

Securities Exchange Commission  
July 28, 2009

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*Via Electronic Mail*

Elizabeth M. Murphy, Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549-1090

**Re: Proposed Rule: Custody of Funds or Securities of Clients by Investment Advisers  
[Release No. IA-2876; File No. S7-09-09]**

Dear Ms. Murphy:

The American Institute of Certified Public Accountants (“AICPA”) has prepared the attached comments on the proposed amendments to the Custody Rule under the Investment Advisers Act of 1940 and related forms, as published in the Federal Register on May 27, 2009.

The AICPA is the national professional association of CPAs with more than 350,000 members, including CPAs in business and industry, public practice, government, and education; student affiliates; and international associates. Our members provide audit, tax, retirement consulting, plan administration, and financial planning services, and many of our members work for a firm that is registered as, or affiliated with, a registered investment adviser. It is from this diverse perspective that we provide our comments and recommendations.

Overall, we support the Commission’s proposed Custody Rule as a means to strengthen investor protections in the U.S. securities markets. As objective experts and trusted advisers, CPAs play a critical role in improving the current system and providing policymakers with the benefit of our experience. Our attached comments identify specific recommendations which we believe best serve the interests of the investing public, focusing on identified risks while leveraging upon existing resources to minimize overlap and reduce cost to the industry and the public.

While each of our comments was based upon detailed analyses, our observations regarding the internal controls report suggest that a more in-depth analysis by the Commission be performed to determine the most appropriate report format and authoritative guidance for this particular requirement. We therefore suggest that the SEC consider convening a Task Force comprised of

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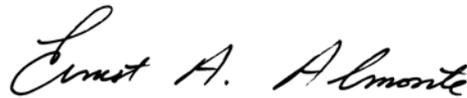
industry participants and qualified custodians for this purpose. AICPA would welcome the opportunity to participate on this Task Force.

We appreciate the opportunity to comment and welcome the opportunity to serve as a resource to the SEC on these issues. If we can be of further assistance, please contact Barry Melancon at (212) 596-6001.

Sincerely,



Barry C. Melancon, CPA  
AICPA President & CEO



Ernest A. Almonte, CPA  
Chairman, AICPA Board of Directors

cc:

SEC

Chairman Mary Schapiro  
Commissioner Luis A. Aguilar  
Commissioner Kathleen L. Casey  
Commissioner Troy A. Paredes  
Commissioner Elise B. Walter

PCAOB

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Charles D. Niemeier, Member  
Martin Bauman, Chief Auditor

# AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

## Comments on proposed amendments to the custody rule under the Investment Advisers Act of 1940 and related forms July 28, 2009

### **I. Background of Custody Rule – Current and Proposed**

The custodial activities of federally-registered investment advisers are regulated by Rule 206(4)-2 (the “Custody Rule”) of the Investment Advisers Act of 1940 (“Advisers Act”). The Custody Rule, among other things, requires registered investment advisers to maintain client<sup>1</sup> funds and securities with a “qualified custodian”<sup>2</sup> in either 1) a separate account for each client under that client’s name or 2) in accounts that contain only client funds and securities and under the adviser’s name as agent or trustee for the clients.<sup>3</sup> With limited exceptions, investment advisers are prohibited from having physical custody of client assets under the Custody Rule. Under the SEC’s proposal, the requirement to maintain client assets with a “qualified custodian” remains unchanged, as well as what constitutes a “qualified custodian.”

Another component of the current Custody Rule is a requirement that advisers have a reasonable belief that the qualified custodian provides account statements directly to clients at least quarterly. (An adviser may also send account statements directly in addition to the qualified custodian, but is not obligated to do so). Advisers to pooled investment vehicles (“PIVs”) are exempt from an account statement delivery requirement so long as the PIV is audited at least annually and distributes audited financial statements to investors within a stated period. If an adviser’s clients do not receive account statements directly from their qualified custodian(s) and that adviser has custody, the adviser must deliver, no less frequently than quarterly, account statements to clients and undergo an annual surprise examination to verify client assets. The SEC estimates that 204 advisers currently are required to undergo a surprise examination and deliver quarterly account statements directly to the client.<sup>4</sup>

Under the SEC’s proposal, the definition of “custody”<sup>5</sup> remains largely unchanged, though an important addition is that custody by “related persons”<sup>6</sup> is now attributed to the adviser. Also under the proposal, the Custody Rule would be amended to require all investment advisers with custody of client assets, including advisers to PIVs, to undergo an annual surprise examination by an independent public accountant to verify client funds and securities, regardless of whether a

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<sup>1</sup> As used throughout this letter, “client” refers to the client of the adviser.

