July 28, 2009

Ms. Elizabeth Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

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

Dear Ms. Murphy:

McGladrey & Pullen, LLP appreciates the opportunity to offer our comments on the proposed amendments to Rule 206(4)-2 under the Investment Advisers Act of 1940 and related forms. McGladrey & Pullen is a registered public accounting firm serving registered and non-registered investment companies. In the paragraphs that follow, we offer our overall comments and respond to certain questions set forth in the proposed rule.

Overall Comments

The proposed amendments would require a registered investment adviser to engage an independent public accountant to verify the client funds and securities for which the adviser has custody by actual examination on a surprise basis at least once annually and to obtain a written internal control report containing an opinion of an independent public accountant regarding the effectiveness of controls placed in operation over the custodial services performed by the adviser or a related person at least once annually. Although the proposed amendments make reference to the internal control report being issued in accordance with the standards of the Public Company Accounting Oversight Board (PCAOB) and footnote 8 of the proposing release indicates that the verification must be performed in accordance with U.S. Generally Accepted Auditing or Attestation Standards and the standards established by the Commission, the specific standards under which the verification of client funds and securities is to be performed and the internal control report is to be issued are unclear.

Since, under the proposed amendments, the services would have to be performed by an independent public accountant who is registered with and subject to regular inspection by the PCAOB, we believe these engagements should be conducted and reported on in accordance with the standards of the PCAOB. Specifically, we recommend that the examination of the client funds and securities for which the adviser has custody be performed in accordance with AT Section 201 (or, alternatively AT Section 101) of the PCAOB’s Interim Attestation Standards and that the report on internal control be performed in accordance with AU Section 624.41-56 of the PCAOB’s Interim Auditing Standards. To the extent that the procedures to be performed exceed those specified by the applicable professional standards (e.g., require a 100% examination or confirmation), those requirements should also be clearly set forth in the rule amendments rather than in the proposing release or other Commission releases.
We believe the cost estimate included in the release for the proposed rule amendments is significantly understated. The requirement to verify 100% of assets and owners’ accounts, the difficulty in doing so, the lack of definitive guidance as to the alternative procedures that would be required for nonreplies, and many other factors, including the sheer number of investments and owners in some of the larger investment vehicles, will all cause actual fees to significantly exceed the estimate included in the proposal.

**Requirement for Annual Surprise Examination**

*Would an annual surprise examination increase protections afforded to advisory clients, including pooled investment vehicles?*

We believe that an annual surprise examination will not significantly increase the protections afforded to advisory clients who invest in a registered or unregistered investment company that is subject to an annual financial statement audit, wherein the existence of assets and completeness of client account balances are tested for accuracy. Accordingly, instead of requiring an annual surprise examination, we recommend that all investment companies be required to undergo an annual financial statement audit. In situations where the advisory clients’ assets are held in individual or pooled accounts rather than in an investment company subject to an annual financial statement audit, we do recommend that an annual surprise examination be required.

We also recommend that the following rules and regulations be adopted to provide for increased protection for advisory clients:

- Investment managers must use non-affiliated custodians, broker-dealers, primary brokers, banks, futures commission merchants, etc. to custody and process investment transactions.
- Investment companies managed by registered investment managers must be audited by PCAOB registered accounting firms.

The remainder of our response letter assumes that annual surprise examinations will be required.

*Should we except from the surprise examination advisers that have custody of client funds or securities solely as a result of their authority to withdraw advisory fees from client accounts?*

Yes. Such advisers should be excepted from the proposed custody rules. We recommend that this exception be afforded to those advisers that maintain all investor funds with non-affiliated registered broker-dealers audited by accounting firms registered with the PCAOB and other approved custodians subject to similar oversight and regulations. This exception would allow small advisers to avoid the cost and administrative burden of the proposed regulations.

*Should the rule require surprise examinations to be conducted more frequently than annually or, alternatively, on a regular periodic basis, e.g., semi-annually?*

No. The custody verification should not be conducted more frequently than annually. Sufficient investor protection should result from the annual financial statement audit and one annual surprise custody examination.

*Should we continue to except advisers from the surprise examination requirement with respect to client assets held in pooled vehicles that are audited at least annually?*

Yes. As stated above we believe that an annual surprise examination will not significantly increase the protections afforded to advisory clients who invest in a registered or unregistered investment company that is subject to an annual financial statement audit, wherein the existence of assets and completeness of client account balances are
tested for accuracy. A secondary consideration is that there are administrative hurdles that would affect the effectiveness and efficiency of such examination procedures. The very nature of pooled vehicles closing their books and preparing financial statements on a monthly basis precludes the timely completion of surprise examinations. In addition, most investment companies (including pooled vehicles) typically do not account for their investor equity ownership in either number of shares or partnership units, but rather on a capital account basis. This would require the investment companies to effectively perform a complete financial statement close process, including valuation of all investments, etc., as of the examination date.

