INVESTMENT ADVISER ASSOCIATION

March 6, 2009

VIA ELECTRONIC MAIL

The Honorable Mary L. Schapiro
Chairman
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Self-Custody of Advisory Client Funds

Dear Chairman Schapiro:

On behalf of the Investment Adviser Association,[1] we are writing to highlight issues relating to self-custody of client funds that have been raised in relation to the Madoff case. As you know, the IAA submitted a written statement to the House Committee on Financial Services at the January 5, 2009 hearing, entitled "Assessing the Madoff Ponzi and the Need for Regulatory Reform." In our statement, we suggested, among other things, that the SEC consider the circumstances under which dually registered broker-dealers like Madoff should be permitted to self-custody client funds managed on a discretionary basis. At a subsequent House Committee on Financial Services hearing to assess the Madoff scheme, joint testimony submitted by SEC officials cited "the need to strengthen the custody and audit requirements for regulated firms."[2]

Given the current interest in these issues, we are following up with more specific recommendations with respect to self-custody.

Background. Under Investment Advisers Act Rule 206(4)-2, SEC-registered investment advisers are deemed to have "custody" of client assets if they hold client funds or securities "directly or indirectly" or if they have any authority to obtain possession of client funds or

[1] The Investment Adviser Association (IAA) is a not-for-profit association that represents the interests of SEC-registered investment adviser firms. The Association's membership consists of investment advisory firms that manage assets for a wide variety of institutional and individual clients, including pension plans, trusts, investment companies, endowments, foundations, and corporations. For more information, please visit our web site: www.investmentadviser.org.

[2] *See* Testimony Concerning Investor Protection and Securities Fraud by a number of SEC officials before the U.S. House of Representatives Committee on Financial Services and Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises (Feb. 4, 2009).

1050 17th Street N.W. · Suite 725 · Washington, DC 20036-5503 · (202) 293-4222 ph · (202) 293-4223 fx · www.investmentadviser.org

securities.[3] Under the rule, investment advisers are not permitted to have custody of client funds or securities unless: (1) a qualified custodian maintains those funds and securities; ***and*** (2) the adviser has a reasonable basis to believe that the qualified custodian sends account statements at least quarterly to each client, or, if the adviser sends the quarterly statements, an independent public accountant verifies all of those funds and securities in a surprise examination at least annually. Thus, while advisers are deemed to have "custody" of client assets under a variety of circumstances, at all times a "qualified custodian" must actually hold the funds and securities.

Qualified custodians include the types of financial institutions (***e.g.***, banks, savings associations, registered broker-dealers, registered futures commission merchants, and certain foreign financial institutions) that customarily provide custodial services and are regulated and examined by their regulators with respect to those services. The rule also permits use of a transfer agent for mutual fund shares in lieu of a qualified custodian. Qualified custodians that are dually registered as investment advisers are permitted to maintain custody of the same client funds for which they provide discretionary investment management services. Thus, under current rules, as a dual registrant, Madoff was permitted to serve as a qualified custodian for its own advisory client funds. Most investment adviser firms, however, employ independent third-party custodians to maintain their advisory client assets.[4]

Many clients choose the qualified custodian that will hold their funds and securities and maintain the primary relationship with that firm for all of their accounts. If an investment adviser selects the qualified custodian on behalf of a client, the custody rule requires the adviser to provide specific information to that client regarding the custodian and how the funds or securities are maintained. Accordingly, all clients have basic information about the custodian maintaining their assets - either from their adviser pursuant to the custody rule or from their own independent relationship with the custodian.

Recommendations. The custody rule is designed to provide significant investor protections against the risk of misappropriation. The Madoff case, however, has focused attention on the lack of independent oversight where a firm acts as both investment manager and qualified custodian with respect to the same assets. There are a number of measures the SEC could consider implementing that may assist in preventing or detecting fraud where no independent custodian safeguards client assets or provides quarterly statements to clients:[5]

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[3] The rule explains that "custody" includes: (i) possession of client funds or securities, (ii) any arrangement in which an adviser is authorized or permitted to withdraw client funds or securities (for example, where the adviser is authorized to deduct advisory fees from a client's account), and (iii) any capacity that gives the adviser legal ownership of or access to client funds or securities (for example, an advisory firm is deemed to have "custody" of client funds and securities if one of its employees serves as a trustee to a client trust – even where the trust assets are held at a bank).

