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July 28, 2009

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

Re: File No. S7-09-09—Custody of Funds or Securities of Clients by Investment Advisers

Dear Ms. Murphy:

Deloitte & Touche LLP ("D&T") is pleased to respond to the request for comments from the Securities and Exchange Commission (the "SEC" or the "Commission") on its Proposed Rule on the *Custody of Funds or Securities of Clients by Investment Advisers*, Release No. IA-2876; File No. S7-09-09 (May 20, 2009) (the "proposal").

D&T appreciates the opportunity to provide comments on the SEC's proposal. We believe the Commission's efforts to enhance investor protection are important. Our comments below are organized to reflect the principal areas in which we hope our feedback will assist the Commission and focus on certain areas of the proposal that could be improved.

A. Procedures For Surprise Examinations

Under the current rule, if an investment adviser's client does not receive account statements directly from a qualified custodian, the adviser must itself deliver quarterly account statements and be subject to an annual surprise examination by an independent public accountant to verify the client assets.[1] The proposal would require all registered investment advisers who have custody of client assets to undergo an annual surprise examination, regardless of whether a qualified custodian is providing account statements directly to clients.[2] We provide below some comments relating to surprise examinations.

1. Guidance Regarding Securities To Be Counted

The current rule requires that, when a surprise examination is required, all cash and securities (other than certain privately offered securities) held by a custodian be included in such

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1 17 C.F.R. § 275.206(4)-2(a)(3)(ii).

2 SEC Release IA-2876, at 10.

surprise examination.[3] The proposal does not change this requirement, but the guidance suggests that the scope of securities to be counted may be expanded. In this regard, the proposal would subject privately offered securities that investment advisers hold on behalf of their clients to the surprise examination.[4] Investment advisers invest client assets in numerous types of securities, including publicly offered securities and investments, private securities and investments, and various types of derivative instruments. Several categories of these securities, however, do not lend themselves to "counting" in the literal sense, and as a result, the procedures that would need to be undertaken to verify existence where an adviser holds a significant number of such securities could be burdensome. For example:

- Derivative securities include instruments, such as credit default swaps, that may change in character between an asset and a liability during a holding period. The ownership of derivative instruments that are not custodied also may be difficult to verify as confirmations related to the existence of the securities may have to be obtained through the counterparty to the underlying agreements to which the derivatives relate.

- Certain types of investments, such as loan participations, investments in other funds, and other private investments, are represented by a contract or a record with the investee's transfer agent, rather than by either a physical security or a record of existence maintained by a qualified custodian. Private investments also may be custodied differently than publicly offered securities. That is, the trading practices relating to such private securities may not require "delivery" of a security for the settlement of an investment transaction. Therefore, there may not be documentation to evidence the existence of the investment; and the form of the documentation may vary in ways that make counting large numbers of such investments impracticable. Additionally, in private transactions, possession of documentation by the custodian may not be evidence of the ownership of the investments as ownership rights may change or may lack substance due to subsequent transactions or agreements of which the custodian may not be aware or have been a party.

- Other asset classes, such as real estate, may also have claims, such as mortgages, associated with the assets that impact the ultimate ownership of the investment. These asset classes can create unique verification challenges as the title to the properties could be held by lenders or other parties that would require individual title searches to be performed.

The Commission should consider these issues in determining whether these types of "securities" need to be counted, and, if so, specific guidance in the final rule should be provided with respect to the anticipated procedures to be performed for counting such securities.

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[3] 17 C.F.R. §§ 275.206(4)-2(a)(3)(ii)(B) and 275.206(4)-2(b)(2)(i)-(ii).

[4] SEC Release IA-2876, at 17-18.

In addition, the inability of the investment adviser to transfer ownership with respect to the types of investments described above without the appropriate parties being made aware of the transfer mitigates the risk of defalcation that might otherwise exist with a freely transferable security. As a result, and as discussed further below, we recommend that the Commission clarify that there is not a need to verify 100 percent of the positions of these investments as of the count date. Instead, the Commission should incorporate guidance in the final rule that focuses on verification procedures that relate to the accurate recording of these transactions in the books and records of the adviser.

