SIFMA
Securities Industry and
Financial Markets Association

July 28, 2009

BY EMAIL TO: rule-comments@sec.gov

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

Re: File No. S7-09-09
Proposed amendments to Rule 206(4)-2, Advisers Act custody rule

Dear Ms. Murphy:

The Private Client Legal Committee of the Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on the proposed amendments regarding custody of client funds and securities by investment advisers.[2] We understand that recent scandals[3] involving misappropriation and other misuse of investors' assets have prompted the Commission to consider additional safeguards under the Investment Advisers Act of 1940 ("Advisers Act") when an adviser has custody of client funds or securities. As a general matter, SIFMA supports the Commission's efforts to enhance controls for maintaining custody of client assets and to improve oversight of custodial arrangements. We recommend, however, that several of the proposed amendments to Rule 206(4)-2 (the "Rule") be revised to better balance the costs of the proposed new requirements and the potential benefits they might provide in improving client asset protection. We also suggest several technical amendments to clarify the application of previously-issued Staff guidance on the Rule. Finally, we ask that the Commission's Divisions of Investment Management and Trading & Markets work with each other and the Financial Industry Regulatory Authority ("FINRA") to create a cohesive approach to custodial arrangements involving investment advisers and broker-dealers that reflects, among other things, the controls that the Commission has established for broker-dealers.

---

[1] SIFMA brings together the shared interests of more than 600 securities firms, banks and asset managers locally and globally through offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. More information about SIFMA is available at http://www.sifma.org.

[2] Custody of Funds or Securities of Clients by Investment Advisers, SEC Release No. IA-2876; File No. S7-09-09, available at http://sec.gov/rules/proposed/2009/ia-2876.pdf (the "Rule Proposal").

[3] *See, e.g.*, *SEC v. Bernard L. Madoff, et al.*, SEC Litigation Release No. 20889 (Feb. 9, 2009).

1. Surprise Audits and Internal Control Reports Do Not Provide Additional Protections for Clients of Dually-Registered Firms or Clients in Wrap Programs.

Currently, only registered advisers with custody that send out account statements to clients (rather than having statement sent directly by the qualified custodian), must undergo an annual surprise examination.[4] The Rule Proposal would require *all* registered advisers with custody of client assets to engage an independent public accountant to perform an annual surprise examination of client assets regardless of whether the custody of assets or the sending of account statements is undertaken as a qualified custodian. Dual registrants and advisers whose client assets are maintained with qualified custodians that are related persons of the advisers would also need to use an accounting firm registered with, and subject to inspection by, the Public Company Accounting Oversight Board (a "PCAOB firm") to perform the surprise examination. Further, if the qualified custodian is a related person of the adviser, the adviser must obtain at least annually a written internal control report prepared by a PCAOB firm, in accordance with the PCAOB's standards, that contains the firm's opinion on the controls in place relating to custodial services and tests of operating effectiveness.

Surprise verifications and internal controls reports could be useful methods to detect irregularities at certain advisers. But for advisers that are dually registered as broker-dealers, and for advisers to wrap fee programs for which a broker-dealer maintains custody of assets, SIFMA believes that the cost of a surprise examination and an internal control report greatly outweighs any potential benefits to clients, and that these two additional requirements would duplicate existing safeguards afforded to advisory clients of dual registrants. The Rule Proposal questions whether surprise examinations and internal control reports would provide additional protection for clients of dually registered advisers.[5] For the following reasons, SIFMA suggests they would not.

a. Clients of Dual Registrants and Wrap Programs with Affiliated Broker-Dealer Qualified Custodians are Sufficiently Protected by Existing Requirements.

Most firms that are dually registered as advisers and broker-dealer custodians, or firms offering wrap programs using an adviser sponsor and its affiliated broker-dealer, are subject to extensive regulatory oversight and maintain strict internal controls, such that the risk of misappropriation is minimal.[6] As the Rule Proposal acknowledges, these firms are already required to be audited annually by

[4] Some advisers are affiliated with or serve as broker-dealer sponsors of separately managed account or "wrap fee" programs and also serve as custodian in the program. These sponsors send account statements to clients in their role as a qualified custodian, and do not undergo a surprise verification. For purposes of the Rule, the Commission's Staff has differentiated the roles played by a dual registrant between advice and broker-dealer functions. *See, e.g.,* Staff Responses to Questions About Amended Custody Rule (updated January 10, 2005), available at http://www.sec.gov/divisions/investment/custody_faq.htm.

