SIFMA
Securities Industry and Financial Markets Association

July 28, 2009

BY EMAIL TO: **rule-comments@sec.gov**

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

Re: **File No. S7-09-09**
Proposed Amendments to Rule 206(4)-2, Investment Advisers Act Custody Rule

Dear Ms. Murphy:

The Asset Management Group ("AMG") of the Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on the U.S. Securities and Exchange Commission's proposed amendments to Rule 206(4)-2 (the "Rule") under the Investment Advisers Act of 1940 (the "Advisers Act") regarding custody of client funds and securities by investment advisers.[2] We recognize that the proposed amendments reflect the Commission's desire to enhance the protection afforded advisory clients' assets under the Advisers Act in response to recent fraudulent conduct involving misappropriation and other misuse of investors' assets.[3] SIFMA commends and supports the Commission's efforts in seeking to improve protections of client assets.

We note for the Commission's information that, like the AMG, another group of SIFMA, constituting the Private Client Legal Committee (the "PCLC"), submitted a letter in which it comments on the Rule Proposal (the "PCLC Letter"). Each of the letters reflects the comments and concerns of the group submitting the letter. The two letters overlap in only limited areas and, in an effort to assist the staff in its review of the letters in a time effective manner, we have identified those areas of overlap in this letter.

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[1]SIFMA brings together the shared interests of more than 600 securities firms, banks and asset managers locally and globally through offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. The AMG currently represents 45 major asset management firms as well as 15 custodians and information vendors. Its investment firms have combined assets under management in excess of $20 trillion. AMG member firms are also admitted to membership in SIFMA. The AMG formulates proposed guidelines to enhance industry practices and also regularly conducts educational events that assist industry leaders and regulators regarding the implementation of new rules and standards in the global financial markets. Current AMG activities include reviewing regulatory reform proposals in light of the financial crisis and coordinating efforts related to those proposals with SIFMA to foster the interests of institutional investors. More information about SIFMA is available at http://www.sifma.org.

[2]Custody of Funds or Securities of Clients by Investment Advisers, Investment Adviser Act Release No. 2876, 74 FR 25354 (May 27, 2009), available at http://sec.gov/rules/proposed/2009/ia-2876.pdf (the "Rule Proposal").

[3]Rule Proposal at 25355.

Throughout its release in which it describes the proposed amendments to the Rule (the "Rule Proposal"), the Commission asks for comment on the terms and conditions that would be added to the Rule if the Rule Proposal is adopted. The AMG appreciates the Commission's request in this regard because, in our view, although the desired purpose of the Rule Proposal is quite laudable, some of those terms and conditions would prove difficult and costly to implement while providing only a small amount, if any, of additional protection of the assets of clients of investment advisers registered under the Advisers Act. In particular, we believe that the scope of the Rule Proposal is overly broad and would unnecessarily burden investment advisers that have only limited access to client assets or that already undergo annual audits. In addition, certain provisions of the Rule Proposal could be revised to achieve the Commission's client asset protection objectives in a more cost effective manner.

Our comments and recommendations on the Rule Proposal are set out more fully below in two sections. The first section addresses the scope of the terms and conditions of the Rule Proposal and the second section describes our comments on specific terms and conditions.

Scope of the Proposed Amendments

Under the Rule Proposal, the Commission would, among other things, require registered investment advisers having "custody" of client assets within the meaning of the Rule, as amended, to undergo an annual surprise examination conducted by an independent public accountant to verify that the adviser has custody of those assets.[4] In proposing to adopt this surprise examination requirement, the Commission stated that such an examination "would provide 'another set of eyes' on client assets, and thus additional protection against their misuse."[5] According to the Commission, the examination also could "identify misuse that the clients have not, which would result in earlier detection of fraudulent activities and reduce resulting client losses."[6] In our view and experience, "custody," as the term would be defined in the Rule as amended, would be overly broad for the purpose intended by the Rule. We question in particular the need for advisers with "deemed custody" of assets or for those that provide services to pooled investment vehicles that are audited at least annually and that distribute audited financial statements to investors in the vehicles to meet the terms and conditions of the Rule, as amended.