<sup>2</sup> Advisers Act Rule 206(4)-2(c)(3) and proposed Rule 206(4)-2(c)(5) define “qualified custodian” as generally including 1) a bank or savings association; 2) broker-dealer registered under §15(b)(1) of Securities Exchange Act of 1934; 3) futures commission merchant registered under §4(f)(a) of the Commodity Exchange Act; 4) a foreign financial institution.

<sup>3</sup> Advisers Act Rule 206(4)-2(a)(1) [and proposed Rule 206(4)-2(a)(1)].

<sup>4</sup> Federal Register p. 25363.

<sup>5</sup> “Custody” is defined in Advisers Act Rule 206(4)-2(c)(1) [and proposed Rule 206(4)-2(c)(2)].

<sup>6</sup> Proposed Rule 206(4)-2(c)(6) defines “related person” as “any person, directly or indirectly, controlling or controlled by you, and any person that is under common control with you. “Control” is defined in (c)(1) of proposed rule.

qualified custodian provides statements directly to clients or, in the case of a PIV, whether the pool is audited at least annually and distributes its audited statements to investors. The SEC estimates that the proposed surprise examination requirement would apply to approximately 9,575 of the 11,272 investment advisers registered with the SEC as of February 2009, or 85% of SEC-registered advisers.<sup>7</sup>

For those advisers who do not utilize an independent custodian to maintain client assets but instead, act as a “qualified custodian” (whether directly or through a related person/entity in connection with adviser-provided advisory services), the annual surprise examination must be performed by an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (“PCAOB”). The SEC estimates that this requirement would impact 372 of the 9,575 advisers.<sup>8</sup> In addition to the surprise examination requirement, proposed rule 206(4)-2 requires all of these 372 advisers to obtain, or receive from the related person, a written internal control report (“internal control report”) prepared by an independent public accountant (“accountant”) registered with, and subject to regular inspection by, the PCAOB.<sup>9</sup> The internal control report must be obtained at least once per calendar year, issued in accordance with PCAOB-standards and contain the accountant’s opinion “with respect to the description of controls placed in operation relating to custodial services, including the safeguarding of funds and securities held by either you (adviser) or a related person on behalf of your advisory clients and tests of operating effectiveness.”

The following are our detailed comments on the proposal.

## **II. Annual Surprise Examination Requirement for Advisers with “Custody”**

### **A. Surprise examination scope**

In the 2003 Adopting Release of the current Custody Rule, the SEC acknowledged that when a surprise examination of the adviser was required, the “accountant must perform the examination in accordance with U.S. Generally Accepted Auditing or Attest Standards and the standards applied by the Commission, except that the accountant must verify *all* or substantiate all client funds and securities covered by the examination.”<sup>10</sup> This applies to all client cash and securities over which the adviser has custody, irrespective of whether they were held by qualified custodians or not. Guidance referred to in the Release is Accounting Series Release (ASR) 103, issued in 1966 and currently codified as Financial Reporting Release (FRR) 404.01.b. As ASR 103 states, the independent public accountant “should make a physical examination of securities and obtain confirmation as appropriate; should obtain confirmation of funds on deposit in banks, and should reconcile the physical count and confirmation to the (adviser’s) books and records”.

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<sup>7</sup> Federal Register p. 25363, footnote 77.

<sup>8</sup> Federal Register p. 25364, footnotes 80 & 81.

<sup>9</sup> Proposed Rule 206(4)-2(6).

<sup>10</sup> [2003 Adopting Release](#), note 33. See also Federal Register p. 25355, footnote 8.

Also required is direct confirmation of positions with all advisory clients having open accounts, and tests of transactions recorded to client accounts (on a sampling basis) from the last surprise examination date. We presume that these same guidelines would apply under the proposed rule.

Whereas the scope of the surprise examination is the same under the proposed rule, the universe of advisers subject to this requirement expands from several hundred to several thousand, even if, as recommended below, the SEC excludes advisers deemed to have “custody” solely through the ability to deduct fees. For a variety of reasons, we suggest that the SEC consider modernizing examination methodology, scope and applicable standards to increase efficiency and reduce the cost of the surprise examination. To that end, we offer the following comments and suggestions:

- Consider concept of testing for investment positions. The 100% verification requirement appears to be a form of forensic testing, which is substantially greater in scope than that performed for a typical attest examination. Normally, such a level of testing is called for only when “red flags” or other risk factors are identified suggesting a heightened risk of fraud or misappropriation. While applying such an approach automatically to surprise examinations may have been acceptable when only a small fraction of investment advisers were involved, we question the potential application of such a detailed scope to literally thousands of registered investment advisers. While any instances of adviser fraud are unacceptable, we are not aware of any responsible suggestion that large numbers of investment advisers are engaged in fraud or misappropriation. Moreover, due to the high degree of automation now prevalent in most custody operations, along with the substantial reduction of the use of physical certificates, surprise examinations now involve physical counting of positions much less frequently and much more often involve testing of computer systems, including automated reconciliations and the disposition of exceptions. Automated controls do not necessarily require 100% testing to gain assurance, as they are programmed to operate the same way every time. Sampling is a commonly-used and accepted technique in the auditing profession and is appropriate in the current securities operations landscape. While we recognize that a role may continue to exist for 100% testing of certificated security positions, we believe existing Commission guidance on the performance of surprise examinations<sup>11</sup> should be updated to permit auditors to use appropriate tests of systems and procedures, including sampling, to at least evaluate custodial positions held in book-entry form, with a mandated expansion of examination scope to 100% testing if “material discrepancies” or material weaknesses in certain basic internal controls- are identified – i.e., the “red flags” suggesting that a forensic approach would be most appropriate.
- Consider concept of utilizing sampling and limiting the scope of confirmations with investors. We also do not believe that the long-standing approach of confirming 100% of open client accounts is effective, as response rates historically have been low. Further, in many cases the clients are not confirming what they know to be in their accounts, but

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<sup>11</sup> Financial Reporting Release (FRR) 404.01 b., also known as Accounting Series Release (ASR) 103).

instead what their advisers or custodians have informed them represent the holdings in their accounts. This suggests that these confirmations inherently provide only limited additional assurance, particularly over investment activity, which by definition is executed by the adviser without the client's involvement. We believe that some combination of limiting the scope of confirmations with clients to non-trading disbursements from client accounts (which are more likely to have had direct client involvement) and allowing client accounts to be confirmed on a sample basis would improve efficiency without diluting the effectiveness of confirmations.

- Exclude valuation of securities from scope of surprise examination. The SEC asks whether, as part of the surprise examination, the accountant should be required to perform testing on the valuation of securities, including privately offered securities. We strongly believe that this should not be introduced into the surprise examination's scope. This is because the primary objective of the surprise examination is to verify the existence of assets under the custody of the adviser. Introducing valuation of these assets into the scope of the surprise examination changes the nature of what is intended to be an existence engagement into a specialized engagement requiring valuation expertise. Additionally, depending on the marketability of the investments being valued, the use of valuation models may become necessary, resulting in significant additional costs to the adviser.

## **B. Surprise Examination Guidance/Standards**

Currently, both the AICPA and PCAOB are engaged in projects<sup>12</sup> to update their auditing confirmation standards to, among other things, acknowledge the now widespread use of electronic confirmations, access to websites of confirming parties, and use of third-party confirmation services. As discussed above, we believe there are substantial opportunities to be gained by revising guidance to allow sampling and/or systems testing. We suggest that the SEC, as part of our above suggestion that examination methodology and scope for surprise examinations be revised, consider these projects and the fact that the reference in ASR 103 to "written" confirmation of client may soon be outdated in comparison to professional standards.

## **C. Scope of investment advisers subject to requirement**

### **1. Focus applicability of the surprise examination requirement on investment advisers who have custody beyond an ability to deduct advisory fees**

As noted, the SEC estimates that 9,575 advisers have custody of client assets, either directly or through related persons. According to the SEC, this number represents the total of: (1) advisers

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<sup>12</sup> Projects to update AU 330, PCAOB release dated April 14, 2009 [located here](#). Details on AICPA's Exposure Draft [located here](#).

who answered “yes” to Item 9A or B of Part 1A, Form ADV<sup>13</sup> and (2) advisers with discretionary authority over client accounts, which the SEC understands “predominantly reflects arrangements with clients to withdraw fees from client accounts.”<sup>14</sup> Data contained later in the proposal (for purposes of estimating how many advisers might open custody accounts for their clients, thereby indicating a level of custody that is greater than simply deducting advisory fees) indicates that 3,617 advisers answered “yes” to Item 9A or B of Part 1A of Form ADV.<sup>15</sup> Collectively, this data indicates that there are 5,958 advisers (9,575 – 3,617) – approximately 60% of the advisers proposed to be newly covered by surprise securities count requirements – that the SEC believes to have “custody” solely as a result of their authority to deduct advisory fees from client accounts.<sup>16</sup>