[5] Rule Proposal at 12.

[6] *See* Appendix A for a description of numerous regulatory protections that currently apply to broker-custodied assets. This list is not intended to be exhaustive, and not all dual registrants are directly subject to all of the regulatory protections in Appendix A, such as firms that clear through another broker-dealer subject to these regulatory protections.

an independent public accountant registered with the PCAOB.[7] This audit is designed to provide reasonable assurance that the broker-dealer's procedures for safeguarding client assets are adequate.

As noted by the Staff in the Rule Proposal, Rule 17a-5 under the Securities Exchange Act of 1934 currently requires that the broker-dealer annual audit include a review of the broker-dealer's procedures for safeguarding client and customer securities, which is also the primary purpose of the internal controls report. In addition, broker-dealers routinely employ internal controls reasonably designed to prevent misappropriation of customer assets, whether by their own employees or by third parties. Indeed, SRO rules require that broker-dealers establish and maintain appropriate procedures for supervision and control with respect to disbursement of customer assets from firm accounts.[8] Rather than require a separate internal controls report covering the same matters, it would be far more efficient and preferable for the Commission to propose amendments to Rule 17a-5 to include aspects of the surprise examination process, such as verifying the existence of funds and securities in advisory client accounts, on a sampled basis. Finally, the empirical evidence suggests that the risk of misappropriation at adequately capitalized, dually-registered firms is fairly remote.[9]

b. The Burdens and Costs of Surprise Examinations and Internal Control Reports are not Justified by Any Additional Protections They May Provide.

The Commission estimates that the average cost to a firm for a surprise examination would be $8,100.[10] SIFMA suggests that this figure significantly underestimates the actual cost of such an examination, particularly if the verifications are required to be undertaken on an account-by-account, asset-by-asset basis.

Based on a survey of 17 member broker-dealers and their accounting firms (including information from several of the top 5 accounting firms), it is projected that the cost to a firm for a surprise examination would be many multiples of the estimated $8,100. The size of the adviser, the number of accounts, the number of custodians used, and the number of holdings coupled with the scope and requirements of the surprise examination requirements will directly impact the cost to firms for the surprise examination.

Specifically, survey respondents reported that their accounting firms have estimated the costs of the surprise examinations as ranging on average between $165,200 and $282,800, with a survey-wide average estimate of $206,294. Notably, five firms (or 29% of the respondents) received estimates from their accounting firms of $500,000 or greater and one firm received an estimate of $1 million for its surprise examination.

---

[7] Rule Proposal at 12.

[8] *See* FINRA Rule 3130 and NYSE Rule 342(a) and (b).

[9] "[I]t is very difficult to steal $1 million from a brokerage firm. The prospect of stealing $10 million from a brokerage firm has only happened 10 times in 39 years. The regulators do a good job, generally speaking, of finding these kinds of actions." Testimony of Stephen Harbeck, President and CEO, SIPC, before the Senate Banking Committee, Hearing on "Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and The Need For Reform" (Jan. 27, 2009).

[10] Rule Proposal at 47.

For example, one SIFMA member that manages privately-offered funds received an estimate of $8,000 -10,000 for a surprise verification of a private fund with only a few investors. But where the same fund has more than a few investors, the estimate rises to $2,500 per investor. Another SIFMA member with 25,000 to 30,000 individual client accounts received an estimate of between $225,000 and $275,000 for the surprise examination, or $750 to $1,100 per account annually.

Adding to the cost of surprise examinations would be the verification of privately issued securities. As these securities are usually recorded only on the books of the issuer, the accountant would have to contact each issuer to confirm the clients' ownership; issuers may or may not promptly cooperate with such requests.

Our members' estimates for the internal controls report are approximately $250,000 (the same estimate the Commission provided), in addition to the significant internal resources needed to assist the preparer of the report. As noted earlier, SIFMA believes that the internal controls report would duplicate much of the content of the Rule 17a-5 audit, and therefore much of this cost could be avoided by simply adding additional procedures to the Rule 17a-5 annual audit.