1. Deemed Custody

Under the Rule Proposal, "custody" is defined to include instances in which a registered investment adviser has authority to withdraw, upon instructions to the custodian, advisory fees from client accounts. The Rule, as amended, would provide in effect that such a registered investment adviser has "deemed custody" of its clients assets and would be subject to the surprise examination requirement. In the Rule Proposal, the Commission asks specifically whether an adviser that has deemed custody should be excepted from the surprise examination requirement.[7] We believe that the answer to this question clearly is "yes."

[4]Rule Proposal at 25356.
[5]Rule Proposal at 25356.
[6]Rule Proposal at 25356.
[7]Rule Proposal at 25356.

a. Advisers with Deemed Custody Should Be Excepted from Surprise Examinations.

As does the PCLC in its letter, we submit that application of the surprise examination requirement to a registered investment adviser with deemed custody is unnecessary to achieve the Rule's intended goal and would only increase costs and complexities in the operation of such an adviser. Deemed custody does not involve the type of holding of client funds and securities that the Rule Proposal is intended to oversee. The Commission states that the proposed amendments to the Rule are intended to decrease the likelihood that customer assets are misappropriated or otherwise misused.[8] Advisers with deemed custody, however, typically have only limited control of client assets, such control reflecting only the authority to buy and sell investment instruments on behalf of client accounts. All transactions in securities and other instruments undertaken on behalf of a client must settle in the name of the client, so it would be quite difficult for an adviser with deemed custody on its own to misappropriate or otherwise misuse client assets.

Application of the surprise examination requirement to an adviser having deemed custody seems to us inconsistent with the rationale that the Commission has articulated for considering an adviser with the authority to debit advisory fees from client accounts to have "custody" of client assets for purposes of the Rule. The Commission recognized in proposing and adopting amendments to Rule 206(4)-2 in 2003 that deemed custody should be considered custody within the meaning of the Rule only to a limited extent.[9] In the release adopting amendments to the Rule that year, the Commission indicated that the concept of deemed custody used in the Rule was intended to result in a client's receiving account statements at least quarterly so that the client could "confirm that the adviser has not improperly withdrawn amounts in excess of its fees" to the client.[10] That is, by deeming an adviser with the authority to debit its fees from clients' advisory accounts to have custody of those accounts for purposes of Rule 206(4)-2, the Commission appears to have been attempting to ensure that either (1) the adviser would provide periodic (at least quarterly) account statements to clients, subject to the adviser's undergoing a surprise examination by an independent public accountant at least annually, or (2) the adviser's qualified custodian would provide such statements at least quarterly to clients. Either procedure would allow the client to confirm the amount of advisory fee payments made with respect to the client's account with the adviser. The Commission also indicated that requiring an adviser with deemed custody to provide periodic account statements to clients under Rule 206(4)-2 would relieve the adviser of the burden of complying with alternative procedures for protection of client assets set out in a series of no-action letters issued by the staff of the Commission.[11] The Commission offers no explanation in the Rule Proposal as to why the logic underlying the deemed custody provisions set out in the 2003 amendments to Rule 206(4)-2 no longer seems to apply. We contend that the logic made sense in 2003 and continues to make sense now.

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[8]Rule Proposal at 25355.

[9]Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2176, 68 FR 56692, 56693 n. 12 (Oct. 1, 2003) ("2003 Adopting Release"). "[A]n adviser that has 'custody' for purposes of rule [sic] 206(4)-2 may not necessarily have custody for other purposes." *See also* Staff Responses to Questions About Amended Custody Rule, Question II.5 (updated January 10, 2005), available at http://www.sec.gov/divisions/investment/custody_faq.htm.

[10]2003 Adopting Release at 56693.

[11]Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2044, 67 FR 48579, 48581 n. 23 (July 25, 2002).