[4] As of April 2008, 644 investment advisory firms (only 5.8% of SEC-registered advisers) report dual registration as a broker-dealer and 44 firms (.4%) report that they are either a bank or a separately identifiable department or division of a bank. *See* *Evolution/Revolution: A Profile of the Investment Adviser Profession (2008)*,

[5] Obviously, there are no ironclad safeguards that would prevent all Ponzi schemes. The SEC and the investment adviser community should, however, continue to examine methods to make such schemes both more

1. **Internal Controls.** The SEC could consider permitting "self-custody"[6] only where firms segregate custodial duties from advisory functions and/or implement additional internal controls to protect clients. Segregation of duties makes it extremely difficult for any one person to perpetrate and hide a fraud. These controls could be modeled on the types of controls firms institute under banking regulations governing arms-length affiliate transactions and other activities.[7]

2. **Third-Party Involvement.** The SEC could consider permitting self-custody only where there is some independent third-party involvement that provides external evidence of a review of the firm's internal controls to safeguard client assets. There are a number of approaches that could serve this goal of adding an independence safeguard to the process. The Commission should permit investment advisers to use any one of these approaches so that firms can leverage their existing reviews and correlate their approach to their specific business model. Depending on the size of the firm and the nature of its business, the third-party involvement could include one of the following types of approaches:
    a. an independent auditor conducts a special purpose or focused audit to verify client assets and sends its report directly to clients and the SEC in addition to the adviser (similar to the current surprise audit option); or
    b. an independent party conducts an audit of internal and/or operational controls (***e.g.***, a SAS 70 review); or
    c. an independent party conducts a compliance control audit (***e.g.***, pursuant to Rule 206(4)-7).

3. **Enhanced Disclosure.** As noted above, the definition of "custody" is very broad and includes situations where an adviser is constructively deemed to have custody even though an independent qualified custodian (bank or broker-dealer) actually holds the client assets. Form ADV asks questions about "custody" generally, but does not currently elicit specific information about firms that themselves act as the qualified custodian for advisory client assets (***i.e.*** self-custody). The SEC could amend Form ADV, Part 1, Item

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difficult to carry out and more readily susceptible to detection. The custody rule is only one aspect of such methods.

[6] For purposes of this letter, we use the term "self-custody" to refer to situations where a firm in its role as registered investment adviser provides investment advice with respect to client assets and the same firm in its role as broker-dealer or bank serves as the qualified custodian for those advisory client assets. While we recognize that under certain circumstances, the SEC staff has deemed an investment adviser to have custody over client assets by virtue of its affiliate serving as the qualified custodian for those assets (***e.g.***, *Crocker Investment Management Corp.* no-action letter, Apr. 14, 1978), the nuances of those arrangements are outside the scope of this letter. We would be pleased to work with Commission staff to provide information about various types of affiliate relationships that may be relevant to custody rule issues.

[7] *See, e.g.*, *Internal Controls: A Guide for Directors*, Office of the Comptroller of the Currency (Sept. 2000) at p.7 ("Banks establish segregation of duties by assigning different people the responsibilities for authorizing transactions, recording transactions, and maintaining custody of assets. Such segregation is intended to make it impossible for any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of his or her duties"). *See also* *Risk Management Principles for Electronic Banking*, Basel Committee on Banking Supervision, at 15 (Principle 6).

9 to ask more specific custody questions designed to identify such firms. For example, the SEC could add one of the following as new question D:

> If you answered "yes" to either Item 9.A(1) or 9.A(2), do you serve as a "*qualified custodian*"[8] for any of your *client* assets? Or
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> If you answered "yes" to either Item 9.A(1) or 9.A(2), are you a broker-dealer registered under Section 15 of the Securities Exchange Act of 1934 that holds your advisory *client* funds or securities in any brokerage account(s) at your firm?