2. Suggested Modifications to Procedures for Surprise Examinations

The proposal notes that as part of a surprise examination an independent public accountant is to undertake certain steps, which include (1) confirming with the custodian all cash and securities held by that custodian and reconciling cash and securities to the records of client accounts maintained by the investment adviser; (2) verifying the books and records of the client accounts maintained by the investment adviser and confirming with clients all funds and securities; and (3) confirming with clients, on a test basis, closed accounts or securities or funds that have been returned since the last examination.[5] The proposal seeks comment on whether the procedures an accountant uses for a surprise examination should be revised. Below we provide some suggestions for modifying the surprise examination procedures.

Although the proposal sets forth the general steps to take as part of a surprise examination, there is some uncertainty in the proposal as to the types of confirmations that will be viewed as satisfactory for purposes of the examination. This issue raises concerns because performing confirmation procedures on certain securities and client account balances presents challenges. For example, investors may not be accustomed to receiving confirmation requests. As a result, investors often may ignore the requests to respond to confirmations, especially to the extent there are no issues noted by the investor with respect to the balances. Such non-replies require the independent accountant to undertake extensive alternative procedures to validate balances even when there are no exceptions related to such balances. To address these challenges with respect to confirmations, the Commission should consider the following guidance in adopting the final rule:

- *Use of sampling*. Where the Commission believes independent annual surprise examinations should be performed, the Commission should consider permitting confirmations to be used on a sample basis for both securities and client account balances. Audit sampling has been long accepted in the auditing community, as well as by the Public Company Accounting Oversight Board ("PCAOB"), in the performance of financial statement audits. The evaluation of statistical results has

5 Release No. IA-2876, at 6. We note that performing valuation procedures on securities is beyond the scope of procedures performed currently in securities counts and would be burdensome and costly to perform. We do not believe the final surprise examination requirement should include any valuation procedures.

supported a conclusion that a well designed, representative sample should provide results similar to a test of the entire population of items at significantly less cost, especially when the population to be tested is large and composed of similar items. We believe that an annual surprise examination should not require more expansive procedures than are currently used in connection with financial statement audits.

- *Negative confirmations*. The Commission should confirm that the use of negative confirmations will be permitted in connection with the surprise examinations. When performing an audit, AICPA Professional Standards and PCAOB Interim Standards (AU 330) state that negative confirmations may be used when (a) the combined assessed level of inherent and control risk is low; (b) a large number of small balances is involved; and (c) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration (if there are issues identified). We believe that, in connection with an audit, the use of negative confirmations is appropriate in limited circumstances, based on the framework provided in AU 330 and when such negative confirmations are effective in providing relevant and reliable audit evidence. An example of the use of negative confirmations is provided in AU 330, which provides that it may be appropriate, when seeking evidence about the existence of demand deposit accounts of a financial institution, for the auditor to use negative confirmations. We believe that this example is similar to circumstances related to the verification of security positions and client account balances, such that it would be appropriate, in connection with surprise examinations, for auditors to have the option of using negative confirmations where the controls around security processing are determined to be effective.

- *Third-party confirmations*. The Commission should confirm that it is permissible to receive affirmative confirmations of client account balances from organizations that are independent from the investment advisers, such as independent third-party administrators or transfer agents, as an alternative to confirmations received directly from individual investors. Our experience in auditing the financial statements of pooled investment vehicles indicates that timely and appropriate responses to confirmation requests are more likely to be received from administrators or transfer agents as compared to multiple individual clients.

We believe that incorporating the points discussed above in the Commission's final rule will help address some of the challenges to obtaining confirmations while still providing protection for investors that is consistent with the objectives of the proposal.

We also note that surprise examinations can be a deterrent to the misuse of client assets in situations where there are not effective controls over security processing. Many organizations, however, engage independent third parties that act as custodians and administrators over the security positions. In these situations, the risk of misuse is addressed primarily through the existence, and the operating effectiveness, of the controls established at both the investment adviser and administrator levels. As a result, the Commission may wish to consider permitting all investment advisers subject to the surprise examination provisions of the proposed rule to elect to *either* (1) undergo an annual surprise examination of the investments as proposed in the rule; *or, alternatively* (2) obtain, or receive from the related person (as defined in the proposal),

no less frequently than once each calendar year, an internal control report, which includes an opinion from an independent public accountant, with respect to the adviser's or the related person's controls relating to custody of client assets. This approach would provide investment advisers flexibility to determine which option is most appropriate for their respective situations while still providing important investor protections.[6]