We recommend excepting from the proposed surprise examination requirement of Rule 206(4)-2 an adviser that is deemed to have custody of client assets solely because it has the authority to deduct advisory fees from clients' accounts upon instructions to the custodian. This approach would relieve an adviser that is deemed to have custody of client assets under Rule 206(4)-2 solely to facilitate its clients verifying the appropriateness of fee withdrawals from a surprise examination intended to enable clients to assess whether their assets are appropriately held on their behalf. The approach contemplates that an adviser having deemed custody would remain subject to the provision of Rule 206(4)-2 requiring that it have a reasonable basis for believing that its qualified custodian had sent the adviser's clients account statements at least quarterly. As a result, a client of an adviser with deemed custody would continue to receive periodic (at least quarterly) account statements from the qualified custodian that would allow the clients to confirm the appropriateness of advisory fees charged, as intended by the amendments to Rule 206(4)-2 adopted in 2003.[12]

b. Other Means to Protect Client Assets Subject to Deemed Custody

Under the Rule Proposal, a surprise examination would serve as the means through which a client of a registered investment adviser having the authority to deduct its fees from the client's account could assess the appropriateness of the fees deducted. We submit, however, that at least two other means, described below, could be used to verify appropriateness of such fees without the costs and administrative burdens accompanying surprise examinations.

i. Express Limitations on the Types of Withdrawals that an Adviser May Make

One alternative to a surprise examination in the case of deemed custody would be to require that the adviser have a written advisory agreement with the client permitting withdrawals by the adviser only for payment of fees and certain related expenses.[13] Such a provision would grant the adviser the authority to withdraw its fee while explicitly limiting the scope of the advisor's authority with respect to the client's account. Such a withdrawal limitation would not limit the ability of an adviser with discretionary authority over a client's account to enter into investment transactions on behalf of the client.

ii. Self Certification

A second alternative to a surprise examination in the case of deemed custody was suggested by statements by the Commission's staff at which the Commission considered the Rule Proposal. In his statements during that meeting, Robert Plaze, Associate Director in the Commission's Division of Investment Management, noted that surprise examinations of advisers having deemed custody would likely focus on fee calculations. According to Mr. Plaze, the surprise examination "would allow the third-party auditor to determine that the amount of the fee that is recorded on the books of the adviser is

[12]Under the Rule Proposal, advisers would not be permitted to send periodic statements to their clients.

[13]Such expenses could include, for example, registration fees in foreign markets, registration/listing fees paid by the adviser on the client's behalf if the client sells privately held securities, and foreign taxes/value-added taxes paid on behalf of the client by the advisor.

consistent with the books of the custodian, and confirm that the amount of the fee that is deducted is that which the client understood was deducted."[14]

We believe that, if the primary objectives of a surprise audit of an adviser having deemed custody are indeed to verify the amount of advisory fees charged and ensure that the client has been informed of that amount, those objectives could be achieved through self certification by the adviser. We submit that self certification would be a less burdensome process than a surprise examination, which, as noted above, appears to be aimed at verifying that client assets continue to be held in an appropriate manner, not at whether the appropriate amounts of advisory fees have been withdrawn from client accounts.[15]

Under a self certification procedure, an adviser would reconcile the fees shown on its records as charged to clients with the fees reflected in the custodian's records. Designated personnel of the adviser would perform the reconciliation according to written policies and procedures that the adviser would develop and adopt. An officer of the adviser could then provide, at least annually, a written certification that he or she had: (1) reviewed the policies and procedures for fee calculations and reconciliations and determined that testing of them by designated personnel had occurred; (2) considered reports, if any, from designated personnel of any deficiencies in such policies, procedures and testing resulting from the testing process; and (3) verified that designated personnel had taken actions to address any deficiencies. The adviser would provide access to the staff of the Commission upon request to the information received from the custodian should the staff wish to confirm the accuracy of the self certification. In addition, advisory clients would receive, as described above, quarterly account statements from the custodian showing advisory fees charged, allowing the clients to verify the accuracy of such fees.

