F T A M
FIFTH THIRD ASSET MANAGEMENT

July 28, 2009

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

Re: Response to Release No. IA-2876; File No. S7-09-09

Fifth Third Asset Management, Inc. (hereinafter "FTAM") appreciates the opportunity to comment on the Securities and Exchange Commission's (hereinafter "Commission") proposed amendments to Rule 206(4)-2 of the Investment Advisers Act of 1940, Form ADV and Form ADV-E (collectively, hereinafter "Proposed Rule").

We agree with the Commission that amendments to Rule 206(4)-2 of the Investment Adviser's Act of 1940 are needed in order to "decrease the likelihood that client assets are misused, or … increase the likelihood that fraudulent activities are discovered earlier and client losses are thereby reduced." To that end, while the Commission's draft proposal contains many elements designed to accomplish this goal, some of the suggested amendments are excessive, inefficient, and not cost-effective.[1]

In the discussion that follows, we provide comments and perspective relating to the Commission's Proposed Rule as well as recommended alternatives that more effectively and efficiently accomplish the Commission's stated objectives. We respectfully request that the Commission consider these comments, as we believe that they set forth a more reasonable approach for increased safety of client assets while also providing advisers with flexible and cost-effective alternatives in achieving this goal.

I. The Proposed Definition Of Custody Is Too Broad

Generally, we agree with the Commission's proposed definition of custody that includes those circumstances where an adviser maintains legal ownership of, holds, possesses, or has the authority to hold or possess client funds or securities. Based on recent events, we understand the real risks involved when advisory and custodial responsibilities are not properly segregated, especially among related entities. However, the Commission's proposed definition of custody is overbroad and in many situations, unnecessarily imposes onerous and costly requirements upon advisers who already maintain effective controls.

[1] We believe that many advisers maintain effective controls to prevent fraud and the misuse of client assets. The Proposed Rule fails to consider these controls and, as a result, adds extraneous and costly requirements.

We believe that limited client risk exists where the management and internal controls of the adviser and the custodian are clearly segregated and the custodian is subject to extensive federal regulation.[2] Risk remains limited even where the adviser and custodian are related entities when the custodian has controls in place (physical and electronic) to prevent the adviser from accessing client assets. Risk is further reduced when a related qualified custodian regularly obtains a Type II SAS 70 Report. Moreover, if enacted as written, the Proposed Rule is punitive in situations where an advisory client has the exclusive power to select the custodian and chooses a related qualified custodian (*i.e.*, the adviser does not require or recommend use of a related qualified custodian). Under the Proposed Rule, because the definition of custody is nearly limitless, advisers who have a related qualified custodian are deemed to have custody without regard to (1) the corporate structure of the custodian (*e.g.*, whether the adviser and custodian are subsidiaries of a Financial Holding Company)[3] or (2) scenarios where the adviser and custodian maintain separate management and internal controls. To our knowledge, the Commission has not brought an enforcement action against an adviser, where a related qualified custodian (*e.g.*, a Financial Holding Company whose internal controls and management are separate from those of the adviser) misappropriated client assets or engaged in a Ponzi scheme.[4] Instead of enacting such a far-reaching definition, the Commission should focus on those situations that present the highest risk to clients (*i.e.,* where the management and controls of the adviser are not segregated from the custodian).

The scenario illustrated above is merely one example of the breadth of the Commission's proposed definition of custody. Another example of how the suggested definition is overly broad is the proposed inclusion of those advisers that automatically debit client management fees. Such an extension is unnecessary. To our knowledge, there have been no enforcement actions, nor has the Commission cited any such cases, that involve situations where fraud occurred solely due to the automatic debiting of client management fees.

