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July 28, 2009

VIA ELECTRONIC MAIL

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

RE: Proposed Custody Rule;
File No. S7-09-09, Release No. IA-2876

Dear Ms. Murphy:

Mallon P.C.[1] welcomes the opportunity to comment on the Securities and Exchange Commission's ("Commission") proposed rule under the Investment Advisers Act of 1940 (the "Act") with regard to enhancing the protections afforded to client assets when an adviser has custody of client funds or securities. We understand the Commission proposed these compliance initiatives in response to a number of recent actions against investment advisers alleging fraudulent conduct, including misappropriation or other misuse of investor assets (i.e. the Madoff scandal). However, due to the various undue impositions the proposed legislation would place on certain investment advisers, we are compelled to provide our thoughts on these proposals.

I. Overview of Proposed Rule

The proposed amendments to Rule 206(4)-2 of the Act require that all registered advisers having custody of client assets must have a reasonable belief that a qualified custodian sends quarterly account statements directly to the advisory clients and undergo an annual surprise examination. The Commission additionally proposes that if the adviser or a related person serves as a qualified custodian for the client, then the adviser must obtain from the related person an annual internal control report which would include (i) an opinion from an independent public accountant registered with the Public Company Accounting Oversight Board (PCAOB), and (ii) a description of the relevant controls in place relating to custodial services and the objectives of these controls, as well as the accountant's tests of operating effectiveness and the test results. Lastly, the newly amended rule would require the adviser and the accountant to inform the

[1] Mallon P.C. is a San Francisco based law office serving the investment management industry. The office provides legal advice and support to startup and established hedge fund managers, as well as registered investment advisers.

Commission within one business day of finding any material discrepancies during an examination that may assist in protecting client assets. Together, these revisions to Rule 206(4)-2 are designed to strengthen the controls relating to the advisers' custody of client assets and deter advisers from fraudulent activity.

II. Unfair Burden on Small and Mid-Sized Investment Advisers

The proposed changes to the Commission rules would essentially require investment advisers to pay for expensive surprise audits and would impose an undue regulatory burden on smaller firms that may not be able to sustain such heavy costs of compliance. Most registered investment advisers trade assets that are held in client accounts at third party brokerage firms. Due to an issue of semantics (i.e. how the law defines the term 'custody'), any investment adviser who deducts service fees directly from client accounts is deemed to have 'custody' over those accounts, even if these accounts are actually held at large, nationally recognized brokerage firms such as Schwab, Fidelity, TD Ameritrade, etc. Because all activity for such accounts are generally automatically tracked by the brokerage firm's back office and sent to the client as part of a monthly statement, we do not find that the Commission proposal would add any regulatory value when oversight of the assets is already being conducted and reported to the client by a third party.

Furthermore, for small and mid-sized investment adviser firms, the burden of engaging an independent public accountant to conduct a surprise audit examination would cost as much as ten percent of the firm's gross income, with relatively little gain in investor protection. For these firms, the cost of compliance would be onerous enough, in some cases, to require these advisers to either cease conducting business or pass on the cost of compliance to their clients in the form of higher advisory fees. We believe that the overall protective public benefit offered by this proposal is not enough to warrant the greater costs to the investment community as a whole.

III. Proposed Alternatives to the Proposed Rule

While we support the Commission's efforts to protect the public and monitor investor assets, we believe there are alternative measures that can be adopted to decrease the burden on those registered advisers who are only deemed to have custody over client assets because they are granted fee withdrawal authority. We strongly believe that the Commission should consider other potential alternatives to the proposed rule, such as the four-prong compliance recommendation originally set forth by TD Ameritrade (letter to Commission dated July 24, 2009). For those advisers who do not have 'true' custody of client assets, the alternative approaches (like TD Ameritrade's) would offer the greatest amount of client protection while imposing a lesser amount of overall burden on smaller investment advisers. For those advisers who do have full custody (i.e. the Madoff case), we recommend that the Commission require such advisers to obtain independent audits of their accounts and mail quarterly statements directly to the clients for added accountability and transparency. To ensure that the Commission's compliance efforts are properly targeted, we believe that the Commission should eliminate the ‘fee deduction authority test’ as a basis for establishing adviser custody and instead adopt a more realistic definition of ‘custody’ that embraces the differences outlined in this letter.

If you have any questions regarding these comments, please contact Bart Mallon at 415-296-8510.

Sincerely,

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