2. Pooled Investment Vehicles

We believe that registered investment advisers that provide services to pooled investment vehicles that are audited at least annually and distribute audited financial statements to investors in those vehicles should be excepted from the surprise examination requirement set out in the Rule Proposal. Although the reconciliation is not in the auditor's final report, as part of the auditing process, the auditors reconcile client assets reflected in the records of the adviser with the holdings of the custodian. The purpose of the surprise examination requirement is to verify client assets in the "custody" of the adviser by reconciling the records of the adviser with a review of the assets held by the custodian. In undertaking the audit of a pooled investment vehicle, the auditors undertake a similar reconciliation. Although that reconciliation is not a part of the report provided by the auditor, it would seem to us an appropriate substitute for the surprise examination.

If the Commission determines that the annual audit in its current form is not an appropriate substitute for a surprise examination, in our view, the Commission, rather than imposing a separate surprise audit examination on advisers of these vehicles, should enhance the audit requirement now

[14]Statements of Robert Plaze, Associate Director, Division of Investment Management, U.S. Securities and Exchange Commission, Open Commission Meeting (May 14, 2009) *quoted in SEC Proposes Custody Rule Amendments: Thousand of New Adviser to be Subject to Surprise Examination Requirement*, ACA Insight, p.1 available at www.iminsightnews.com (May 15, 2009).

[15]As discussed more fully below, the AMG believes that pooled investment vehicles should be excepted from the surprise examination requirement. Alternatives to surprise examinations for advisers with deemed custody would not be necessary for pooled investment vehicles if they are excepted from the surprise examination requirement entirely.

included in the Rule to mandate that the independent public accountant performing the audit verify the positions that the adviser holds at year-end. Such an enhancement would result in pooled vehicles not registered as investment companies under the Investment Company Act of 1940 (the "1940 Act") becoming subject to a requirement similar to that imposed on 1940 Act registered companies.[16] If, as would be the case under our proposal, the annual audit included confirmation of custody of client assets and the audit results were distributed to investors in the pooled investment vehicles to review, a surprise examination, we believe, would be unnecessary to achieve the Commission's goal of protecting client assets for at least two reasons. First, the results of the surprise examination would be reported to the Commission, rather than investors in the vehicles who would be in a better position to verify custody of their own assets. Second, a surprise examination would add costs, which likely would be burdensome, both in terms of financial resources and in terms of the time spent by the adviser's personnel in responding to surprise examinations, with little or no benefit to clients from the perspective of protecting their assets.

3. Custody by Related Persons

We agree with the view articulated in the PCLC Letter that a related person's holding of assets over which an adviser exercises discretion should not be the only basis for deeming the adviser to have custody of those assets. We submit that the PCLC Letter sets out reasoned comments on why custody on the part of the adviser should not be presumed in such circumstances and proposes an appropriate framework for addressing when an adviser should be deemed to have custody of client assets held by a related person.

Comments on Specific Provisions

1. Surprise Examinations

a. A Surprise Examination of Advisers that Have Custody of Client Assets is Unnecessary to Verify that those Assets are not Being Misappropriated or Misused.

In the experience of the members of the AMG, surprise examinations of the sort contemplated by the Rule Proposal provide only a very limited amount of protection for the assets of clients of registered investment advisers. Advisers such as AMG members typically have in place organizational structures and functions that are designed to minimize the risk that client assets will be misappropriated or misused. Front office personnel, primarily those who interact directly with clients and manage clients' assets, generally are separate from, perform different tasks from, and have separate reporting lines for supervisory purposes from, those personnel responsible for reconciling the adviser's records with those of custodians. Designated personnel, such as those who are responsible for internal audit or risk management, typically review reconciliations of the adviser's records with those of the custodian. This division of responsibilities and functions among adviser personnel with respect to clients and their assets

