THE BANK OF NEW YORK MELLON

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July 28, 2009

Via Electronic Filing

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

Re: Custody of Funds of Securities of Clients by Investment Advisers, SEC File No. S7-09-09, 74 Federal Register 25354 (May 27, 2009) ("Proposing Release")

Dear Ms. Murphy:

The Bank of New York Mellon Corporation appreciates the opportunity to comment on the Securities and Exchange Commission's (the "Commission") recent proposal to amend the rules applying to investment advisers who maintain custody of client assets. We agree that the Commission should take affirmative steps further to protect investors from potential investment adviser fraud involving the misappropriation of client funds and securities. We believe, however, that the proposed amendments, particularly the proposed definition of "custody," do not recognize certain realities in the marketplace for custodial and investment management services, and are overly broad as a result. We are also concerned that the proposed amendments do not give due consideration to the substantial additional burdens the proposed amendments would place on custodians such as banks that already are regulated under federal and state law. Accordingly, we respectfully urge the Commission to more narrowly tailor the proposed amendments to their intended purpose.

The Bank of New York Mellon Corporation

The Bank of New York Mellon Corporation is a global financial services company focused on helping clients manage and service their financial assets, operating in 34 countries and serving more than 100 markets. The company is a leading provider of financial services for institutions, corporations and high net-worth individuals, providing asset management and wealth management, asset servicing, issuer services, clearing services and treasury services. It has $20.7 trillion in assets under custody and administration, $926 billion in assets under management, services $11.8 trillion in outstanding debt and processes global payments averaging $1.8 trillion per day, all as of June 30, 2009. Its principal banking subsidiary is The Bank of New York Mellon. BNY Mellon Asset Management is the umbrella organization for The Bank of New York

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Mellon Corporation's 19 affiliated investment management firms, many of which are registered with the Commission. As a leading provider of both custody and asset management services, The Bank of New York Mellon Corporation can provide a unique perspective on the issues raised in the Proposing Release.[1] Another of our affiliates, Pershing LLC, will also be taking the opportunity to share with the Commission its perspectives on some of the issues raised by the Proposing Release for securities broker custodians.

The Proposed Amendments

The Commission conducted a comprehensive review of the rules regarding the safekeeping of investor assets in response to a number of recent enforcement actions against investment advisers alleging, among other things, misappropriation of client assets.[2] The Proposing Release suggests two major changes to Rule 206(4)-2 under the Investment Advisers Act of 1940 (the "Custody Rule") intended to address perceived shortcomings relating to the safekeeping of client assets.

First, the Commission proposes that all registered investment advisers who are deemed to have custody under the Custody Rule be required to submit to an annual surprise examination by an independent public accountant.[3] The surprise examination would be designed to verify the existence of client funds and assets held in the investment adviser's custody. According to the Proposing Release, the Commission believes such a surprise examination would provide "another set of eyes" on client assets, and perhaps detect misuse of funds or securities earlier than might otherwise be the case, reducing client losses.[4]

Second, the Commission proposes to expand the definition of "custody" to include cases where a "related person" of an investment adviser "holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services" the investment adviser provides to clients.[5] In those cases, in addition to being subject to an annual surprise examination, the investment adviser would have to obtain or receive from the related custodian, no less frequently than once per calendar year, an internal control report, which includes an opinion from an independent public

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[1] Although we are not specifically commenting here, we are in general agreement with those commenters who believe subjecting investment advisers to a surprise annual examination solely because they have the authority to debit fees will impose undue costs on those advisers and custodians without a corresponding benefit to investors. Indeed, the Proposing Release does not address the potentially significant costs that would be borne by custodians as a result of this change. Generally, however, we believe that investment advisers who are deemed to have custody solely by virtue of their ability to debit fees from client accounts should be exempt from the surprise annual examination requirement.

[2] Proposing Release, 74 Fed. Reg. 25354, at 25355.

[3] Id.

[4] Id. at 25356.

[5] Id. at 25375.

accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB").[6] A "Type II SAS 70 Report" conducted in accordance with PCAOB standards would satisfy this requirement.[7]

The "Related Person" Concept is Too Broad

When viewed in combination, the proposed amendments reach too far and create an un-level playing field for investment advisers affiliated with custodians. For example, the proposed amendments would result in virtually all of BNY Mellon Asset Management's registered investment advisers being deemed to have "custody" of client assets simply because of their affiliation with The Bank of New York Mellon. We believe this is an anomalous result based on a faulty premise.