While the proposal identifies a number of recent SEC enforcement actions alleging misuse of client funds by registered investment advisers<sup>17</sup>, none appear to include instances where such misuse was facilitated by the ability to deduct fees from client accounts. However, under the Commission’s cost-benefit analysis computations, these advisers would incur approximately \$77.26 million in additional costs for surprise examinations.<sup>18</sup> Almost 50% of federally-registered advisers – 4,791 of 11,030 as of April 2008 – manage less than \$100 million in assets under management and 1,071 advisers manage less than \$25 million.<sup>19</sup> The cost of an annual surprise audit would represent a noticeable cost for these advisers with little demonstrable benefit.<sup>20</sup> We do not suggest that this category of advisers be summarily excluded, but we also believe, because such practices appear to have had a more limited history of misuse and may disproportionately represent smaller businesses, that they should not be subject to the same requirements as advisers with greater levels of access to client assets.

Accordingly, we suggest that the SEC provide advisers with clarification specific to advisory contracts related to what is and is not custody. In SEC staff responses to questions about the custody rule when it was last amended, Item III.3 addressed a scenario in which the advisory contract required the custodian to calculate the fee. Under these circumstances, the custodian was viewed as acting as agent for the client, and hence the adviser did not have custody.<sup>21</sup> Guidance and suggestions to advisers such as this would be very helpful and would appropriately focus resources on those advisers presenting the greatest degree of risk.

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<sup>13</sup> See page 12 of [Form ADV, Part 1A](#).

<sup>14</sup> Federal Register p. 25363, footnote 77.

<sup>15</sup> Ibid, p. 25365, footnote 99.

<sup>16</sup> Item 9A & B of Part 1A, Form ADV reads: “In this Item, we ask you whether you or a *related person* has *custody* of *client* assets. If you are registering or registered with the SEC and you deduct your advisory fees directly from your *clients’* accounts but you do not otherwise have *custody* of your *clients’* funds or securities, you may answer “no” to Item 9A.(1) and 9A.(2).

<sup>17</sup> Federal Register p. 25355, footnote 11.

<sup>18</sup> Ibid, p. 25370, footnote 160.

<sup>19</sup> [Evolution/Revolution](#) report, p. 3 & footnote 4 on p. 22.

<sup>20</sup> Assumption is that adviser’s revenues are likely to be 1% of assets under management (AUM) or less.

<sup>21</sup> “Staff Responses to Questions About Amended Custody Rule,” pps. 3-5.

**2. Consider ways to exclude specific advisers with custody provided an independent review mechanism at the qualified custodians exists to verify and reconcile debits from advisory accounts with the advisory agreement**

We are aware that some custodians have varying types of mechanisms in place which enable them to monitor deductions to client accounts. Does an opportunity exist whereby the custodian could verify actual deductions from the advisory account, referring to the advisory account agreement, such that the custodian is acting as an agent for the client and hence the adviser is not deemed to have custody? We suggest that this option be explored as a way of focusing the surprise examination requirement on those advisers that present the greatest degree of risk.

**III. Internal Control Report**

As noted in Section I, the Commission proposes that certain advisers who maintain custody directly or through an affiliate be subject to an internal control examination over the custody function in addition to an annual surprise count. While the SEC does not mandate a specific type of report, it indicates that a “Type II SAS 70 Report” conducted in accordance with AU 324 of PCAOB interim standards would satisfy this requirement.<sup>22</sup> Proposed amended Rule 204-2 would require that the internal control report be maintained by the investment adviser in its books and records and be made available to the SEC or SEC staff upon request.<sup>23</sup>

The SEC’s rationale for adding this particular requirement to the Custody Rule is that advisers who maintain client assets themselves or with a related person/entity present a higher risk to advisory clients of fraudulent activity as a result of this relationship. Indeed, several of the recent enforcement actions cited by the SEC in the proposal involve allegations of misappropriation of client assets where advisers or related persons maintained client assets.<sup>24</sup> While all of these advisers are subject to a surprise examination requirement under the proposal, the close relationship between the adviser and custodian creates a greater risk that custodial reports could be compromised and hence the utility of the surprise exam could be limited. The added internal control report requirement, the SEC reasons, would serve to “inform” the surprise examination process and could possibly “act as a deterrent to advisers that may otherwise consider misappropriating client assets directly or through a related person in the guise of providing custodial services as a qualified custodian.” The SEC estimates that the proposal’s requirement to obtain an annual internal control report would apply to a total of 372 advisers.<sup>25</sup>

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<sup>22</sup> Federal Register, p. 25359, footnote 42.