[16] *See* Section 30(g) of the 1940 Act, which generally requires that a financial statement included in an annual report that a registered investment company must file with Commission or provide to shareholders contain a certificate from an independent public accountant. The certificates must be "based upon an audit not less in scope or procedures followed than that which independent public accountants would ordinarily make for the purpose of presenting comprehensive and dependable financial statements."

makes it very difficult, as a practical matter, for any single employee or group of employees of the adviser on their own to misappropriate or misuse client assets. Imposing a surprise examination on advisers structured, as AMG members typically are, in such a manner as to make misappropriation or misuse of client assets unlikely, would, we believe, provide little, if any, asset protection benefit to clients while subjecting advisers to unnecessary examination costs.[17]

b. The Proposed Surprise Examination Would Not Provide the Intended Protection of Client Assets and Would Be Overly Burdensome.

The Commission's proposed surprise examination requirement would seem to reflect the conclusion that conducting an unannounced custody review at a different time each year would provide additional protection of the assets of investment adviser clients. In our experience, a surprise examination would not in practice provide such protection, but would instead increase greatly the burden on an advisers subject to such an examination. An important component of a custody examination relating to an adviser would likely be what is referred to as a "vault examination." Such an examination typically would be performed as part of a year-end audit and include confirmation of settled positions in the custodian's "vault,"[18] as well as any unsettled securities transactions and outstanding derivatives, such as futures, swaps, options and currency trades, including collateral, held by multiple counterparties to those transactions and derivatives.

Well planned and executed vault examinations require extensive coordination among the adviser, auditor, custodian and counterparties for all open and unsettled positions in advance of the commencement of a year-end audit. Advance coordination would not, however, be possible in the case of a surprise examination, raising significant logistical challenges in trying to ensure that the examination: (1) is performed appropriately and (2) delivers an accurate report. While the reporting and reconciliation of positions held by a custodian are relatively straightforward and automated, the reporting by counterparties often is not standardized and requires manual reconciliation efforts. The operational burdens of performing any vault examination are already significant; a surprise vault examination would tend to magnify those burdens because of the inability to coordinate various aspects of the examination in advance. In our view, the market is not currently equipped to handle unannounced, ad hoc, and sporadic requests from independent public accountants to confirm portfolio positions.

[17] AMG members typically are large organizations with multiple functional units subject to separate reporting lines, as described above. We recognize that smaller registered investment advisers typically would not have such a separation of functions; personnel at small advisers may of necessity perform multiple roles. In our view, a smaller adviser could achieve the equivalent of separation of functions through other means and be appropriately excepted from the surprise examination requirement. The Commission could provide that a small adviser, in lieu of a surprise examination, obtain a fidelity bond from an unaffiliated third party under which the adviser's clients would receive reimbursement if the adviser misappropriated or misused client assets. In such a case, the economic interests of the third party would act as a catalyst to protect against misappropriation of assets.

[18] "Vault" includes the means used by a custodian to hold physical assets, as well as evidence the custodian has of assets held by third parties, including assets held in book entry form by entities such as clearing corporations.

c. Internal Auditors Could Perform the Client Asset Custody Examination According to Compliance Policies and Procedures Related to Protection of Client Assets, Supplemented by Certification by an Officer of the Adviser.

In the Rule Proposal, the Commission asks about "alternatives to the surprise examination that might provide similar protections."[19] One such alternative to what the Commission identifies would be to require advisers to adopt compliance polices and procedures to be administered by a registered adviser's chief compliance officer ("CCO") and to have the CCO provide periodic certification to the Commission that the adviser has in place policies and procedures intended to protect client assets. We believe that such a policies and procedures approach is desirable, but suggest that such an approach should have elements different from those outlined in the Rule Proposal.

Advisers such as those that are AMG members generally have appropriate controls in place to protect client assets from misappropriation or other misuse. In our experience, such internal policies and procedures provide effective protection of clients in a less burdensome, more cost effective manner than the proposed surprise examination. In our view, coupling those policies and procedures adopted by an adviser with periodic certifications to the Commission by a designated officer of the adviser that the adviser has in place policies and procedures reasonably designed to protect client assets would be a most effective means of protecting those assets.