3. An Exception If Custody Is Based Only On The Ability To Withdraw Fees

Where an investment adviser is deemed to have custody of client assets due only to its authority to withdraw advisory fees from client accounts, we believe that the act of having the independent qualified custodian send account statements to the client provides an appropriate layer of protection for investors.[7] In these circumstances, however, it is not clear that a surprise examination is also needed. Because an independent custodian is sending account statements directly to the client and because the clients would confirm their balances based on these same statements during the surprise examination, such an examination would not serve to expand the protection provided to investors. In other words, the independent qualified custodian is providing the account information directly to the client, and in turn, these would be the same account balances the independent accountant would then confirm with the client. This redundant step seems unnecessary. Accordingly, in these circumstances, we urge the Commission to provide that only delivery of the account statement by the independent qualified custodian is required.

4. An Exception for Pooled Investment Vehicles

The proposal requires that if a pooled investment vehicle is audited at least annually and the audited financial statements are distributed to its limited partners (or other investors) within 120 days of the end of its fiscal year, it must still undergo a surprise examination.[8] Under the current rule, such a surprise examination is not required.[9] Although surprise examinations may provide additional investor protection against the misuse of client assets, we do not believe that, in this situation, a surprise examination *in addition to* the currently required annual audit procedures would increase investor protection sufficiently such that their use should be required. For audits performed under auditing standards generally accepted in the United States as set forth

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6 As a general matter, we also encourage the Commission to review its other regulations that currently impose surprise examination requirements (such as Rule 17f-2(f) promulgated under the Investment Company Act of 1940) and, where appropriate, to harmonize such regulations with the final rule.

7 *Cf.* 17 C.F.R. § 275.206(4)-2(a)(3)(i) (exempting an investment adviser from the surprise examination requirement where it has a reasonable belief that the qualified custodian sends a quarterly account statement to each client for which it maintains funds or securities).

8 SEC Release IA-2876, at 10.

9 17 C.F.R. § 275.206(4)-2(b)(3).

by either the AICPA or the PCAOB, the auditor will test the financial statement assertion of existence of cash and securities of the pooled investment vehicle during the annual audit. Although the tests performed in an audit of financial statements with respect to verifying existence may not involve all securities or client confirmations on all investor accounts, such testing is similar to that performed in a security count with respect to the existence of the securities and the appropriateness of the investor account balances.

We recommend that the Commission retain the existing approach and continue to permit pooled investment vehicles—where the advisers are deemed to have self-custody of client assets based solely on serving as a general partner (or in some other capacity) of a limited partnership or other form of pooled investment vehicle—to be exempt from security count requirements, provided the pooled investment vehicle (1) undergoes an annual audit, and (2) distributes its audited financial statements to all limited partners (or members or other beneficial owners) within 120 days of the end of its fiscal year (180 days to the extent the pooled investment vehicle is structured as a fund of funds).

Alternatively, to the extent the Commission has concerns that the audited financial statements do not provide sufficient information for the investor to understand the impact of the financial position of the pooled investment vehicle on the individual investor account balances, the proposal could require the financial statements to include a supplemental schedule of individual partner's capital balances. This supplemental schedule would also be subject to auditing procedures in connection with the annual financial statement audit.

In addition to retaining the current exemption as described above, we believe the Commission should provide in the final rule that for pooled investment vehicles, an exemption will be granted if the audit is performed on financial statements prepared on another comprehensive basis of accounting, such as an income tax basis or pursuant to International Financial Reporting Standards, without requiring a reconciliation to financial statements prepared in accordance with accounting principles generally accepted in the United States. We believe such an exemption would be appropriate because the accounting convention used by the pooled investment vehicle does not impact the risk of whether the investments or client accounts exist.

B. Procedures For Internal Control Reports

We believe that the protection of an investor's assets is enhanced through the implementation and effective operation of a well-designed system of internal controls that is focused on the proper authorization and recording of investment transactions and on the security of investments held.