<sup>23</sup> Proposed Rule 204-2(a)(17)(iii).

<sup>24</sup> Federal Register, p. 25359.

<sup>25</sup> Federal Register, p. 25370 and p. 25364, footnote 80.

### **A. Investment advisers subject to internal control report requirement**

The AICPA supports the SEC proposal's requirement obligating all advisers who are acting, either directly through a related person, as a qualified custodian over client assets to obtain an annual report on the design and operating effectiveness of a qualified custodian's controls relating to custody of client assets. We agree with the SEC that advisers not utilizing an independent custodian present a higher risk to advisory client assets and recent enforcement actions highlight this fact. In connection with this proposal, we suggest that the SEC:

- Undertake a comprehensive analysis of the 372 advisers that would be subject to this requirement and assess ways that existing internal control-related examinations can be incorporated into the internal control report requirement under the proposal, consistent with SEC objectives;
- Consider, in this analysis, the following suggestions (below) with respect to the Type II SAS 70 report and authoritative standard(s).

#### **1. Integrate existing reporting on internal controls for qualified custodians**

The Custody Rule (current and proposed) defines "qualified custodian" to include banks or savings associations, registered broker-dealers, futures commission merchants and foreign financial institutions.<sup>26</sup> As noted in the proposal, there are 372 advisers with custody that are also broker-dealers, banks or futures commission merchants, or have a related person acting as a qualified custodian for advisory clients' funds or securities.<sup>27</sup> Of these 372 advisers, 139 have direct custody (i.e., adviser is also registered as a broker-dealer, futures commission merchant or bank) and 233 have custody through a related person (i.e., related person is a registered broker-dealer, futures commission merchant or bank).<sup>28</sup> Most, if not all, of these entities are already required to obtain various reports pertinent to the custodian's internal controls. These include:

- **Broker-Dealers.** Regardless of whether a broker-dealer is an "issuer"<sup>29</sup> or "non-issuer," all 5,308 (as of July 1, 2009)<sup>30</sup> are subject to regulation and oversight by the SEC and one or more self-regulatory organizations ("SROs") and are subject to various requirements relevant to the safekeeping of client assets. These include Exchange Act Rule 17-a-5,<sup>31</sup> which requires an assessment by an independent public accountant of the broker-dealer's accounting system, control procedures and procedures for safeguarding securities, as well as Rule 17-a-13, which requires the broker-dealer to perform quarterly reconciliations of its overall positions at a clearing agency to the broker-dealer records. Effective for fiscal

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<sup>26</sup> See footnote 1 of this comment letter.

<sup>27</sup> Federal Register, p. 25364.

<sup>28</sup> Federal Register, p. 25364, footnote 80.

<sup>29</sup> "Issuer" is defined in [Exchange Act Section 3\(8\)](#).

<sup>30</sup> Obtained from SEC website in "FOIA" section.

<sup>31</sup> See SEC [Rule 17a-5\(g\)](#)

years ending after December 31, 2008, all independent public accountants of broker-dealers, even broker dealers who are otherwise not “issuers”, must be registered with the PCAOB.

- **“Issuers”:** Under the Sarbanes-Oxley Act of 2002 (“Act”), all “issuers” are required to file an attestation report of their independent auditors on internal control over financial reporting under Section 404(b) of the Act. The applicable PCAOB standard for conducting a 404(b) audit (also known as an “integrated audit”) is AS5.<sup>32</sup> Currently, the effective date for compliance by “non-accelerated filers” is for fiscal years ending on or after December 15, 2009,<sup>33</sup> whereas “accelerated filers” and “large accelerated filers” are currently required to obtain integrated audit reports. While the proposal does not note how many of the 372 qualified custodians are “issuer” broker-dealers, we presume that the SEC could obtain this data from Form ADV<sup>34</sup>. Additionally, the PCAOB currently has a mechanism in place to inspect integrated audit reports during its inspection of PCAOB-registered firms.
- **Futures commission merchants (“FCM”).** In general, a FCM is an individual or firm, registered with CFTC, who solicits or accepts orders for trading in commodity futures and options on futures.<sup>35</sup> The only instance in which 1) an FCM will not also be registered as a general-purpose broker dealer (and hence not obtaining the reports described above), and 2) an investment adviser, is if the FCM only conducts business in securities futures, which are regulated as both futures and securities. This is because such firms must register with both the SEC and CFTC, but may notice file with one regulator if already registered with another. And, because registered investment advisers by definition provide advice on “securities” (which includes any “security future”),<sup>36</sup> we surmise that only a very small number of the 372 advisers in the category at hand are advising exclusively on securities futures such that the FCM, or qualified custodian, is not also registered as a general-purpose broker-dealer.
- **Banks.** While there is no regulatory requirement mandating that banks acting as custodians obtain a SAS 70 report, the marketplace has created a demand for this information and, as a result, we believe that at least some bank custodians already obtain SAS 70 reports. We suggest that the SEC explore ways to leverage the results of these reports so as to avoid duplication. As with FCMs, we surmise that only a small number of the 372 advisers subject to an internal control report requirement are also banks (or