We propose, in particular, that designated personnel of a registered adviser be required to provide the Commission with the results of an annual audit of client asset protection policies and procedures undertaken by an independent internal auditor. The internal audit report would summarize the adviser's policies and procedures for protecting client assets, discuss the results of testing performed to verify their efficacy, and describe any modifications that the designated personnel recommend be made to the policies and procedures as the result of such testing. The designated officer would then certify that the adviser has in place: (1) requisite policies and procedures with respect to protection of client assets, as modified, if at all, by designated personnel based on the auditors' recommendations; (2) processes to modify such policies and procedures as business conditions and regulatory changes dictate; and (3) processes to test periodically the efficacy of such policies and procedures. The designated officer's certification would be filed with the Commission annually. This approach, which is similar to the chief executive officer ("CEO") certification requirement applicable to a broker-dealer registered with the Commission under FINRA Rule 3130,[20] would help to ensure that the adviser has in place effective protections for client assets while relying on less expensive internal resources and avoiding surprise examinations that might be disruptive to the adviser's business.[21]

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[19] Rule Proposal at 25356.

[20] FINRA Rule 3130 requires the CEO of a broker-dealer to "certify annually … that the member has in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable FINRA rules, MSRB rules and federal securities laws and regulations, and that the chief executive officer(s) has conducted one or more meetings with the chief compliance officer(s) in the preceding 12 months to discuss such processes."

[21] We also recognize that a third party, such as The Depository Trust Company, could provide periodic verification of client assets to the Commission.

d. Supplemental Opinion of an Independent Public Accountant

Although, in our view, self certification of the sort described above would appropriately protect client assets subject to the custody of the adviser, we believe that, if the Commission determines that additional protections are warranted, supplementing self certification with an opinion of an independent public accountant with respect to the controls placed in operation relating to protection of client assets would provide such protections. Self certification coupled with verification by an independent public accountant would be, in our judgment, less burdensome and less costly than the proposed surprise examination.[22]

e. If the Commission Adopts a Surprise Examination Requirement to Verify Custody of Client Assets, It Should Be Limited to a Review of a Sample of Client Accounts.

Under the Rule Proposal, an independent public accountant would be required to verify annually by "actual examination" of the client accounts of a registered investment adviser that the adviser has custody of client assets.[23] We submit that it is unnecessary and unduly expensive to require verification of all client accounts. In our experience, a review of a sample that represents a cross section of client accounts, chosen at random by the independent public accountant, would be sufficient to protect clients from misappropriation or misuse of their assets. In our view, if a review of the sample confirms that client assets are being protected appropriately, little reason exists to believe that the adviser is engaging in misappropriation or misuse of client assets. A sampling approach to verification of client assets, moreover, would be less costly than reviewing all customer accounts. We estimate that the costs of conducting an examination of all such accounts would range from $8,000 to $275,000, depending on the size of an adviser. A narrower review by the independent public accountant should decrease the costs of such an examination significantly.

f. Examinations to Verify Custody of Client Assets Should not Involve Valuation of the Underlying Securities.

The Commission asks in the Rule Proposal whether the independent public accountant performing a surprise examination to verify custody of client assets should also test the valuation of securities held in custody by the adviser. We strongly believe that the answer to this question is "no."

Assessing how assets are held is a different function from valuing those assets. In addition, an adviser, particularly one that claims compliance with Global Investment Performance Standards,[24] may use different methodologies when calculating its performance record and its advisory fees. Broadening a surprise examination to include valuation of assets, moreover, would increase the cost of the examination. For these reasons, to the extent the Commission imposes a surprise examination requirement or some

[22]The Commission may want to consider requiring the auditor to represent, each time that it provides an opinion on the adviser's self certification, that it meets the independence standards of Regulation S-X, 17 CFR § 210 (2009).