We believe that the definition of custody should include those situations where (1) an adviser has legal ownership of, holds, possesses, or has the authority to hold or possess, client funds or securities; (2) where an adviser participates in the selection of the custodian; or (3) where the adviser and related custodian do not maintain separate internal controls and management. Conversely, the definition of custody should <u>not</u> include (1) scenarios where the client retains the exclusive power to select the custodian (*i.e.*, the adviser does not participate in the selection process) and selects a related qualified custodian;[5] or (2) where a related person (*e.g.*, a trustee),

[2] For example, Financial Holding Companies are subject to routine oversight and are regulated by several federal agencies, including, but not limited to, the Federal Reserve; the Federal Deposit Insurance Corporation; and the Office of the Comptroller of the Currency.
[3] A "financial holding company" as that term is contemplated in the Gramm-Leach-Bliley Act of 1999 (citing the definition provided in section 2 of the Bank Holding Company Act of 1956). Financial holding companies are subject to oversight by the Federal Reserve Board and are subject to other federal regulation.
[4] Additionally, the Proposed Rule contains no citations to cases of this nature.
[5] As an adviser with a related qualified custodian, FTAM has policies and procedures in place that prohibit participation in the selection of any custodian, including its related custodian.

with discretionary authority, selects the adviser to act in a sub-advisory capacity. In these scenarios, under the Proposed Rule, the adviser is subject to the Proposed Rule's requirements without exhibiting any intent to obtain custody of client assets. As a result, such an extension is unreasonable.

For the reasons set forth above, we ask the Commission to reconsider its proposed definition of custody. We believe that the suggested changes extend the definition of custody to those entities that pose the highest risk to client assets while also limiting the requirements of the Proposed Rule for advisers that maintain adequate controls, and thus, present minimal risk.

II. Surprise Examinations

A. Independent Verification Should Not Be Limited To Surprise Examinations Where The Affiliated Custodian Is Subject To Extensive Federal Oversight And Obtains An Internal Control Report

We agree that independent verification of client assets decreases the likelihood that assets are misused and increases the likelihood that fraudulent activities are discovered earlier, thereby reducing client losses. We also agree with the Commission's basic premise that advisers deemed to have custody should obtain independent verification of client funds and securities. However, a surprise examination should <u>not</u> be the only method of independent verification in situations where (1) a related qualified custodian maintains effective controls regarding safekeeping of client assets; or (2) where an adviser obtains a financial audit that includes independent verification of client assets. As discussed below, we believe that other forms of independent verification exist that are as effective as a surprise examination.

As some commentators have already suggested, in those situations where an investment adviser acts both as the client's adviser and its custodian, it is reasonable to require an annual surprise examination. However, in some situations, the surprise exam is both unnecessary and not cost-effective.[6] For example, the Commission acknowledges that some qualified custodians (*e.g.*, banks) are subject to extensive oversight and regulation. The Commission further acknowledges that surprise examinations may be unnecessary where the custodian is a bank.[7] Similarly, we believe that a surprise examination is unnecessary where the adviser is deemed to have custody solely based on the fact that a qualified custodian is a "related person" when (1) such custodian is subject to extensive oversight and regulation; (2) maintains internal controls and management separate and apart from the adviser; and (3) obtains a Type II SAS 70 that specifically addresses controls for safekeeping client assets (including physical examination of securities and reconciliation of cash and securities). The additional regulation and oversight of banks constitutes independent verification and provides the "extra set of eyes" that the Commission seeks. To require a surprise exam in such a situation is redundant, adds little to the Commission's goal of

[6] A surprise examination is merely one of many ways to achieve independent verification.
[7] *See* p. 12 of the Proposed Rule.

reducing misappropriation of client assets, and does not provide enough additional assurance to justify the additional cost. Independent verification need not be redundant and should allow the adviser to adopt a verification approach that is both cost effective and adequately addresses client risks.