In light of these survey results, and the lack of additional protections a surprise examination and an internal control report could provide, SIFMA urges the Commission to exclude from these two proposed requirements both dual registrants and advisers to wrap programs where an affiliated broker-dealer has custody of client assets. In the alternative, dual registrants and wrap advisers should be excluded from undergoing surprise verifications; the Rule 17a-5 broker-dealer annual audit (modified to include client asset verification procedures), combined with the internal controls report would provide sufficient protection to clients. If instead the Commission determines to require both the surprise examination and the internal controls report, we ask that advisers be permitted to use the same accountant to perform both tasks, to reduce costs and duplicative efforts.

2. Advisers with Custody Resulting Solely from the Authority to Withdraw Fees Should Be Excepted from Surprise Examinations.

The proposed amendments would extend the requirement to have a surprise examination to those advisers with the authority to cause the qualified custodian to pay its advisory fees directly upon the presentation of a bill (*e.g.*, through account fee debit arrangements) or other debit instructions. The Rule Proposal questions whether advisers that have custody of the client assets solely as a result of this authority should be excepted from the surprise examination requirement.[11]

SIFMA does not believe that advisers with custody limited to this authority have a sufficient degree of custodial control of client assets to merit applying a surprise examination requirement. The surprise examination would not meaningfully increase client protection from the misappropriation or misuse of assets. Further, as the Rule Proposal notes, the qualified custodians who have *actual* custody of these clients' assets are already subjected to appropriate and sufficient internal audit controls.[12]

[11] Rule Proposal at 10.

[12] Rule Proposal at 4.

For these reasons, we believe the Commission should expressly except these advisers from the annual surprise examination requirement provided the advisers deduct their fees in compliance with the procedures outlined in numerous Staff no-action letters: (1) the client provides written authorization permitting the adviser's fees to be paid directly from the client's account held by the qualified custodian; (2) the adviser sends both the qualified 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 qualified custodian agrees to send the client, at least quarterly, a statement indicating all amounts disbursed from the account (which is standard practice, as we note above).[13] Even if advisers were deemed to have custody under these circumstances, these procedures should provide sufficient protection to make a surprise examination unnecessary. The Commission could add to these procedures additional requirements, such as requiring disclosure on statements asking clients to check the amount of the fee against the bill they earlier received.

The Commission proposed, as an alternative to the surprise examination, having the chief compliance officer ("CCO") certify to the Commission that all client assets are properly protected and accounted for. SIFMA does not believe that the CCO should be put in the role of an accountant and forced to perform a verification, which we believe would be the only effective way in which a CCO could provide a certification to the Commission. The CCO's proper role is to confirm that the adviser's compliance procedures regarding custody are reasonably designed and function appropriately. A CCO could, for example, review the adviser's reconciliation procedures, and compare the adviser's and custodian's records to client account statements.

3. The Surprise Examination Procedure should be Updated to Reflect Current Practices Used in Broker-Dealer Audits.

Unlike broker-dealer regulations, which allow for sampling procedures in conducting an examination, the Rule Proposal describes the surprise examination as requiring an independent public accountant to, among other things, "(i) confirm with the custodian *all* cash and securities held by the custodian, including physical examination of securities if applicable" and to "reconcile all such [assets] to the books and records of client accounts maintained by the adviser, and (ii) verify the books and records of client accounts maintained by the adviser by examining the security records and transactions since the last examination and by confirming *with clients* [emphasis added] *all* funds and securities in client accounts." The Commission further referenced a 1966 interpretive release[14] that describes the surprise verification procedure. The release specifies that client assets should be verified by, among other things, "obtaining from clients written confirmation of the funds and securities in the clients' accounts as of the date of the physical examination." The Commission requested comments on whether a surprise examination's "verification" of client assets provides additional protection for clients that are also broker dealers?" As discussed above, SIFMA believes that the current audit requirements applicable to broker-dealers are sufficient to ensure the protection of client assets.