1. Type of Internal Control Report

The proposal is unclear as to the type of internal control report that would be acceptable for the purpose of its requirements. The proposal suggests that one way to fulfill the internal control report requirement would be through a Type II Report issued in accordance with Statement on Auditing Standards No. 70, *Service Organizations* ("Type II SAS 70 Report"). It is unclear, however, whether *only* a Type II SAS 70 Report would be acceptable. Separately, a

Type II SAS 70 Report is not intended for use in meeting an investment adviser's compliance requirements, and thus, it is not clear that the Type II SAS 70 Report is an appropriate internal control report standard for use in this setting.

Regardless of the type of internal control reporting that may be permitted, it is important to clarify that no engagement to report on internal controls is designed to detect material misstatements resulting from fraud or error. In contrast, audits of financial statements are to be performed to provide reasonable assurance that material misstatements, whether caused by error or fraud, are detected. While we agree that the internal control requirement can act as "an additional check on the safeguards relating to client assets,"[10] it does not include any substantive testing of actual balances nor does it test the accuracy of balances on the confirmations that are sent in connection with the surprise examinations.[11]

2. Control Objectives

The proposal currently includes a list of control objectives that "might be relevant to custodial operations."[12] The list that is contained in the proposal does not include all the control objectives that it is expected would be addressed in a Type II SAS 70 engagement for a custodian or an investment adviser. For example, it does not include any control objectives related to maintenance changes to client accounts, and rather focuses on documentation for the opening of accounts. It would be useful to include an objective for a broader range of changes, such as changes to authorized signers or address changes. The proposal also explains that the internal control report would address control objectives related to the general control environment and information systems (in addition to those related to custodial operations). To create a baseline for the types of procedures that are to be performed, we suggest that the final rule identify the minimum list of control objectives relevant to custodial operations, the control environment, and information systems that the Commission would expect to be covered in preparing such a report.

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10 *Id.* at 21.

11 We also note that the International Audit and Assurance Standards Board has recently proposed International Standard on Assurance Engagements 3402, *Assurance Reports on Controls at a Third Party Service Organization*. In the event the final rule identifies a Type II SAS 70 Report as an acceptable format for the internal control requirement, the Commission should acknowledge the international equivalent in its final release and provide guidance as to the extent to which this format may be acceptable. The Commission may also wish to consider the forthcoming guidance from the AICPA regarding reporting on controls at a service organization, *see* Proposed Statement on Standards for Attestation Engagements, *Reporting on Controls at a Service Organization*, which will supersede the guidance for service auditors and SAS 70 reports currently in AICPA AU 324, *Service Organizations*.

12 SEC Release IA-2876, at 23.

We have attached as Appendix A a proposed list of control objectives that could be considered for inclusion by the Commission. In the event the Commission decides that the report should cover a minimum list of control objectives, the Commission should provide some guidance as to what principles should guide investment advisers as they develop the ultimate list of control objectives.

C. Proposal's Requirement For PCAOB Registration And Inspection

D&T is already a registered public accounting firm and, as such, would be able to perform the proposed surprise examinations and provide internal control reports to the extent the final rule requires that such processes be performed by a registered public accounting firm.[13] Nonetheless, the proposed requirements related to PCAOB registration would have several important ancillary effects—particularly with respect to inspections—that we wish to highlight for the Commission's attention.

1. PCAOB Inspection Process

Under the proposal, it is contemplated that registered audit firms providing internal control reports or performing surprise examinations of advisers (or their related persons) that serve as qualified custodians for client funds or securities would need to be "inspected" by the PCAOB (SEC Release IA-2876, at 20, 25). It is unclear, however, what these inspections would entail, and whether the PCAOB even has the authority, under the Sarbanes-Oxley Act of 2002 (the "Act"), to inspect firms that do not provide audit services to issuers.

Section 104(a) of the Act states that inspections are performed "in connection with [a registered firm's] performance of audits, issuance of audit reports, and related matters involving issuers." This may limit the PCAOB's ability to review the investment adviser internal control and surprise examination engagements, even of those public accounting firms that are registered and perform audits of issuers.

The proposal also seems to contemplate that the PCAOB would evaluate the "overall quality control system" of a firm. It is not clear, however, whether the PCAOB has the authority to do so for firms that do not perform any audit engagements for issuers. In addition, if the issues regarding the PCAOB's authority are resolved, it remains unclear what form of report the PCAOB would provide as a result of performing an inspection of a firm's "overall quality control system."