[23]Rule Proposal at 25355-56.

[24]Global Investment Performance Standards are a set of voluntary, industry-wide, ethical principles that provide guidance to investment firms on calculating and reporting their investment results to prospective clients. The standards were created by, and are administered by, the CFA Institute, a not-for-profit association of investment professionals that, among other things, awards the Chartered Financial Analyst designation. *See* http://www.gipsstandards.org/index.html.

other type of examination to verify custody of assets for purposes of the Rule, the examination should not include any requirement as to valuation. The Commission should instead address any concerns it has about valuation of securities held on behalf of clients of registered advisers outside of the Rule Proposal, the focus of which is verification of an adviser's custody of client assets.

g. The Deadline for Filing Form ADV-E Should Be Extended for Funds of Funds.

The Rule Proposal specifies that an accountant that performs a surprise examination for purposes of the Rule would need to file Form ADV-E under the Advisers Act within 120 days of the commencement of the examination, rather than 30 days after its completion, as the Rule now requires.[25] The Commission provides no reason for this change. In our experience, a 120-day requirement would prove most challenging to meet for a hedge or private equity fund of funds, as such funds of funds would need, for purposes of the examination, to obtain information and documentation from the funds in which they invest, a time consuming process. As also noted in the PCLC Letter, the experience of our members indicates that the information-gathering process typically takes at least two and sometimes three cycles of requests to assemble the necessary information. A more practical deadline for filing Form ADV-E, in our view, would be 180 days from the date of the commencement of the examination.

3. SAS 70 Reports

a. Requiring a Registered Investment Adviser to Obtain a SAS 70 Report Relating Solely to Internal Controls Surrounding Custody of Client Assets is Unnecessary.

Under the Rule Proposal, the Commission proposes to require an adviser that maintains, or uses a related person[26] to maintain, client assets as a qualified custodian (as defined in the Rule) in connection with the provisions of advisory services would be required to obtain, or receive from the related person, an annual internal control report relating to the custody of client assets. That report would need to be received from an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB").[27] The Commission notes in the Rule Proposal that the accountant may, in connection with such a report, want to review, among other items: (1) safeguards against misappropriation of physical securities; (2) the accuracy and timeliness of the reconciliation of cash and securities positions between the custodian and depositories, and between the custodian and accounting systems; (3) whether client-initiated transactions include a record of the client's authorization and whether the transactions are recorded accurately in the client's account; and (4) whether documentation for account openings is received, authenticated and recorded accurately in applicable systems.[28]

The Commission asks in the Rule Proposal if the proposed SAS 70 report requirement would provide additional protection for clients and whether it makes sense to require both a surprise examination

[25]Rule Proposal at 25357.
[26]Proposed paragraph (c)(6) of Rule 206(4)-2 would define "related person" of an adviser as "any person, directly or indirectly, controlling or controlled by [the adviser], and any person that is under common control with [the adviser]."
[27]Rule Proposal at 25358-59. This type of audit is typically referred to as a "SAS 70" audit, which is a reference to applicable accounting rules.
[28]Rule Proposal at 25359.

and a SAS 70 report. We note, as a preliminary matter, that the AMG regards obtaining a SAS 70 report assessing internal controls, including control with respect to protection of clients assets, generally to be a best practice on the part of an Advisers Act-registered investment adviser. Nevertheless, we see no policy reason to impose a SAS 70 report requirement on a registered investment adviser if the adviser is subject to a surprise examination requirement. The proposed SAS 70 report generally would involve an auditor's reviewing or assessing internal controls and not assessing whether client assets are being protected from misappropriation or misuse from an adviser. A SAS 70 report, therefore, would not seem to assist in achieving the stated policy goals of the Rule Proposal and, in any event, would be unnecessary if the Commission adopts an examination requirement, the stated goal of which is to verify custody of client assets.

