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July 28, 2009

By electronic delivery.

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

Re: Custody of Funds or Securities of Clients by Investment Advisers; SEC File Number S7-09-09; 74 Federal Register 25354 (May 27, 2009).

Dear Ms. Murphy:

The American Bankers Association[1] ("ABA") appreciates the opportunity to comment on the Securities and Exchange Commission's ("SEC") proposed amendments to Rule 206(4)-2 of the Investment Advisers Act of 1940, which governs custody of investment advisory client assets. We understand the SEC's rationale for the proposed amendments and its intent to protect client assets from fraudulent activity. While we applaud the SEC's efforts to implement rulemaking to protect client assets, we are concerned about what we believe is the unnecessary reach of these proposed amendments and their potentially detrimental effect on the legitimate and important bank custodial business.[2]

ABA strongly urges the SEC to exempt registered investment advisers from the surprise examination when client assets are held at domestic banks or savings associations, U.S. branches of foreign banks, or non-depository trust companies (collectively referred to as "banks"). Indeed, the stated purpose of the proposed amendments – to deter fraudulent activity by investment advisers – is already being accomplished when investment advisers use extensively-regulated banks as their custodians. We would draw the SEC's attention to the existing regulatory framework for banks as the Commission carefully weighs the significant costs of the proposal against its marginal benefits.

[1] The American Bankers Association brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.6 trillion in assets and employ over 2 million men and women.

[2] Bank custodial services are a significant business for institutions providing trust and related services. In 2008, FDIC-insured institutions held $50 trillion in 10 million custodial and safekeeping accounts. These accounts contributed $8 billion to bank income, approximately one quarter of total fiduciary and related income received. See, FDIC Quarterly, 2009, Volume 2, No. 1, Table VIII-A.

Proposal's New Requirements

Under the proposed amendments to 17 CFR 275.206(4)-2, an investment adviser that is considered to have custody of client assets must undergo an annual surprise examination by an independent public accountant ("IPA") that is registered with the Public Company Accounting Oversight Board ("PCAOB"). Under the proposed rule an adviser is considered to have custody of client assets if: (1) the adviser directly or indirectly holds client assets; (2) a "related person" directly or indirectly holds client assets; (3) the adviser is authorized or permitted to withdraw client assets maintained with the custodian; or (4) the adviser has legal ownership of or access to client funds. A "related person" is defined as any person that is directly or indirectly controlling or controlled by the adviser or any person under common control with the adviser. "Control" is defined as the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise.

Although the proposal is principally directed at investment advisers registered with the SEC, its requirements will indirectly affect bank custodians. As the proposal explains, in order to verify assets during the surprise examination, the IPA "may have to rely on custodial reports issued by the adviser or its related person."[3] We are concerned that this verification may require on-site examination of the bank custodian's books and records. In addition, if client assets are held by an affiliated qualified custodian, such as a bank or broker-dealer, the adviser must obtain a written report and opinion regarding the custodian's controls relating to custody of client assets ("Type II SAS 70 Report") from a PCAOB-registered IPA.

Unnecessary Reach into Well-Regulated Bank Custody Business

ABA strongly believes that the proposal constitutes an unnecessary intrusion into bank trust departments and ignores the significant involvement of the federal and state banking regulators in supervising, examining and regulating banks, including the bank custody business.[4] Under the proposal, an IPA must confirm with the custodian all client assets simply because the assets are held with an affiliated bank and the adviser is deemed to have custody. This confirmation process would likely require the adviser's IPA to request access to the books and records of the affiliated bank, even though these books and records have already been examined by federal and/or state banking regulators and IPAs.[5]

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[3] SEC Proposal, 74 Fed. Reg. 25359.

[4] Depending on the charter, national and state banks and savings associations may be examined and regulated by the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation, the Federal Reserve Board of Governors, the Office of Thrift Supervision and/or state banking regulators. Non-depository state-chartered trust companies are regulated and examined by the relevant state agency. OCC-chartered trust companies are examined and regulated by the OCC.

[5] All FDIC-insured institutions must be audited each year by an IPA who is licensed to practice and in good standing under state law, as well as peer-reviewed each year in a manner consistent with the standards of the American Institute of Certified Public Accountants. IPAs must audit and report on the bank's internal controls on financial reporting directly to the bank's board of directors. Federal bank regulators require that the IPA's audit work papers, policies and procedures be made available to the bank's examiners upon request. In addition, many banks hire IPAs to conduct Type II SAS 70 reports on their custodial operations.