2. Resources and Reporting Timeframes

At a minimum, expanding the number of firms that the PCAOB is required to register and potentially to inspect may strain PCAOB resources. The SEC should consider additional steps that the PCAOB can take in light of this increased burden to prepare for the expansion of its registration and inspection responsibilities. In particular, increasing the number of firms that the

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13 SEC Release IA-2876, at 25.

PCAOB must inspect may result in a longer time period for issuing inspection reports. If additional PCAOB inspection requirements are adopted, the SEC may wish to consider providing guidance as to how the additional inspections contemplated by the proposal can be accomplished so that the timeframe within which inspection reports are issued is not extended.

D. Independence

The proposal states that the independence of the public accountant would be measured against the standard articulated in Rule 2-01(b) and (c) of Regulation S-X.[14] We believe that the SEC should consider whether it is appropriate to apply the SEC independence rules to all investment adviser-related engagements. In situations where the investment adviser is using the audit of the pooled investment vehicle to comply with the current custody rules, the auditors must meet the standards of independence in the SEC independence rules. Yet, when performing audits of pooled investment vehicles offered by investment advisers, auditors are not currently required to follow PCAOB independence rules related to such matters as the provision of tax services, contingent fees, and communications with audit committees.[15]

In addition, the application of the independence rules to investment advisers raises a broader issue. Specifically, the manner in which the independence rules apply to investment company complexes and determining whether entities within an investment company complex, including investment advisers, will be deemed "affiliates" of the audit client is an important element that we believe the Commission should consider and address. We provide some background and our recommendations on this subject in Appendix B.

E. Costs and Complexity

In reviewing the cost analysis in the release, we believe that the Commission may not have taken into account certain additional costs associated with the proposed enhancements to the custody rule. For example, it is expected that the proposal will subject a much broader group of investment advisers to surprise examination procedures than have been subject to such procedures. Many of the advisers that will now be subject to the surprise examination procedures, such as securities firms, have operations that are significantly different than those advisers that have had surprise examinations performed in the past. As a result, the estimates of the costs to be incurred by the advisers in having the surprise examinations performed, to the extent based on historical amounts, could significantly underestimate such costs due to issues that impact the level of effort the independent accounting firms will need to expend for items such as: a larger number of investment accounts to be confirmed, especially for larger investment advisers; a number of pooled investment vehicles that were previously but are no

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14 SEC Release IA-2876, at 8 n.12.

15 *See* Deloitte & Touche LLP (on behalf of BDO Seidman LLP, Deloitte & Touche LLP, Ernst & Young LLP, Goldstein Golub Kessler LLP, Grant Thornton LLP, KPMG LLP and PricewaterhouseCoopers LLP), SEC No-Action Letter (Aug. 28, 2006).

longer excluded from the count requirements; the number of investments to be verified; and the types of investments to be verified, which might not be custodied in the same manner as those associated with the advisors currently subject to the examinations. For example, securities firms, in particular, carry a much broader array of investment products than investment advisers that had been subject to the rule in the past. Each of the variables described above would need to be considered in developing an estimate of the costs to be incurred by the investment advisers going forward; these variables could significantly impact the cost estimates in the proposal.

Additionally, the proposal does not make clear whether the investment advisers themselves would be required to pay an accounting support fee to the PCAOB directly. Further, it does not appear that consideration has been given to the additional costs associated with the potential new requirements related to PCAOB inspection of firms performing services for certain investment advisers. These additional costs would include costs associated with additional PCAOB personnel and resources.

We appreciate the Commission's concern with respect to the cost impact of the proposal and regret that we are unable to provide specific estimates of fees that we likely would charge for the contemplated services. The nature of our clients that would be subject to this proposed rule vary greatly and the impact to each of them varies greatly as well. If the Commission staff is interested in discussing the variables that determine the fees and related costs, we would be happy to meet with them.

F. Effective Date and Transition

1. Surprise Examinations

Because of the complexity of this undertaking, we recommend that this rule take effect for annual periods beginning on or after twelve months after the SEC approves the rule. This proposed effective date will provide time for the accounting profession to develop policies and procedures in response to the final rule and, more importantly, will allow time for investment advisers to make arrangements to meet the final rule's requirements before they become effective.