---

[13] *See, e.g.,* Securities America Advisers Inc. (publicly available Apr. 4, 1997); John B. Kennedy (publicly available June 5, 1996); and Investment Counsel Association of America, Inc. (publicly available June 9, 1982).

[14] Investment Advisers Act Release 201 (May 26, 1966).

The Commission also asked whether it "should revise or expands the guidance we have provided regarding the surprise examination." To the extent that the Commission elects to retain the annual surprise examination requirements, SIFMA strongly encourages the staff to review these standards and publish revised guidelines that are tailored to today's environment. SIFMA suggests that the mechanics of the surprise examination be made less burdensome, in two ways. First, unlike broker-dealer regulations, the Rule Proposal, current requirements, and the 1966 release require a one-hundred percent examination, which requires substantial additional time, money and resources to complete. SIFMA acknowledges that a complete count of funds and securities is currently required for surprise examinations. But especially when an adviser is deemed to have custody only as a result of limited authority to debit fees or by virtue of a related person custodian, SIFMA submits that the costs of a one-hundred percent examination for these advisers are not justified by any additional client protections. SIFMA is not aware of any material problems encountered in using sampling techniques in broker-dealer audits and submits that the costs associated with compliance would be disproportionate to any incremental protection to clients. This is especially important for advisers that invest client assets in privately issued securities. As noted above in Section 1.b., an accountant seeking to verify these assets must contact each issuer; if a single issuer is uncooperative or dilatory, the surprise examination may be delayed or even left incomplete.

Second, the Rule Proposal also requires that accountants confirm "with clients all funds and securities in client accounts." SIFMA questions how this requirement would work in practice. If a client fails to respond to confirmation requests, would the examination then be incomplete? SIFMA understands that the Staff recently began contacting clients in adviser exams, asking them to confirm their assets with the Staff. SIFMA is concerned that these contacts with clients have led to unnecessary concern by clients about the safety of their assets, and SIFMA questions the benefit of asking each client to confirm information from their most recent account statements provided by a qualified custodian, when the Staff already has access to those account statements. SIFMA members have reported that it is very difficult for accountants to confirm account balances with every client, which has led to delays in completing examinations. SIFMA believes that accountants should be permitted to contact a sample of clients during surprise verification.

4. The "In Connection With" Requirement is Overbroad, and an Adviser Should be Able to Rebut the Presumption of Custody of Assets "Held by a Related Person.

The Rule Proposal would require advisers or their related persons who maintain custody of client funds and securities "in connection with" advisory services provided by the adviser to its clients to: (1) use a PCAOB member accounting firm to perform the surprise examination, and (2) obtain at least annually a written internal control report prepared by the PCAOB member accounting firm. The Rule Proposal would sweep into the Rule certain advisers that have no actual or constructive custody, including those advisers that only have deemed custody pursuant to the ability to withdraw fees as discussed in Section 2 above. SIFMA asks that the Commission permit advisers to rebut the presumption that they have custody "in connection with" the provision of certain advisory services, or that they have custody of assets in the actual custody of a related person. In particular, the mere fact that a related person has custody of assets as to which the adviser provides nondiscretionary advice alone, should not cause the adviser to be deemed to have custody of such assets.

The "in connection with" language is overbroad and could cause an adviser to be deemed to have custody of assets over which the adviser has no authority or ability to gain access. For example, if a client obtains financial planning services from an adviser that include recommendations as to assets in various accounts held at the adviser's related broker-dealer, the adviser would appear to have custody over these assets under the Rule Proposal. In this case, the adviser may not know the identity of the accounts over which it is providing advice, and the independent public accountant may not be able to provide a meaningful review of those accounts. Similarly, if an adviser provides discretionary or nondiscretionary advice to a plan participant about its 401(k) plan assets held by a related bank or mutual fund transfer agent, the adviser would appear to have custody under the Rule Proposal, but it is unclear how the independent accountant would "verify" the participant's account balance. While the Rule Proposal notes that "[t]he 'in connection with' limitation of the proposed rule is designed to prevent an adviser from being deemed to have custody of client assets held by a related person broker-dealer (or other qualified custodian) with respect to which the adviser does not provide advice," the new language nevertheless will cause advisers to have custody in situations where they have no authority or ability to gain access to those assets, including those advisers that only have deemed custody pursuant to the ability to withdraw fees as discussed in Section 2 above.