The Commission appears to assume that advisers always control the client's choice of custodian.[8] That is incorrect. Investors frequently exercise their individual discretion in choosing their custodians and investment advisers, using different processes (such as requests for proposals, due diligence and consultants) and criteria without any regard for affiliation between the custodian and the adviser. Institutional investors such as corporate and public pension plans, Taft-Hartley plans, foundations, endowments and family offices, almost always make these choices independently. These investors negotiate separate contractual arrangements with separate legal entities.

BNY Mellon Asset Management investment advisory firms have many clients that have chosen to use The Bank of New York Mellon as their custodian. That is no surprise, as The Bank of New York Mellon is the largest global custody bank. But that does not mean the investment advisers chose "to use" The Bank of New York Mellon for their clients' custody services or even had any influence over the clients' decision. Indeed, many clients of BNY Mellon Asset Management advisers custody their assets with third party custodians. Most importantly, BNY Mellon Asset Management investment advisers interact with The Bank of New York Mellon as custodian in the same manner as they do with any third party custodian. The investment advisers do not have access to The Bank of New York Mellon's custody systems,[9] do not have authority to obtain possession of client assets, and therefore do not have the opportunity to misappropriate client assets. Indeed, The Bank of New York Mellon, being subject to the kind of "extensive regulation and oversight of [its] custodial practices" recognized by the

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6 Id. at 25358-9.

7 Id. at fn. 42.

8 In several instances in the Proposing Release, the Commission uses phrases such as investment advisers "maintain client funds or securities," e.g., id. at 25354, or "the use of" a qualified custodian by an investment adviser, e.g., id. at 25360, suggesting that the Commission assumes the adviser makes this decision in all cases.

9 Although advisers have the ability to view client custodial account information, such practice does not raise the risks the proposed amendments are intended to address, and therefore does not rise to the level of "access" as we refer to here.

Commission,[10] does not permit *any* investment adviser, whether affiliated with The Bank of New York Mellon or not, the opportunity to misappropriate client assets.

The Proposing Release refers to the "in connection with" requirement as a limitation on the degree to which custody with a related person will be imputed to the adviser.[11] The limitation, however, extends only to assets as to which the adviser does not give advice or have investment discretion, which is no limitation at all.[12] Under the proposed formulation, any time an investment adviser provides advice or management with respect to assets held by a related party custodian, the adviser will be deemed to have custody. This is an unfair result and inconsistent with the reality of the marketplace.

Under the Custody Rule, an adviser has custody when it holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them. Interpreting that standard, the Commission staff issued the Crocker no-action letter correctly stating that the question of whether an adviser has custody is a question of fact, and listing a number of factors that would be taken into consideration to determine whether an adviser has custody when an affiliated entity holds the client's assets pursuant to a custodial agreement.[13] Under Crocker, whether an adviser has custody of a client's assets by virtue of an affiliated company holding such assets depends on the following factors:

1) Whether clients' property in the custody of the affiliated company might be subject, under any reasonably foreseeable circumstances, to the claims of the adviser's creditors.
2) Whether advisory personnel have the opportunity to misappropriate clients' property.
3) Whether advisory personnel ever have custody or possession of or direct or indirect access to clients' property or the power to control the disposition of such property to third parties for the benefit of the advisor or its affiliated persons.
4) Whether advisory personnel and personnel of the affiliated company who have possession or custody of, or control over, or access to, advisory clients' property are under common supervision.
5) Whether advisory personnel hold any position with the custodian or share premises with the custodian and, if so, whether they have, either directly or indirectly, access to or control over clients' property.[14]

The Crocker factors are a well-tailored method of addressing the Commission's concerns about situations in which an investor's adviser and custodian are affiliated because they go to the heart of the matter -- does the adviser actually hold or have any authority to

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[10] Proposing Release at 25360.

[11] Id. at 25358.

[12] Id.

[13] Crocker Investment Management Corp., SEC No-Action Letter (Apr. 14, 1978).

[14] Id.

obtain possession of the client's assets? Yet the Proposing Release states that the Commission would withdraw Crocker if it adopts the proposed amendment.[15] In essence, the Commission proposes to replace the finely-tuned tool of fact-based analysis with the blunt club of a legal presumption – one that is based on a premise that we have pointed out misses the mark. We respectfully suggest the Commission reconsider its proposal and leave in place a standard based on the facts rather than create a rule that blindly will put advisers affiliated with custodians at a competitive disadvantage.[16]

Advisers to Pooled Investment Vehicles Should Not Be Subject to a Surprise Examination

Investment advisers are deemed to have custody under the Custody Rule if they serve as a general partner (or in a similar capacity) of a limited partnership or other pooled investment vehicle. Such advisers are not required to have a qualified custodian send account statements with respect to a pooled investment vehicle that is audited at least annually and sends its audited financial statements to the investors in the vehicle.[17] This exception recognizes the many protections afforded investors in the pooled investment vehicle as a result of the annual audit. Most pooled investment vehicles are in fact audited, either as a matter of practice or because it is required by the vehicles' governing documents.