As the SEC has recognized in this and past releases, bank custodians are "subject to extensive regulation and oversight."[6] This extensive regulation and oversight has provided a significant bar to the type of fraud cited in the release as the impetus for the amendments. In fact, none of the examples given in footnote 11 of the Proposing Release involves a bank subject to federal or state laws and regulations.

Federal and state banking regulators engage in thorough on-site examinations every twelve months – some larger institutions have regulators on the bank's premises throughout the year to examine banking activities continuously.[7] During an examination, banking regulators do not simply rely on documentation provided by the institution to determine compliance with banking laws and to evaluate the bank's transaction, compliance, credit, and strategic risks. Examiners sample and test various operations to ensure that important transactions have been properly completed and that the bank's recordkeeping function is accurate. In addition, examiners review and test the bank's internal controls on custodial activities, conflicts of interest, recordkeeping of securities transactions, segregation of duties, cash and asset reconcilements, and management information systems. The testing of internal controls allows the examiner to determine whether the bank is able to identify transactional mistakes or fraudulent activity.

Affiliated Banks and Advisers Are Distinct Entities

We believe that the proposal also places unwarranted suspicion on affiliated banks and investment advisers. These institutions have legitimate business to conduct between themselves – business which is frequently initiated by the client. Adviser clients, especially institutional clients, often request or expect that their assets be held at the affiliate bank and are comforted by the fact that the bank is in the same holding company as the adviser. In addition, clients often establish their custodial relationship prior to the selection of the advisory relationship. Many of these clients are sophisticated investors who have weighed the risks and benefits of choosing to transact with affiliated banks and advisors and have determined that the benefits outweigh the risks.

Within a parent holding company, banks and their affiliates operate as distinct and separate legal entities. Under this regime, bank custodians carefully maintain client confidentiality even with accounts managed by an affiliated adviser. Bank trust departments also maintain books and records, and engage in external and internal examinations of their businesses, separate from an affiliate adviser.

Practical Concerns and Burdens of Proposal

In addition to concerns about the heightened scrutiny for business arrangements between affiliates, ABA would like to raise a number of practical concerns with the proposal. We are concerned that a bank may risk violation of contractual and legal privacy requirements if an adviser's IPA is allowed to examine the bank's client records and assets. Therefore, for the amendment as proposed to be implemented fully, a bank would have to isolate the adviser's client records and assets for examination by the adviser's IPA, as well as amend certain client contracts. Such efforts would be time consuming and costly.

[6] SEC Proposal, 74 Fed. Reg. 25354.

[7] 12 USC 1820 (d). Certain depository institutions with less than $500 million in assets may be examined every eighteen months.

In addition, the scope and timing of IPA surprise examinations would likely become quite expensive for banks with numerous custodial accounts. A number of questions are raised: What period would the surprise examination cover – a day or several months of records? And how often would various adviser IPAs make these requests? How would IPAs confirm securities held at the Depository Trust Corporation or other subcustodians when held in an omnibus account? Depending on the recordkeeping burden, banks may be required to hire full-time employees to assist the IPA in confirming client assets. In addition, in an increasingly sophisticated market, many adviser assets are held with subcustodians overseas. Confirming the assets in these arrangements during a surprise examination could get very time-consuming and costly for the bank custodian.

In its cost-benefit analysis, the SEC has failed to account for the costs of the proposal to the bank custodian. The SEC staff measured possible effect by assuming an average cost of $8,128 per investment adviser. However, each investment adviser will generate surprise audit requests which will affect custodians. The proposal does not account for these indirect costs to bank custodians, but should do so in order to meet cost estimate standards.

Conclusion

In conclusion, ABA appreciates this opportunity to offer comments on the registered investment adviser custody proposal. ABA believes that the proposed amendments to Rule 206(4)-2 are not necessary in the case of bank custodians and that they are too burdensome. For the reasons set forth above, we urge the SEC to exempt banks custodians from the surprise examination. Should you have any questions or comments with respect to the issues raised in this letter, please do not hesitate to call the undersigned at (202) 663-5053.

Sincerely,

Phoebe A. Papageorgiou