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<sup>32</sup> [An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements](#) (Auditing Standard No. 5).

<sup>33</sup> SEC [Release 33-8934A](#) and [Release 33-8934](#).

<sup>34</sup> Form ADV, [Schedule A, Question 7b](#) requires an adviser to report whether its owner(s) is a “public reporting company.”

<sup>35</sup> AICPA Practice Aid: [Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools](#).

<sup>36</sup> Securities futures are essential a contract for the sale or future delivery of a single-security or security based index. A security future is included in the definition of “security” in Section 3(8) of the Exchange Act.

have a related person acting as such). Note, also, that “issuer” banks may also be required to obtain an integrated audit (discussed above).

## **2. Comments/suggestions specific to the Type II SAS 70 report**

As noted, we support the SEC proposed requirement for an internal control examination for those advisers who are acting (or a related person is acting) as a qualified custodian for client assets, but question whether Type II SAS 70 report is the most appropriate format for the following reasons:

- SAS 70 reports are primarily an “auditor to auditor” or a “management to auditor” tool. They are generally obtained for purposes of providing multiple “users” of a “service provider” with a report on the service provider’s controls, which the user’s auditor can consider in establishing the scope of his or her procedures in auditing the user’s financial statements. Accordingly, the reports typically are lengthy, providing detailed descriptions of controls and tests of their operating effectiveness. Our analysis of the SEC’s proposal suggests that the SEC may be envisioning the most likely “user” of such a report in this context to be the adviser’s client (or its auditor), since the transactions processed by the service organization end up in the financial statements of the client and not the investment adviser.<sup>37</sup> Further, a Type II SAS 70 report often is written in the context of a custodian control system being part of a user entity’s overall control system, and notes that its proper evaluation must also consider “user controls”, such as controls over the authenticity of instructions provided to the custodian and review of reports the custodian generates. While the SEC’s proposal contains no requirement to distribute the controls report, we consider it likely – particularly because its existence will be reported in the public Form ADV filing – that an adviser’s clients, or prospective clients, may ask to review it. We are concerned that individuals without sufficient sophistication could misinterpret report findings, either negatively or positively. Accordingly, we question the ability of an investment adviser’s clients to understand and appreciate the findings of a Type II SAS 70 report. For example, proposed Form ADV (Item 9C of Part 1A) asks whether the report contains an “unqualified opinion.” A “qualified opinion” would indicate the existence of a “significant deficiency” or “material weakness” in the control system, suggesting a heightened risk of misappropriation but provides no context as to whether actual risk of misappropriation is heightened or whether user controls may mitigate that risk. More importantly, an “unqualified opinion” over custodian controls

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<sup>37</sup> Although custodians and investment advisers maintain information related to customer securities transactions, customer securities in the possession or control of a custodian are not reported as assets in the financial statements of the custodian or the investment adviser, as they are assets of the customer and as such, the results of trading or investment income earned related to customer securities transactions are reflected in the accounts of the customer, as the users of the SAS 70 report will be the customers and their auditors. In general, we believe that most of the 372 custodians in this category will be registered as separate legal entities such that generally, the only cash flows occurring from custodian to adviser are advisory fees to the adviser.

provides no assurance that the related adviser is in compliance with Adviser Act requirements.

Other observations, for the SEC's consideration, relevant to the Type II SAS 70 report:

- The applicable standard for Type II SAS 70 examinations for "issuers" is PCAOB interim standard *AU 324: Service Organizations*, which was derived from AICPA standards and thus is substantially similar to AICPA Professional Standard AU 324, issued by the AICPA Auditing Standards Board ("ASB") and followed by auditors of non-public companies. As part of the ASB's strategy to converge its standards with international standards, AU 324 is being revised such that two new standards will be created to replace it – an attestation standard for the performance of controls examinations and an auditing standard directed to user auditors' evaluation of the resulting reports. While the new attestation standard will not contain major differences from existing guidance, differences will exist which could cause confusion in the marketplace.
- Also, under the SEC proposal, auditors preparing the internal control report would be required to follow PCAOB standards and be subject to PCAOB registration, inspection and enforcement. At present, we do not believe that PCAOB has been inspecting service auditor examinations nor do we believe they should. The proposal should consider an appropriate exemption.
- Specific examples of control objectives are mentioned in the proposal as relevant to custodial operations; however, the relevant professional guidance (discussed below) does not include any specific minimum control objectives to be examined. We believe the examples contained in the SEC's proposal (with the possible exception of valuation, for reasons described previously) represent a good base, with the addition, as applicable, of control objectives which assess the operational system infrastructure, network security, information security and the general operating environment. However, without a defined framework, the possibility exists for inconsistent performance of control examinations.

For these reasons, we believe the SEC and PCAOB should consider a rule-making or standard-setting effort to devise an examination and reporting format better tailored to regulatory reporting and potential review by less sophisticated users, and to converge with other applicable professional guidance. We suggest that the SEC consider convening a Task Force comprised of industry participants and qualified custodians to determine the most appropriate report format and authoritative guidance that could be used to satisfy this requirement. AICPA would welcome the opportunity to participate on this Task Force.

#### **IV. Cost Considerations**

We believe that, notwithstanding the fact that audit costs vary widely depending on, among other things, the size and location of the adviser's business and the complexity of its investment

strategies. The SEC's estimate of \$8,100 per adviser for the surprise examination appears significantly understated, particularly given its forensic-type of scope. For a small organization (for example, with less than 100 clients and straightforward positions in U.S. equities and bonds), we believe it reasonable to assume that a surprise examination could cost \$10,000 - \$15,000. Larger, more complex organizations could experience fees that are multiples of the SEC estimate, and in a minority of cases, an order of magnitude larger than the SEC's estimate.

## V. Independence Considerations

Under the proposal, the independent public accountant performing either the annual surprise examination of client assets or the internal control report of a related custodian must adhere to the independence standards of Rules 2-01(b) and (c) of Regulation S-X<sup>38</sup>. The SEC has asked, in the proposal, whether the independent public accountant that performs the surprise examination be a different accountant than the accountant that performs the internal control examination.<sup>39</sup> We do not believe that application of independence standards precludes, or should preclude, the same accounting firm from performing both the surprise annual examination and internal control examination, since these are two separate auditing/attest engagements and the performance of one should not impair the independence of the other.

Although the independence standards do not operate to preclude the same accounting firm from performing both examinations, we recommend that, because the definition of "affiliate of the audit client" is very broad in Rule 2-01<sup>40</sup>, the SEC consider issuing some practical guidance to firms who must implement these rules that would permit them to provide non-audit/attest services to an affiliate of the adviser, subject to specific safeguards. Otherwise, we are concerned that existing services provided by accountants to organizations deemed "affiliates" of the adviser but having no relationship to the adviser's operations would be curtailed, causing disruption but having little, if any, impact on either perceived or actual independence.

Finally, the proposal also requires that the internal control examination be performed in accordance with PCAOB standards. Since "PCAOB standards" includes PCAOB independence rules, which in some respects are even more restrictive than the SEC independence rules, we suggest that auditors of non-issuer qualified custodians be exempt from PCAOB independence standards similar to how the SEC has exempted the auditors of broker-dealers or investment advisers which are not "issuers".<sup>41</sup>

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<sup>38</sup> Proposed Rule 206(4)-2(c)(3).

<sup>39</sup> Federal Register, p. 25359.

<sup>40</sup> Rule 2-01(f) definition of "affiliate of the audit client."

<sup>41</sup> See Question 1 under Broker-Dealer and Investment Advisers, Application of the Commission's Rules on Auditor Independence: FAQs.

## VI. Auditor Qualifications

### A. Surprise Examination

- Require PCAOB-registration, inspection and oversight only for auditors of an adviser who is an “issuer” or an adviser acting as a qualified custodian (directly or through a related person)

As noted in Section I, the proposal requires that, for those advisers who do not utilize an independent custodian to maintain client assets, the surprise examination be performed by an independent public accountant registered with, and subject to regular inspection by, the PCAOB, in accordance with the rules of the PCAOB. As noted by the SEC, this requirement is predicated upon the SEC’s belief that these requirements will provide “greater confidence in the quality of the examination performed by the independent public accountant, which is even more important when an adviser or its related person, rather than an independent custodian, maintains client funds or securities.”<sup>42</sup> The SEC asks whether, instead, they should require that all surprise examinations under the Rule be conducted by an accountant that is registered with, and subject to regular inspection by, the PCAOB.<sup>43</sup> While we support the concept of requiring that auditors of advisers who are either “issuers” or acting as a qualified custodian (directly or through a related person) be subject to PCAOB registration, inspection and enforcement, we do not believe it is warranted that auditors performing the surprise examination of other advisers be subject to this requirement.