SIFMA suggests that the Rule Proposal be modified to contain a rebuttable presumption that an adviser has custody of client assets if any of its related persons have custody of advisory client assets with respect to which the adviser has investment discretionary authority and has access to client funds beyond the ability to instruct the qualified custodian to withdraw fees from a client account. The factors an adviser could consider when determining whether the presumption is rebutted could be based on the factors found in the Staff's no-action letter to Crocker Investment Management Corp.:[15]

(1) Whether clients' property in the custody of the affiliated company might be subject, under any reasonably foreseeable circumstances, to the claims of the adviser's creditors.

(2) Whether advisory personnel have the opportunity to misappropriate clients' property.

(3) Whether advisory personnel ever have custody or possession of or direct or indirect access to clients' property or the power to control the disposition of such property to third parties for the benefit of the adviser or its affiliated persons.

(4) Whether advisory personnel and personnel of the affiliated company who have possession or custody of, or control over, or access to, advisory clients' property are under common supervision.

(5) Whether advisory personnel hold any position with the custodian or share premises with the custodian and, if so, whether they have, either directly or indirectly, access to or control over clients' property.

We note that the *Crocker* factors have provided a useful framework for analyzing imputed custody issues for over thirty years, without raising any investor protection issues of which we are aware. Rather than adopt an approach that jettisons the *Crocker* test and deems an adviser to be irrebuttably presumed to have custody of client assets held by a related person custodian, we suggest that the Commission instead update the *Crocker* test. For example, the term "common supervision" in factor 4 may now be overbroad; in some financial services firms, advisory personnel and custodial personnel at an affiliate may *ultimately* be under common supervision at the holding company level, but not necessarily under common *direct*

[15] Publicly available Apr. 14, 1978.

supervision, where collusion to misappropriate assets might most likely occur. SIFMA suggests that factor 4 be modified to apply to employees under common direct supervision. Also, Crocker factor 5 has presented problems in larger firms where it is common for higher-level employees to have a title with several related entities. Factor 5, like factor 3, contains an "access and control" test, but factor 5 appears to require more scrutiny of advisory personnel who hold positions with the custodian, for no apparent reason. SIFMA suggests that factor 3 is sufficient to detect opportunities to misappropriate client assets, and that factor 5 is duplicative and should be removed.

Under this modified *Crocker* approach, when an adviser can demonstrate that, under these factors (as they may be revised), it has no opportunity to misappropriate client assets, then no client protection purpose would be served by subjecting the adviser to surprise verification and internal control requirements. Further, where the related qualified custodian is a broker-dealer, the Rule 17a-5 audit provides additional protection for advisory client assets.

Finally, SIFMA asks the Commission to clarify that an adviser that has custody only of privately-issued securities need not obtain an internal controls report on its own procedures for safekeeping these assets. As the Commission noted in the 2003 release adopting amendments to the Rule, private securities typically have restrictions on transferability that place them at low risk of misappropriation.[16] An internal controls report on the adviser itself would not appear to provide additional protections for client assets.

5. The Commission Should Not Require Advisers to Use Independent Custodians.

The Rule Proposal asks whether the Commission should require advisers to use an independent qualified custodian, whether this requirement would result in greater costs, and if greater costs are likely, whether the "additional custodial protections" for client assets provided by an independent qualified custodian would warrant the additional costs. SIFMA firmly opposes requiring advisers to use independent qualified custodians, for the following reasons.

First, the Rule Proposal refers to "potentially greater risks to client assets that may be presented when an adviser or its related person acts as custodian for client assets." SIFMA believes that these "potentially greater risks" are simply not present where the related person qualified custodian is a broker-dealer or bank. These two types of custodians hold the vast bulk of client assets (apart from mutual fund shares held by transfer agents), and these custodians are subject to extensive regulation and examination of their custodial practices, as the Commission acknowledges.[17]

Second, the requirement would disrupt millions of wrap fee program accounts, where client assets are typically held with a dual registrant program sponsor or an affiliate of the sponsor, as well as accounts managed by a dual registrant where custody is provided by the dual registrant or an affiliate. The separation of custodial functions from advisory services could result in the temporary or permanent cessation of certain service offerings, such as margin and cash management services.