2. Internal Control Reports

We recommend the Commission consider providing a transition period prior to requiring internal control reports by the independent auditor. During this transition period, the Commission should encourage investment advisers to go through an internal process to identify the pertinent controls and make an internal assessment of those controls. The effort to identify, document, and assess the pertinent controls can itself be a significant and time consuming exercise. Additionally, we believe the implementation of this requirement would be more effective and efficient, if management had time to undergo such an initial process internally, prior to subjecting the controls to an examination by an independent audit firm. Accordingly, we suggest providing investment advisers twelve months to perform their initial internal assessment, and then requiring the initial internal control report for fiscal years beginning on or after twelve months after SEC approval of the final rule.

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D&T appreciates this opportunity to comment on the proposal. Our comments are intended to focus the Commission's attention on certain areas of the proposal that could be clarified or altered—without sacrificing any investor protection—as the proposal is finalized.

If you have any questions or would like to discuss these issues further, please contact Robert Kueppers at (212) 492-4241 or Brian Gallagher (617) 437-2398.

Very truly yours,

/s/ Deloitte & Touche LLP

cc: Mary L. Schapiro, Chairman
Luis A. Aguilar, Commissioner
Kathleen L. Casey, Commissioner
Troy A. Paredes, Commissioner
Elisse B. Walter, Commissioner

APPENDIX A

Below are control objectives that the Commission may wish to consider:

Custodial Operations Objectives:

1. New client accounts are authorized and established in accordance with client instructions in a complete, accurate and timely manner.

2. Modifications to client accounts are authorized and established in accordance with client instructions in a complete, accurate and timely manner.

3. New securities and changes to securities are authorized and established in a complete, accurate and timely manner.

4. Contributions and withdrawals to client accounts are authorized and processed in a complete, accurate and timely manner.

5. Trades are authorized, processed and recorded in accordance with portfolio guidelines and relevant account restrictions in a complete, accurate and timely manner.

6. Trades are settled in a complete, accurate and timely manner.

7. Valuations are received from an authorized source and recorded in a complete, accurate and timely manner.

8. Investment and dividend income is received from an authorized source and processed in a complete, accurate and timely manner.

9. Corporate actions are received from an authorized source and processed in a complete, accurate and timely manner.

10. Security positions and cash reflected in the portfolio accounting system are reconciled to the actual positions and balances held by custodians, including discrepancies being identified, researched and resolved in a complete, accurate and timely manner.

11. Account statements reflecting holdings and fair value are provided to clients in a complete, accurate and timely manner.

General Computer Control Objectives:

Information Security—(Logical, Physical, Environmental)

1. Controls provide reasonable assurance that logical security tools and techniques are configured, administered and monitored to restrict access to programs, data, and other information resources.

2. Controls provide reasonable assurance that physical access restrictions are configured, administered and monitored to ensure that only authorized individuals have the ability to access or use information resources.

3. Controls provide reasonable assurance that information resources are protected against environmental hazards and related damage.

Change Management—(Network, operating system, database (tables), applications)[1]

1. Controls provide reasonable assurance that new and modified network, system software, applications and database structures are authorized, tested and approved by management, and implemented in a complete, accurate and timely manner.

Computer Operations—(Batch processing, backup and recovery, problem management)

1. Controls provide reasonable assurance that programs and jobs are authorized, scheduled and executed in a complete, accurate and timely manner.

2. Controls provide reasonable assurance that all production programs needed to process batch and online transactions and related reports are executed and monitored timely and to normal completion.

3. Controls provide reasonable assurance that data is backed up, retained and can be restored to prevent the loss of key financial information.

4. Controls provide reasonable assurance that processing incidents are identified, tracked, recorded, and resolved accurately, completely and in a timely manner.

[1] It is preferable to break these down into separate objectives. This is especially true if the service organization does not follow a single change management process.

APPENDIX B

The proposal states that the independence of the public accountant would be measured against the standard articulated in Rule 2-01(b) and (c) of Regulation S-X.[1] We recognize that addressing the independence rules in this area raises issues that apply more broadly than simply in the investment adviser context. Therefore, our comments below also are relevant for application of the rules generally to investment company complexes. It is necessary to address these issues more broadly because investment advisers are included within the independence rules, in large measure, through operation of Rule 2-01(f)(4)(iv), which specifies the tests for determining whether entities within an investment company complex will be deemed "affiliates" of the audit client. We believe that it is important for the SEC to clarify the application of its independence rules in relation to these investment advisor requirements.