Similarly, the SEC could add a new subpart to current question C to elicit more specific information about affiliates:[9]

> If you answered "yes" to either Item 9.B(1) or 9.B(2):
>
> (1) is that *related person* a broker-dealer registered under Section 15 of the Securities Exchange Act of 1934?
> (2) does that *related person* serve as a "*qualified custodian*" for any of your *client* assets?

Alternatively, the SEC could amend the instruction to Item 9 to state: "If you are registering or registered with the SEC and you do not have *custody* of your *clients*' funds or securities pursuant to 206(4)-2(c)(1)(i), you may answer "no" to Item 9.A(1) and 9.A(2)."

In addition, the SEC has pending proposed amendments to Form ADV, Part 2, the plain English brochure that provides clients with key information about an adviser's business practices. The currently proposed amendments would require advisers to explain that clients will receive account statements from their custodians and should review them carefully. Under the proposal, if clients are to receive statements from their adviser rather than the custodian, more specific disclosure will be required, including "the risks that clients will face" as a result.

We recommend that the SEC update its proposed amendments to Form ADV, Part 2 (proposed Item 15) to require firms to include specified information about advisory assets maintained by dual registrants or an affiliate,[10] including information about the firm's controls reasonably designed to mitigate any risks involved in self-custody arrangements. The SEC could also require disclosure designed to elicit whether self-custody arrangements are an integral or substantial aspect of the firm's business model and use this information to better focus inspection staff attention in these areas. We would be pleased to work with Commission staff on specific instruction language for proposed Item

[8] "Qualified custodian" would be defined in the glossary pursuant to Rule 206(4)-2(c)(3).

[9] *See* n.6, *supra.*

[10] *See id.*

15. We also take this opportunity to again urge the Commission to move expeditiously to adopt amendments to Form ADV, Part 2 in light of the compelling investor protection benefits the new plain English brochure would achieve.

The type of information elicited by these new questions in Form ADV would permit the SEC staff more easily to identify and focus on firms that self-custody client assets and to conduct appropriate inquiries, inspections, and other activities based on that information. Similarly, this information, accompanied by investor education efforts, could provide more transparency to clients and prospective clients about firms that self-custody. This transparency would also serve an information-sharing function with other governmental regulators and FINRA to better focus their examinations.

4. **Examinations.** The SEC has authority to examine both investment advisers and broker-dealers. With respect to dual registrants that self-custody discretionary client assets, the SEC could consider conducting examinations of the entire firm on a regular basis. One combined team of broker-dealer and investment adviser inspection staff would be able to examine the firm in a coordinated fashion.

5. **Broker-Dealer Rules.** The SEC may also wish to consider evaluating whether changes to the broker-dealer custody rules could address the potential for fraud in self-custody situations (***e.g.,*** assessing the sufficiency of current net capital rules, customer safeguard rules, fidelity bonding amounts, and the content of FOCUS reports).

6. **Unregistered Advisers.** Currently, the custody rule applies only to advisers "registered or required to be registered." Therefore, the rule does not apply to unregistered hedge fund advisers. The IAA continues to support registration and regulation of hedge fund advisers by the SEC.[11]

We hope that these recommendations are of some assistance as you consider potential changes to the custody rule to prevent and detect fraud. Please do not hesitate to contact us if we may provide any additional information or assistance. We look forward to working with you on these important issues.

Sincerely,

Karen L. Barr

Karen L. Barr
General Counsel

[11] *See, e.g.,* Statement of IAA Principles and Recommendations for Regulatory Reform (Jan. 2, 2009); ***Letter*** *to Jonathan G. Katz, Secretary, SEC from IAA (then ICAA) Executive Director David Tittsworth and Associate General Counsel Caroline Schaefer re: Regulation under the Advisers Act of Certain Hedge Fund Advisers,* Rel. No. IA-2266 (Sept. 14, 2004).

cc: The Honorable Kathleen L. Casey, Commissioner
The Honorable Elisse B. Walter, Commissioner
The Honorable Luis A. Aguilar, Commissioner
The Honorable Troy A. Paredes, Commissioner

Andrew J. Donohue, Director, Division of Investment Management
Erik R. Sirri, Director, Division of Trading and Markets