B. Independent Verification May Be Obtained From Qualified, Independent Parties, Not Just PCAOB-Registered Accountants

Regardless of the manner in which the independent verification is achieved, we recommend that the Commission not limit the independent verification process to accountants registered with the Public Company Accounting Oversight Board ("PCAOB"). There are several qualified compliance-consulting firms, many with former Staff members, that possess the competency and resources to adequately perform the annual independent verification. We recommend that the Commission adopt standards that require (1) an adviser with custody of client assets to undergo an annual independent verification of client assets; (2) that the party performing the independent verification be completely independent of the adviser and its related persons; and (3) that the adviser make certain disclosures as discussed in section III.B.2. below.

C. The Independent Verifier Should Be Permitted To Sample Client Accounts

When the independent verification of client assets requirement applies, the accountant or person performing the independent verification should be able to "test" or "sample" client accounts, positions and/or transactions consistent with standard audit principles. We feel it is excessive and unnecessarily burdensome for the person performing the independent verification to (i) confirm *all* cash and securities and reconcile all such cash and securities to the books and records of client accounts maintained by the adviser and to (ii) verify the books and records of clients maintained by the adviser by examining the security records and transactions since the last examination and by confirming with clients *all* funds and securities in client accounts.[8] We recommend that the Commission permit the party performing the independent verification to apply standard auditing principles in its sample selection-methods and size.

We also believe that the independent verification should be limited to verification of client cash and securities positions. To require a valuation audit only adds complexity and cost to the verification. Therefore, we strongly recommend that the Commission not include valuation within the scope of the independent verification as valuation is outside of the Proposed Rule's stated objective of decreasing the likelihood that client assets are misused, or increasing the likelihood that fraudulent activities are discovered earlier.

[8] *See* fn. 8 of Proposed Rule.

D. The Commission Should Reevaluate Its Cost Estimates For Independent Verification

We ask the Commission to reevaluate the cost of independent verification in light of several factors discussed below. In the Proposed Rule, the Commission estimates that the aggregate cost for a surprise examination for eleven advisers, with respect to 100% of their clients, averages $8,000. We believe that this estimate is too low. We anticipate that the accountants, or other qualified persons performing verification of client securities under the Proposed Rule, will be subject to increased scrutiny by the Commission and the investing public. Additionally, given that the Commission believes that the Proposed Rule, if enacted as written, subjects a significant majority of all investment advisers to the independent verification requirement, the principles of supply (many advisers) and demand (few accountants) are likely to increase the cost. Furthermore, as acknowledged by the Commission, internal control reports (*e.g.*, Type II SAS 70) and other audit engagements similar in nature to a surprise examination are very expensive, often exceeding $100,000.[9] Based on these factors, we believe that the costs associated with an annual independent verification will drastically exceed the Commission's estimate, perhaps by as much as ten to twenty times.

Based on the foregoing, we recommend that the Commission reevaluate the anticipated costs of independent verification and amend the Proposed Rule to (1) permit other independent and qualified persons (*e.g.*, compliance consultants) to perform the independent verification and (2) allow the persons performing the independent verification to employ appropriate audit sampling principles. Although these recommendations are likely to reduce the cost of the independent verification, it is anticipated that said costs will significantly exceed the Commission's cost estimates.

III. Other Requirements, Considerations and Recommendations

A. The Commission Should Reevaluate The Proposed Filing Requirements

We recommend that the Commission revisit its proposed filing requirements related to independent verification. Specifically, we recommend that filings related to the independent verification process be limited to instances where the person performing the independent verification identifies fraud or a material deficiency. With limited examination staff and resources, and the Commission's estimate that more than 11,000 advisers will be subject to the Proposed Rule, there is no doubt that the Staff will be overwhelmed with routine filings, resulting in an inefficient use of Commission resources. Instead of this approach, we recommend that the Commission develop specific risk indicators and limit required reporting to situations with elevated risks, allowing for more efficient and effective use of examination and enforcement Staff resources. Finally, because the protection of client assets is the Commission's central objective, it should require advisers to immediately notify affected clients when the verification process reveals fraud or material deficiencies.

[9] *See* p. 48 of the Proposed Rule; *see also* fn. 106.