Under the proposed rule, an adviser that has custody solely because of its relationship to a pooled investment vehicle would be subject to the surprise examination requirement.[18] The Commission notes that an annual audit does not require verification of *all* funds and securities in a pooled investment vehicle's account.[19] But an annual audit is in some ways broader than the surprise annual examination contemplated by the proposed rule. Audits cover both assets and liabilities, with the goal of obtaining reasonable assurance about whether the financial statements of the pooled vehicle are free of material misstatement. As such, we do not believe an additional, costly surprise examination will provide any additional benefits to investors in pooled investment vehicles.

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[15] Proposing Release, *supra* note 1, at 25358, n. 39.

[16] The Commission also sought comment on whether it should prohibit outright "the use of" an affiliated custodian. See id. at 25360. As discussed herein, institutional investors generally choose their custodians and advisers separately. A prohibition would deprive an investor from choosing to use investment advisers that happen to be affiliated with its custodian, and vice versa. We strongly believe such a prohibition is not necessary or appropriate in the public interest and that depriving investors of choice would harm, rather than protect, them. A prohibition would be also inherently overly broad and unfair to an entire industry segment of highly qualified investment advisers who happen to be affiliated with custodians.

[17] Rule 206(4)-3.

[18] Proposing Release at 25356.

[19] Id.

Custodians Will Bear Additional Burdens

The Commission estimates that the number of advisers that will be subject to a surprise examination will jump from 204 to 9,575.[20] In addition to other costs, the Proposing Release estimates cost of the annual surprise examination to be $8,100.[21] We believe this estimate to be too low. Perhaps more importantly, the Proposing Release fails to address the costs borne by the custodians (and perhaps the investors) that will be the recipients of the auditors' verification requests.[22] As stated in the Proposing Release, auditors "may have to rely on custodial reports issued by the adviser or its related person."[23] We believe custodians will feel compelled, as a matter of client relations, to do what they can to facilitate the surprise examinations, and will do more than simply supply copies of reports. In fact, we expect that custodians will incur significant costs as a result of the proposed changes. As an example, we expect The Bank of New York Mellon, with its extensive custody businesses will have to respond to hundreds of such requests each year if the Commission adopts the proposed amendments in their current form. Responses might also entail verification procedures with subcustodians regarding foreign holdings, adding another level of complexity and cost. Yet the Proposing Release does not even attempt to quantify such costs, and it is uncertain as to whether some or all of these costs would be ultimately borne by the investors. We believe the Commission should refine its cost-benefit analysis by including such costs.

Conclusion

The Bank of New York Mellon Corporation understands the Commission's desire to enhance the rules concerning the safekeeping of investor assets. However, we encourage the Commission to examine more closely the unintended consequences of its proposal. Under the changes as currently proposed, BNY Mellon Asset Management investment advisers, and others similarly situated, would be subject to a surprise annual examination and be required to obtain an internal control report merely because of their affiliation with a custodian, irrespective of whether they hold or have any authority to obtain possession of investor assets. The "related person" provision is thus overly broad. The Commission should maintain the fact-based standard set forth in the Crocker no-action letter. We also believe that imposing an additional surprise examination requirement on advisers to pooled investment vehicles is redundant and of no discernible benefit to investors. Lastly, the Commission needs to more fully justify the costs custodians (and possibly investors) will be forced to bear under the proposed changes; and the unintended result those costs may have on the availability and competitiveness of the services offered to investors by advisers and custodians who happen to be affiliates.

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[20] Id. at 25363-4.

[21] Id. at 25365.

[22] Of course, many such custodians are banks that are not subject to the Commission's jurisdiction.

[23] Proposing Release at 25359.

We appreciate the opportunity to present our views on this very important topic and stand ready to discuss them with the Commission or the staff. If you have any questions concerning these comments, please contact the undersigned at (412) 234-2053 or Marc Frimet, Senior Managing Counsel, at (212) 922-6296.

Sincerely yours,

James M. Gockley
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The Bank of New York Mellon Corporation