To our minds, the cost to a registered adviser that is subject to a surprise examination of obtaining a separate SAS 70 report, particularly in light of what we see as the very limited, if any, additional protection that such an audit would provide to investors with respect to protection of client assets, would outweigh its benefits. The Commission staff estimates that the average cost for a SAS 70 report would be approximately $250,000 per year;[29] AMG members' experience, however, is that the amount may be significantly higher in practice, depending on the size of the adviser. In many cases, the additional costs of a SAS 70 report would ultimately be borne by investors through increased fees charged by the affiliated prime broker/custodian.

If the Commission determines that a review of internal controls around a registered investment adviser's protection of client assets is necessary irrespective of whether it imposes a surprise examination requirement, we believe that appropriate measures could be adopted by the Commission as alternatives to a separate SAS 70 report referencing the effectiveness of controls relating to custodial services. If an investment adviser currently obtains a SAS 70 report, for example, the adviser could expand the scope of the existing SAS 70 examination, as necessary, to include controls over the protection of client assets to meet the terms and conditions of the Rule, as amended. If, on the other hand, an investment adviser or related person does not currently obtain a SAS 70 report, the adviser could be required to obtain a controls attestation report under the AICPA Statements of Standards for Attestation Engagements section 501, "Reporting on an Entity's Control over Financial Reporting" ("AT 501") or an agreed-upon procedures report from an independent public accountant. The AT 501 standard establishes requirements and provides guidance for the performance of an examination of the design and operating effectiveness of an entity's internal control over financial reporting that is integrated with an audit of financial statements. The report produced by the independent public accountant could include an opinion on the effectiveness of the entity's internal controls. An agreed-upon procedures engagement would result in the issuance of a report of findings based on specific procedures performed on a subject matter. In this case, the scope of the review could be customized based on the adviser's or related person's roles and responsibilities with respect to custodial services. The independent public accountant would not perform an engagement or review and the engagement would not culminate with the issuance of an audit opinion, but the report would contain all of the procedures and findings resulting from the testing performed by the independent public accountant. The AT 501 or agreed-upon procedures alternatives would, in our view, meet the Rule Proposal's intended objective while providing a more cost effective solution than the SAS 70 report.

[29]Rule Proposal at 25365.

b. The Proposed Amendments Should not Apply to Offshore Funds.

By virtue of applying to all Advisers Act-registered investment advisers having custody of client assets, the Rule Proposal would, if adopted, cover, among other things, a fund formed under the laws of a jurisdiction other than the United States that utilizes a custodian affiliated with a registered investment adviser that serves as an investment manager or sub-adviser to such a fund. Such coverage of the Rule as amended appears to us to be unintended because it would result in an independent public accountant having to verify assets held by a non-U.S. entity in a non-U.S. jurisdiction related to an investment vehicle that may not involve any U.S. investors. Foreign application of the Rule as amended also would force a non-U.S. custodian that is subject to home country regulation to subject itself to a SAS 70 examination. For all of these reasons, we believe that a registered investment adviser should be excepted from the surprise examination and SAS 70 requirements in connection with any non-U.S. fund advised by a registered adviser employing the services of a non-U.S. custodian affiliated with the adviser.

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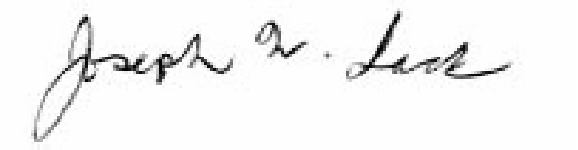
The AMG very much appreciates the opportunity to comment on the Rule Proposal and hopes that our comments are carefully considered by the Commission and its staff. If members of the staff have any questions regarding the topics discussed in this comment letter, they should contact the undersigned at 212.313.1165 (jsack@sifma.org).

Very Truly Yours,



Joseph W. Sack
Managing Director, SIFMA Asset Management Group

cc: Andrew J. Donohue, Director, Division of Investment Management, SEC
Robert Plaze, Associate Director, Division of Investment Management, SEC
Sarah Bessin, Assistant Director, Division of Investment Management, SEC