[16] Investment Advisers Act Release No. 2176 (Sept. 25, 2003) at nn. 26-27.

[17] Rule Proposal at 27-28.

Finally, a migration of this magnitude would take significant time, money and resources to accomplish. There would be costs in moving these accounts to another custodian, with potentially different accounting systems and interfaces. Additional time may be needed to reconcile trade records between the program's executing broker and a third-party custodian. Finally, some SIFMA members report that their affiliated custodians provide custody in wrap programs for no cost, or for below-market fees. The disruption to wrap clients, and potentially higher custody fees, are not justified by any likely increased benefits to clients.

6. The Revised Rule Should Reinstate Current Language that Permits Funds of Funds to Deliver their Audited Financial Statements to Investors within 180 days of their Fiscal Year-End.

Rule 206(4)-2 currently permits advisers to privately-offered funds not to send quarterly account statements to investors so long as the fund at least annually distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all investors within 120 days of the end of its fiscal year or in the case of a fund of funds, within 180 days of the end of its fiscal year. After Advisers Act Rule 203(b)(3)-2 was vacated, the Staff issued a no-action letter to the ABA Subcommittee on Private Investment Entities, confirming that advisers to funds of funds may continue to rely on the 180 day deadline for distributing audited financial statements to investors.[18]

The Rule Proposal, without comment, omits the 180 delivery period. The rationale for giving fund of funds a 180 day deadline to deliver their audited financial statements – the practical difficulties that advisers to funds of funds face in completing the fund of funds' audit prior to receiving the audited financials for the underlying funds – has not changed. SIFMA asks the Commission to reinstate the 180 day period in Rule 206(4)-2(b)(3).

7. The Revised Rule Should Incorporate Prior No-Action Relief for Insurance Company Custodians.

SIFMA respectfully requests that the Commission incorporate, into the proposed amendments, the Staff's no-action position issued to American Skandia Life Assurance Corporation.[19] In that letter, the Staff agreed to treat insurance companies that have custody of advisory clients' funds invested in a variable insurance product in a manner similar to mutual fund transfer agents for custody purposes (*i.e.*, such insurance companies are a permitted substitute for a "qualified custodian"). New section (b)(5) of the Rule would provide: "(5) <u>Interests in variable insurance products</u>. With respect to a variable insurance product, you may use the issuing insurance company or an affiliate of the insurance company in lieu of a qualified custodian for purposes of complying with paragraph (a) of this section."

SIFMA also submits that in the context of variable insurance product asset allocation programs, the internal controls report required of such an insurance company custodian and provided to its affiliated adviser, and the surprise examination of the affiliated adviser, are unnecessary, for several reasons. First, the insurance companies that are the issuers of the underlying variable contracts are subject to extensive

[18] Publicly available Aug. 19, 2006.

[19] Publicly available May 16, 2005.

state regulation. These insurance companies are also audited by independent accounting firms and their audited financials are available for review by regulators.

Second, the underlying variable insurance product is contractual in nature and such contracts are subject to both state regulation and approval as well as federal securities registration requirements. In addition, in variable insurance product asset allocation programs, the contract holders maintain actual possession of the variable contract and the underlying assets are owned by the insurance company.

Third, the NAIC's Annual Financial Reporting Model Regulation (Model Audit Rule), which has been adopted by 23 states (with the remaining states to adopt before year end 2009), requires filing of Management's Report of Internal Control over Financial Reporting with the state insurance commissioner (similar to the report required by Section 404 of the Sarbanes-Oxley Act). The Model Audit Rule provides for a risk-based assessment of the insurer's control environment with a report on all significant and critical internal control elements. The risk-based assessment evaluates control systems and facilitates identification and correction of control weaknesses and the development of new controls. Signatures of the CEO and CFO are required under the Model Audit Rule and all supporting documentation is available to the state insurance department during the course of a financial condition examination. The Model Audit Rule is effective for year-end 2010, with first reports issued in early 2011. Finally, the co-issuers of variable contracts are insurance company separate accounts that are themselves generally unit investment trusts subject to regulation and examination by the Commission and subject to annual audit by independent accountants, including a review of controls surrounding variable insurance product client statements. For all of the above reasons, SIFMA believes it is reasonable and appropriate to treat advisory variable insurance product asset allocation programs differently under the rule and to recognize that the surprise examination requirement applicable to the affiliated adviser and the internal control report applicable to the insurance company would provide little additional investor protection given existing requirements.