***Background*—**In its 2000 independence rulemaking, the SEC proposed a definition of investment company complex that was "based on ISB Standard No. 2 [which] defines 'mutual fund complex' to mean the mutual fund operation in its entirety, including all the funds, plus the sponsor, its ultimate parent company, and their subsidiaries."[2] ISB No. 2, in its definition of mutual fund complex, did not include investments held by mutual funds (i.e., "portfolio companies"). In addition, as noted in footnote 2 to ISB No. 2, the "independence restriction further extends to any parent company to which the investment advisory fees from the client funds are material, and to all other subsidiaries of those covered parent companies." ISB No. 2 also included a diagram of the mutual fund complex. Significantly, the SEC's proposed rule in 2000 did not expand the definition of mutual fund or mutual fund complex beyond that set forth in ISB No. 2, so as to include the companies in which funds invested or "portfolio companies" or parent companies to which an advisor is immaterial. Similarly, the SEC's proposed rule included a diagram that depicted the entities within the investment company complex, and, consistent with the diagram in ISB No. 2, the SEC's diagram did not include portfolio companies held by a fund in the investment company complex and did not propose expanding the investment company complex to parents of an investment adviser to which the adviser was immaterial. In addition, it is worth noting that the SEC's proposed definition of the investment company complex was a stand-alone concept to identify an audit client and its affiliates in the investment company complex context. The SEC's proposal included a separate provision that addressed how to evaluate whether an entity is an "affiliate of an audit client" in situations other than those involving investment company complexes.[3]

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1 SEC Release IA-2876, at 8 n.12.

2 Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. 43,147, 43,181 (proposed July 12, 2000) (citing to Independence Standards Board Standard No. 2, *Certain Independence Implications of Audits of Mutual Funds and Related Entities* (Dec. 1999) ("ISB No. 2").

3 *Id.* at 43,159.

The SEC's final rule included several modifications that merit discussion. First, the SEC stated in its final rule release that "we have adopted in rule 2-01(f)(14) a definition of investment company complex that is more limited than the one proposed. As adopted, the SEC's rule only includes an entity under common control with the adviser if the entity provides services to an investment company in the investment company complex."[4] The SEC also clarified that it "added a new section to the definition of 'affiliate of an audit client' [which] . . . provides that when the audit client is part of an investment company complex, each entity in the investment company complex is an 'affiliate of the audit client.' In this respect, we are following the ISB's Standard No. 2, 'Certain Independence Implications of Audits of Mutual Funds and Related Entities.'"[5] Based on this language in the final release, several conclusions can be drawn. For one, it is reasonable to conclude that for purposes of evaluating whether an entity within an investment company complex is an "affiliate," in those situations where a portfolio company is not providing services to an investment company (e.g., a mutual fund), the portfolio company should not be viewed as within the investment company complex. In addition, because the SEC stated in its final release that it intended to follow ISB No. 2 for purposes of evaluating whether an entity within an investment company complex, it is reasonable to conclude that the SEC does not intend that a parent entity to which the investment adviser is immaterial should be included within the investment company complex.

The final SEC rule also stated, "[a]fter considering the comments on this issue, we have decided to *adopt this provision substantively as proposed, but to move it* to the definition of 'affiliate of the audit client' to make its purpose and effect clearer."[6] This guidance in the final release is important because it clarifies that the SEC did not intend the first three prongs of the "affiliate" definition—the control and significant influence prongs—to apply in the context of evaluating affiliates of investment company complexes.

***Recommended Clarifications*—**Based on the foregoing, we believe that the Commission should clarify that:

- The SEC adopted ISB No. 2 as it related to investment company complexes excluding: (1) portfolio companies held by funds; and (2) parents of immaterial advisers.

- The SEC's movement of the definition of investment company complex to "affiliate of the audit client" was not intended to expand the definition of investment company complex to encompass the other prongs within the SEC's definition of "affiliate of the audit client."

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4 Revision to the Commission's Auditor Independence Requirements, 65 Fed. Reg. 76,007, 76,063 (Dec. 5, 2000).

5 *Id.* at 76,060.

6 65 Fed. Reg. at 76,060.

- Other entities under common control with the investment advisor should not be included in the investment company complex unless they provide services to the fund.