It is the AICPA’s position that CPA professionals are singularly competent and capable of performing the types of examinations required in this proposal with the integrity and competence required and expected, without being PCAOB-registered. Further, the performance of audits and attest examinations is subject to AICPA peer review requirements. We do not believe there is an argument to be made that otherwise licensed and trained CPAs cannot perform this attest function with competence without the additional oversight of PCAOB. The incremental cost of a PCAOB-registered auditor, as well as the potential scarcity of finding such an auditor in certain communities of the United States, leads us to submit that such a requirement would be unduly burdensome and costly to many advisers, without significant benefit to the public or the SEC.

We believe that similar considerations should apply to the Commission’s question as to whether audits of pooled investment vehicles should only be performed by PCAOB-registered and inspected firms.

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<sup>42</sup> Federal Register, p. 25360.

<sup>43</sup> Ibid.

## **B. Internal Control Report/Exam**

- Auditors of qualified custodians should be subject to PCAOB-registration, inspection and enforcement authority, with triennial inspections for auditors of “non-issuer” qualified custodians.

The AICPA has previously recommended that auditors of public broker-dealers - as well as non-public broker dealers - that perform *clearing or custodial functions* should be subject to registration, inspection and enforcement by, the PCAOB.<sup>44</sup> We continue to support this recommendation, and agree that auditors of all qualified custodians as defined in the Custody Rule (broker-dealers, futures commission merchants and banks) be subject to PCAOB registration, inspection and enforcement.

Under Sarbanes-Oxley, PCAOB-registered firms that audit more than 100 “issuers” are subject to annual inspections, while firms with 100 or fewer “issuer” clients are subject to triennial inspections.<sup>45</sup> The AICPA does not believe that *non-public* qualified custodians that perform clearing or custodial functions should be treated the same as an audit firm’s “issuer” clients for purposes of determining the frequency of a PCAOB-registered firm’s inspection. The SEC proposal does not address this particular issue, yet this is a significant factor for the SEC to consider in assessing whether, should the number of firms inspected annually by the PCAOB significantly increase, whether PCAOB resources would be sufficient to meet this demand.

## **C. Proposed changes to Adviser’s Form ADV**

Among other things, the SEC proposes to amend Schedule D of Form ADV which would require advisers to (i) identify the accountants that perform audits or surprise examinations and that prepare internal control reports; (ii) provide information about the accountants, including address and PCAOB registration and inspection status, (iii) indicate the type of engagement (audit, surprise examination, internal control report) and (iv) indicate whether the accountant’s report was unqualified. The SEC has asked whether this information would be readily available such that it would not be burdensome to provide.<sup>46</sup>

We question whether the PCAOB registration and inspection status of accountants should be part of the Form ADV. This information is readily and publicly available on the PCAOB website. Moreover, it does not appear appropriate to require an adviser to report information about a third party’s operations on Form ADV, for which (as with all statements made on Form ADV) it potentially could face legal liability for an incorrect response. We believe the Commission should reconsider the need for this information in Form ADV or whether it can be obtained in a

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<sup>44</sup> [AICPA Press Release](#) dated April 27, 2009.

<sup>45</sup> Sarbanes-Oxley Act §104(b)(1)(A) & (B).

<sup>46</sup> Federal Register p. 25362.

Securities Exchange Commission  
July 28, 2009

different way. In no case, though, do we believe that the information should be collected in a manner which associates the accountant with the Form ADV filing as a whole.

Notwithstanding the above, we further note, in relation to the question as to whether an independent public accountant is subject to inspection by the PCAOB, there is no question on the form as to when the accountant was last inspected by the PCAOB.<sup>47</sup> We suggest this addition, and also that the Commission consider expanding this question to include the date of the accountant's last AICPA peer review, if the accountant is not inspected by PCAOB.

Finally, the questions are unclear as to whether the accountant named in the responses is the one responsible for performing the specified examination (or PIV audit) in the prior year or the current year. The questions seem to assume that the same accountant engaged in the current year performed the prior year's work, which may not always be the case. Additional questions may be needed to separate the prior year and current year accountants.

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<sup>47</sup> Proposed Schedule D, Section 9.C.(4).