8. The Revised Rule Should Incorporate Prior No-Action Relief for Advisers with Inadvertent Custody of Client Assets.

The Rule Proposal defines custody to include "[p]ossession of client funds or securities, (but not of checks drawn by clients and made payable to third parties,) unless you receive them inadvertently and you return them to the sender promptly but in any case within three business days of receiving them. . . ." This definition would effectively overturn a recent Staff no-action position that provides better protection for client assets. SIFMA urges the Commission to revise the definition of custody to conform to the practice described in that no-action letter.

Specifically, in 2007, the Staff provided no-action assurances to advisers that sought to avoid having custody when they received tax refunds, class action settlement checks, and other client assets from non-clients and forwarded those assets to clients or their custodians. If instead advisers returned those assets to the senders, clients likely would experience delays in receiving their assets, and the risk of loss would increase, as the senders would likely not be fiduciaries to clients and would not have procedures to properly safeguard client assets. In its letter to the Investment Advisers Association, the Staff stated that it would not recommend enforcement action under Rule 206(4)-2 if an adviser "promptly forwards client assets that it inadvertently receives from Third Parties in the situations and under the circumstances described above within five business days of the adviser's receipt of such assets, to its client (or former client) or a qualified custodian."[20] While the Rule Proposal does not explain the reason for the implicit withdrawal of the no-action letter, SIFMA submits that client assets will be better protected if advisers who receive client assets from a non-client are permitted to continue to forward them to the client or the client's custodian and not be deemed to have custody in these situations.

* * *

Thank you for giving SIFMA's Private Client Legal Committee the opportunity to comment on the foregoing proposed rule amendments. If you have any questions regarding this comment letter, please contact the Committee's staff advisor, Kevin Carroll, at 202.962.7382 (kcarroll@sifma.org), or outside counsel, Steven Stone, at 202.739.5453 (sstone@morganlewis.com).

Sincerely,

Mark Shelton
Chair, SIFMA Private Client Legal Committee

cc: Andrew J. Donohue, Director, Division of Investment Management, SEC
James Brigagliano, Co-Acting Director, Division of Trading and Markets, SEC
Daniel Gallagher, Co-Acting Director, Division of Trading and Markets, SEC

[20] Publicly available Sept. 20, 2007.