Additionally, instead of the proposed four day filing requirement for a change to or termination of persons performing the independent verification, we recommend that the Commission require advisers to immediately update Form ADV, Part I and Schedule D to reflect the change in persons performing the independent verification and to make reasonable efforts to notify the clients affected by the change within thirty days of such change.

B. The Commission Should Reevaluate The Proposed Disclosure Requirements

1. Form ADV, Part I Disclosures

We recommend that the Commission revisit the proposed disclosure requirements. Specifically, as it relates to Part I of Form ADV Item 9 and Schedule D, we believe an adviser should:

(a) disclose whether it or its related person serves as a qualified custodian with respect to the adviser's client's funds or securities;
(b) identify the names of related persons that serve as qualified custodian for adviser client funds or securities;
(c) disclose the total assets and number of accounts for which the adviser or a related person has custody with respect to the adviser's client's funds or securities;
(d) disclose the type of annual verification performed;
(e) identify the party engaged to perform the annual verification of client assets;
(e) disclose the date of the most recent annual verification;
(f) indicate whether the annual verification report was qualified or unqualified; and
(g) provide a statement of qualifications and independence of the party performing the annual verification.

2. Form ADV, Part II Disclosures

We recommend that the Commission modify Item 7 and Schedule F of Form ADV, Part II to require advisers to disclose basic information regarding its custody arrangements. Specifically, we recommend that Form ADV, Part II disclosures include:

(a) a description of the adviser's or any related persons' custody of client funds or securities, including a brief description of the qualified custodian's services and qualifications;
(b) a description of the nature of the independent verification of client assets where the adviser has custody of client assets;
(c) the name of the person performing the surprise examination along with her qualifications and a statement of independence; and
(d) a description of any material deficiencies noted in the most recent annual verification.

We believe that the aforementioned disclosures will allow clients to make educated decisions regarding the custody of their assets.

C. Requiring An Internal Control Report Is Not Necessary Where Independent Verification Is Required.

Based upon our recommendations for independent verification set forth above, we believe that the requirement to obtain an internal control report is redundant and unnecessarily burdensome. As previously recommended, we believe that an adviser with custody of client assets should be subject to an annual independent verification requirement. However, where both the adviser and custodian are subsidiaries of a Financial Holding Company, additional independent review is unnecessary when the client chooses the related qualified custodian and the custodian maintains internal controls and oversight that are separate from the adviser. Under these circumstances, we believe Rule 206(4)-7 of the Advisers Act already requires the adviser (1) to evaluate its conflicts of interest and risks, (2) to adopt and implement written policies and procedures reasonably designed to prevent violations, and (3) to review, at least annually, the adequacy of its policies and procedures. We recommend that the Commission reconsider its proposal that requires advisers to obtain a separate annual internal control report.

Alternatively, if the Commission requires advisers to obtain an internal control report, we request clarification regarding those situations where, when selected by the client, a related person acting independently and separately as a qualified custodian (1) does not obtain an independent control report; or (2) the report is not prepared by a qualified auditor; or (3) the internal control report does not specifically address all of the circumstances contemplated in the Proposed Rule; or (4) the internal control report reveals material control weaknesses. As currently proposed, in those situations where the client retains sole authority to select the custodian, the advisor has no recourse from any of the scenarios set forth above. We ask the Commission for guidance in these areas.

To the extent that the Commission elects to subject advisers with custody of client assets to the independent verification and internal control report requirements, we recommend that the Commission permit the same party to perform both reviews and to prepare any required reports. Finally, with respect to the internal control report, if required, we request that the Commission more specifically define the control objectives that are subject to the internal control report or that the adviser is reasonably expected to review.

