports the proposal requiring the independent public accountants that prepare internal control reports to be registered with, and subject to regular inspection by, the PCAOB. Auditors that are registered with the PCAOB are subject to annual or triennial inspections conducted by PCAOB staff. The inspections are designed to ensure that PCAOB member accounting firms are complying with the standards and rules established by PCAOB, the Commission, and industry when carrying out their accounting functions. While some state accounting boards require accounting firms to go through peer reviews, those peer reviews are usually conducted by other accounting firms chosen by the reviewed accounting firm and there is no assurance that the standards of review are consistently applied firm to firm. PCAOB inspections provide some assurances that the accounting firms performing the internal control reviews are complying with required standards and rules and conducting quality reviews. Given the heightened risks associated with having a non-independent custodian maintain custody of client assets, NASAA believes that accountants performing internal control reviews of those advisers should be subject to inspections by PCAOB to provide the public with confidence in the quality of the reviews performed by the accounting firms.

NASAA recognizes that requiring the use of PCAOB-registered public accountants may increase the costs of obtaining internal control reports, but we believe that the additional costs will be outweighed by the additional protections afforded to investors, noted above. As a practical matter, moreover, the firms most likely to use non-independent custodians are those larger financial institutions that custody client assets at affiliated companies. Given the resources of those firms, the additional costs associated with the PCAOB-requirement should be easily manageable.

The need for both internal control reports and surprise examinations.

NASAA believes that the requirement for an internal control report and the requirement for a surprise examination are independently valuable, not duplicative. While an audit of a company's internal control system will assess whether a company's internal controls are reasonably designed to prevent and detect misappropriation of client funds/securities, internal controls are not foolproof and can be manipulated by employees acting in collusion. For its part, the surprise examination requirement will serve two purposes. It will act as an additional deterrent for those contemplating overriding their company's internal controls to misappropriate client assets. A person is less likely to misappropriate funds/securities if they are put on notice that those funds/securities can be verified at any moment. Second, a surprise examination may detect the misappropriation and put an early end to what otherwise could be a long and ultimately very damaging pattern of abuse.

ACCOUNT STATEMENTS

Requiring account statements from advisers with custody.

History has shown that clients can develop enormous trust in their advisers and that advisers sometimes take advantage of that trust. Therefore, we strongly support requiring every adviser to ensure that the qualified custodian delivers statements directly to clients at least quarterly. Some problems may persist where the adviser was purchasing assets not held by the custodian (private offerings, annuities, etc.), but many brokerage firms have adapted their systems to include information on many of these types of products. Because of the importance of comparing statements, it would also be beneficial to include a prominent notice with the annual offer of the disclosure document that reminds clients to review the custodian's statement and question any discrepancies between information provided by advisers and custodians.

FORM ADV AMENDMENTS

Disclosures regarding related persons.

NASAA supports each of the Commission's proposed changes for Form ADV, including disclosing the identity of all "related persons." However, based on questions received from state advisers, there is still confusion as to who a related person is, especially when

there is some non-ownership relationship between a broker-dealer and an investment adviser. Questions such as how a broker-dealer imposing supervisory oversight of the business of a third party adviser whose employee is also an agent of the broker-dealer affects the answers on the ADV form. It may be helpful to include in the instructions that a contractual or marketing arrangement with an unaffiliated broker-dealer or other entity does not make that entity a related person. We would recommend the Commission consider clarifying the instructions or providing examples of the types of relationships that might exist between an adviser and some of the more common entities listed on the form ADV—especially broker-dealers—as they apply to not only "related persons" but also "affiliated persons" and "control persons."

CONCLUSION

In summary, NASAA strongly supports the proposed rule amendments, and we appreciate this opportunity to share our views. If you have any questions about this comment letter, or NASAA's position on related issues, please do not hesitate to contact me.

Sincerely,

/s/ Patricia D. Struck
Patricia D. Struck
Administrator, Wisconsin Securities Division, and
Chair, NASAA Investment Adviser Section