APPENDIX A

<u>Protections for Broker Custodied Assets</u>

Protection	Details
1. *Brokers Must Control Customer Securities They Hold (*Possession or Control of Customer Securities: Exchange Act Rule 15c3-3(b); FINRA Rule 2330; IM-2330; NYSE Rule 402)	▪ Brokers -must promptly obtain and maintain physical control of all customer “fully paid” and “excess margin securities” in a “satisfactory control location” ▪ Satisfactory control locations include securities depositories (such as the Depository Trust Company) and banks. ▪ Brokers must identify and segregate - by customer - both fully paid and excess margin securities. ▪ Determinations are required daily
2. *Brokers Must Reconcile Securities Held Quarterly* (Quarterly Securities Counts: Exchange Act Rule 17a-13)	▪ Brokers must perform a quarterly “box count” of customer securities – that is, physically examine and count all securities and compare the results of the count with the broker’s records, to verify there are no discrepancies.
3. *Brokers Cannot Borrow or Pledge Customer Securities unless the Customer Owes it Money* (Hypothecation: Exchange Act Rules 8c-1 and 15c2-1; NYSE Rule 402))	▪ Brokers may not pledge customer securities in an amount exceeding the customer's indebtedness or commingle the securities with securities of the broker or other customers. ▪ Even where permitted, brokers must notify a customer in writing before pledging customer securities as collateral for repayment of indebtedness. ▪ Brokers also may not borrow customer fully paid securities without a written agreement and providing collateral to the customer.
4. *Brokers Must Set Aside Money Owed to Customers* (Protection of Customer Cash--Special Reserve Bank Accounts: Exchange Act Rule 15c3-3(e))	▪ Brokers must segregate net amount of monies owed to customers. ▪ Brokers must deposit cash or qualified liquid securities - in accordance with an enumerated reserve formula --in a separate “Special Reserve Bank Account” for the benefit of customers ▪ The account must be free of liens and separate from any other account of the Broker ▪ Determinations and deposit required weekly
5. *Brokers Must Send Customers Quarterly Account Statements Detailing Transactions and Securities Held* (Customer Account Statements: Exchange Act Rule 15c3-2; NASD Rule 2340; NYSE Rule 409; CBOE Rule 9.12)	▪ Brokers must send customers quarterly account statements ▪ Statements must show amount of money and value of securities held for the customer as of the period end date ▪ Monthly statements required if certain transactions are made in any month (e.g., options, commodities and certain money transfers)
6. *Brokers Must Send Financial Reports to Customers* (Broker Financial Statements: Exchange Act Rule 17a-5(d)-(e); NASD Rule 2270; NYSE Rule 418))	▪ Brokers give customers copies of their financial reports annually. ▪ The report must contain (1) a balance sheet prepared in accordance with GAAP; (2) a statement of the broker’s net capital under SEC rules; (3) a statement that an annual audited report is available if the report notes any material inadequacies; and (4) a statement that the Statement of Financial Condition of the most recent annual audit report is available at the broker’s principal.
7. *Brokers Must Hire PCAOB Accountants to Conduct Audits and File Financial Statements with the SEC* (Annual Audits by Independent Certified Public Accountants: Exchange Act Rule 17a-5(f))	▪ Brokers must be audited annually by an independent public accountant registered with the PCAOB [*Requirement for PCAOB membership effective 2009*] ▪ Brokers must file audited financial statements with the SEC ▪ Brokers must also file annually a statement indicating an agreement with an independent public accountant to conduct the broker’s annual audit during the following calendar year.
8. *Brokers are Required to Supervise their Business and Personnel* ((NASD Rule 3010(c)(2)(A); NYSE Rule 342.26; NYSE Rule 401(b))	▪ Brokers must maintain policies and procedures for safeguarding of customer funds and securities, including appropriate procedures for supervision and control for disbursement of customer assets from customer accounts. ▪ Brokers must inspect office locations on a regular cycle.

	▪ Included in inspections is testing and verification of the broker's policies and procedures for safeguarding customer funds and securities.
9. *SIPC Coverage Protects Against Misappropriated or Missing Funds and Securities* (Securities Investor Protection Act of 1970)	▪ Brokers must join SIPC unless their business is limited to (1) distributing mutual funds, (2) selling variable annuities, (3) insurance, or (4) rendering investment advice to mutual funds or insurance company separate accounts. ▪ SIPC protects customers of failed brokers. ▪ Customers of a failed broker get back all securities (such as stocks and bonds) registered in their name or are in the process of being transferred to their name. The failed broker's remaining customer assets are then divided on a pro rata basis with funds shared in proportion to the size of claims. If sufficient funds are not available to satisfy customer claims (such as for missing cash or securities), SIPC may advance funds to supplement the distribution to customers, up to a maximum of $500,000 per customer, including a maximum of $100,000 for cash claims.
10. *Brokers are Required to Deliver Trade-by-Trade Confirmations* (Exchange Act Rule 10b-10)	▪ Brokers must deliver a confirmation in writing to the customer at or before the completion of each transaction that contains certain specified information. ▪ The confirmations must detail information pertaining to the trade such as information regarding the quantity, price, time, whether the broker-dealer acted as agent or principal and the amount of remuneration received from the customer in connection with the trade.
11. *Website Access*	▪ Although not required by any specific rule, many brokers (particularly brokers that permit online trading) routinely post information regarding completed trade and account statements on their website enabling clients to have immediate password-protected access to information regarding any activity transpiring in their accounts. ▪ Customer web access has been included as a condition of Rule 10b-10 exemptive orders issued by the SEC.