CENTER FOR CAPITAL MARKETS COMPETITIVENESS

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The Honorable Mary L. Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street NW
Washington, DC 20549

RE: Application of Adviser Act Rule 206(4)-2 "Custody of Funds or Securities of Clients by Investment Advisers" to certain private equity firms

Dear Chairman Schapiro:

The U.S. Chamber of Commerce is the world's largest business federation, representing more than 3 million businesses and organizations of every size, sector, and region. The Chamber created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy. To achieve this objective it is an important priority for CCMC to ensure that reasonable safeguards are in place to protect investors. Accordingly, we welcome this opportunity to comment on the application of the Securities and Exchange Commission's ("SEC") rules on Custody of Funds or Securities of Clients by Investment Advisers ("Custody Rule")[1] to private equity funds, many of which will become subject to the requirements of the Custody Rule for the first time on March 30, 2012.

Background

In December 2009, the SEC approved amendments to the Custody Rule. The purpose of the rule is to "apply additional safeguards where the safeguards are needed most — that is, where the risk of fraud is heightened by the degree of control the

[1] §17 CFR 275.206(4)-2

adviser has over the client's assets."[2] The rule was finalized prior to passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). Title IV of Dodd-Frank requires many private equity fund managers who were not previously registered to file their registration forms and be subject to the same registration requirements, regulatory oversight and other requirements that apply to other SEC-registered investment advisers, by March 30, 2012. Accordingly, many private equity firms will be required for the first time to achieve compliance with a number of provisions applicable to registered investment advisers, including the Custody Rules.

The typical private equity fund is organized as a limited partnership in which the private equity firm serves as the general partner and investment manager. Private equity funds make the majority of their investments in the equity securities of private operating companies, normally referred to as the portfolio companies. Private equity funds employ a "buy-and-build" investment strategy that maximizes potential for portfolio companies while creating wealth for sellers, partners and intermediaries. Typically, private equity funds are pooled investment vehicles that invest in and own private companies, whose securities are non-negotiable.

The CCMC believes that a vibrant free enterprise system needs a wide variety of investment and sources of capital in order for the capital markets to operate efficiently. To highlight this issue the Chamber, last year, issued a report: ***Sources of Capital and Economic Growth: Interconnected and Diverse Markets Driving U.S. Competiveness.***[3] Private equity plays an important role in this capital formation process. However, as will be described in greater detail below, we continue

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[2] Remarks by Chairman Mary L. Schapiro, SEC Open Meeting held June 22, 2009. Available at: http://sec.gov/news/press/2009/2009-269.htm

[3] Available at: http://www.centerforcapitalmarkets.com/resources/publications/

to be concerned that the traditional SEC model of public company regulation can run at odds with the private equity business model.

Application of Adviser Act Rule 206(4)-2 to Certain Private Equity Firms

While we agree with the SEC's intent in promulgating rules to safeguard investors' assets from misuse, we believe it is unnecessary to require that private equity funds be required to maintain clients' securities with a qualified custodian when the securities being held are non-negotiable and are subject to an annual audit in compliance with U.S. Generally Accepted Auditing Standards (GAAS) set by the Auditing Standards Board of the American Institute of Certified Public Accountants. Therefore, we believe it is appropriate for the SEC to issue guidance providing that advisers to private equity funds, which invest in and hold non-negotiable securities of private companies, may comply with the provisions of the Custody Rule by maintaining such securities in a secure third party location, such as a vault of a law firm or a safe deposit box, rather than with a qualified custodian. This coupled with the fact that U.S. GAAS requires auditors to verify the existence of the physical securities, would ensure that the securities are in a safe place but would avoid the unnecessary expense of engaging a qualified custodian, which can cost as much as $100,000 per year.

Retaining a qualified custodian is an added expense that will provide little if any additional protection to investors of firms that invest in and hold non-negotiable securities of private companies and which are audited in accordance with U.S. GAAS. Foreign firms that invest in U.S. companies will not bear this cost, thus disadvantaging U.S. based-firms. Moreover, the costs of compliance with this requirement will be disproportionately borne by smaller U.S.-based private equity firms, which are a significant source of job-creating capital for small and early stage businesses.

The guidance we are seeking is consistent with the purpose of the Custody Rule, by providing investors in private equity firms that invest in and hold non-negotiable securities of private companies with assurances that their investments do in fact exist and are not misused.[4] Because the assets of private equity firms are non-negotiable, there is little risk of misappropriation that is not mitigated by an annual audit according to U.S. GAAS. Moreover, we note that the treatment sought here is similar, in substance, to the Custody Rule's exception for firms that hold "Certain privately offered securities," which are not required to engage a qualified custodian.[5] This exception applies if uncertificated securities are acquired from the issuer in a non-public offering, the firm is audited, and audited financial statements are provided to investors. Like uncertificated securities of private companies eligible for this exception, the risk of misuse of non-negotiable securities held in a vault of a law firm or a safe deposit box and subject to audit is minimal. Therefore, the requirement to maintain such securities with a qualified custodian are unnecessary, especially in light of the significant costs associated with engaging a qualified custodian.

Conclusion

Extension of the requirement to maintain clients' securities with a qualified custodian to many private equity firms would impose significant costs that are disproportionate to the minimal benefits, if any, in terms of investor protection. Accordingly, we are proposing that the SEC issue guidance providing that firms that invest in and hold non-negotiable securities of private companies, and which are audited according to U.S. GAAS, are not required to engage as a qualified custodian.

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[4] *See e.g.* http://sec.gov/news/press/2009/2009-269.htm

[5] §17 CFR 275.206(4)-2(b)(2)

Thank you in advance for your consideration. We would be happy to meet with your staff to discuss our concerns in greater detail.

Sincerely,

Tom Quaadman

cc: The Honorable Elisse B. Walter, Commissioner
The Honorable Luis A. Aguilar, Commissioner
The Honorable Troy A. Paredes, Commissioner
The Honorable Daniel Gallagher, Commissioner