D. Requirement That An Adviser Have A Reasonable Belief That The Qualified Custodian Provides Clients With Quarterly Account Statements

In light of the independent verification requirement, we believe that the additional requirement that advisers have a reasonable basis for believing that qualified custodians send clients quarterly account statements does not help the Commission achieve its stated goal to decrease the likelihood of misappropriation of client assets. Therefore, we ask the Commission to reconsider this unnecessary requirement. Alternatively, we recommend that the Commission exempt advisers from these requirements when an institutional or qualified investor selects its custodian and the adviser has policies and procedures in place that prohibit participation in the selection of the custodian.

If the Commission elects to adopt the requirement that advisers have a reasonable basis for believing that the qualified custodian sends client account statements at least quarterly, we recommend that the Rule specifically address instances where the client, especially institutional clients, selects the custodian without any participation from the adviser. In these situations, the adviser has little, if any recourse, if the qualified custodian fails to send quarterly statements. Therefore, we ask the Commission to detail the actions to be undertaken by an adviser once it determines, through reasonable efforts and due inquiry, that a qualified custodian does not provide the client with timely or accurate account statements.

Finally, we ask the Commission to amend the Proposed Rule to prescribe specific standards regarding "due inquiry." While the Commission provided a few examples of what it considers due inquiry, we believe that the Rule should provide advisers with specific standards.[10] If the Commission declines to provide specific standards, we believe that the "due inquiry" requirement should be stricken from the Rule.

E. Books And Records Requirements

We recommend that the Commission eliminate the proposed internal control report books and records requirement. We believe that if the records created are material to mitigating conflicts or risks, Rule 206(4)-7 sufficiently addresses general compliance and related record keeping requirements.

F. Unanswered Questions

Although the Proposed Rule covers a wide range of situations, we believe that the Proposed Rule fails to address several important topics. We request that the Commission specifically respond to the following concerns:

1. The Proposed Rule is silent regarding those situations where the client selects (without the adviser's participation) a custodian that does not fall within the definition of "qualified custodian," as defined by the Proposed Rule. How does the Proposed Rule apply when the client selects a related or independent custodian that does not meet the definition of "qualified custodian"

[10] *See* fn. 61 of Proposed Rule.

2. The Proposed Rule broadly defines custody and mandates several requirements when the adviser has custody of client assets. It is unclear, however, how the Proposed Rule applies when an adviser has temporary custody of client assets through its inadvertent actions (*i.e.*, such as when the adviser mistakenly fails to return client assets within three business days of receipt). Can the adviser address and resolve these circumstances under its Rule 206(4)-7 policies and procedures? Or does the adviser become subject to the full breadth of the Proposed Rule? In the scenario illustrated above, we believe that compliance with the Proposed Rule is costly and unnecessarily burdensome given the circumstances. We request that the Commission provide specific guidance on how advisers should treat circumstances where it has inadvertent and temporary custody of client assets.

3. We anticipate that clients, prospects, consultants, sponsors, or members of the general public will request copies of the annual verification reports. We believe accountants consider these reports to be confidential and will not allow distribution to clients. We also recognize the objective of the Proposed Rule is to protect client assets so we expect clients will be interested in the content of these reports. Should advisers provide copies of the reports to its clients? How should it treat prospective clients? Can an adviser disclose in its Form ADV whether it received a qualified or unqualified report? Can the adviser represent "no material deficiencies" if that is accurate? What are the adviser's reporting responsibilities if material weaknesses are identified? We believe advisers may find it challenging to provide representations regarding its annual verification reports. We request that the Commission provide guidance on how advisers should handle client requests related to its annual verification reports.

IV. Conclusion

We agree with the Commission that additional safeguards are needed to protect client assets. However, we believe that the Commission can accomplish this objective without subjecting more than 11,000 advisers to a rule that includes an annual surprise exam and other costly requirements. For those advisers that have adequate controls in place, the requirements of the Proposed Rule are redundant, costly, and do little to mitigate the risks the Commissions seeks to address.

If you have any questions or concerns, please do not hesitate to contact FTAM's Chief Compliance Officer, James Mautino, at (513) 534-7452.

Respectfully submitted,

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