Guidance Regarding Surprise Examinations

Should we require an accountant to perform testing on the valuation of securities, including privately offered securities, as part of the surprise examination?

No. We feel that the focus of the surprise examination should be to test the existence of the assets rather than their valuation. Depending on the underlying investments, testing asset valuations can be very time consuming and we believe that the cost of testing valuations would, in most cases, exceed the benefits.

Should we require an adviser to certify a listing of funds and securities and client accounts that were examined by the accountant as part of the surprise examination?

Yes. We feel that the adviser should provide a listing of investments and client accounts to the accountant, accompanied by an assertion of the adviser that such listings are complete and accurate. As part of the examination, this listing should be reconciled to the underlying books and records by the accountant.

Are there any procedures currently required to be performed as part of the surprise examination that are no longer necessary? … For example, is confirming all client balances necessary to adequately protect investors.

In cases where the annual surprise examination is required, we believe that the auditor should be permitted to confirm a statistical sample of the assets and client account balances rather than confirming 100% of all assets and account balances. Based on our experience, when we apply audit sampling techniques to client account balances, we rarely receive sufficient signed confirmations. In addition, clients often indicate on their confirmation replies that they are simply confirming that the information agrees to the periodic statements that they receive from the investment advisers, but that they cannot confirm the true accuracy of such statements. If the auditor is required to perform alternative procedures for all confirmations that are not returned, the work effort involved if 100% confirmation is required would be significantly more than if a statistical sampling approach is permitted.

Commission Reporting

Should the term “material discrepancy” be defined or supplemented with guidance?

Yes. We feel that in order to achieve consistency of application, a standard definition and guidance should be provided.

Should we require the accountant’s certificate to be provided to clients or investors in pooled investment vehicles?

We recommend that such accountants’ reports be limited to filing with the Commission. Because the surprise examination procedures are specified by the rules, distribution of such reports should be restricted to the adviser and the Commission, and they should not be made available to investors because they did not agree to the sufficiency of the examination procedures.
Is 120 day reporting requirement reasonable for all types of advisers? If not, what time limit should we require for the surprise examination?

We believe that if audit sampling is permitted or if the confirmation process is limited to the existence of assets, the 120 day requirement would be achievable for most types of advisers. However, for those advisers that hold non-exchange traded instruments (derivatives, private company investments, loan participations) and that conduct trading with a large number of counterparties, the 120 day guideline may not be achievable.

Privately Offered Securities

We request comment on the feasibility of requiring that advisers obtain a surprise examination with respect to privately offered securities?

Because such advisers typically only enter into a few transactions with respect to privately offered securities in any given period, we do not believe that the surprise examination for such advisers will significantly enhance protection for advisory clients.

Internal Control Report and PCAOB Registration and Inspection

We request comment on whether we should require advisers that serve, or have related persons that serve, as qualified custodians for client funds and securities to obtain or receive an internal control report.

We believe that for registered broker-dealers and futures commission merchants that hold customer funds and securities, there are sufficient regulations, regulatory oversight, and required annual audit procedures in place to protect advisory clients.

However, we believe that if a qualified custodian is affiliated with the investment adviser, that an internal control report should be obtained.

Should we require that the independent public accountant that performs the surprise examination be a different accountant than the accountant that prepares the internal control report?

We believe that there is little or no benefit of having different firms perform these services, certainly not enough to outweigh the additional costs and administrative burden placed on the adviser. The knowledge that the accountant has of its client’s policies, procedures, and books and records provides for an efficient and effective execution of both engagements.

Independent Qualified Custodian

We request comment on the practical aspects of requiring advisers that have custody to maintain client assets with an independent qualified custodian. Would the requirement of using an independent qualified custodian result in greater costs?

We believe that the use of an independent qualified custodian provides better protection for advisory clients and would not result in significantly greater costs.
Costs

The Commission requests comments on all aspects of the cost-benefit analysis, including the accuracy of the potential costs and benefits identified and assessed in this release, as well as any other costs or benefits that may result from the proposals.

We believe that the average cost identified in the release is significantly lower than what the industry will actually experience. The effort to effectively plan, execute, and report results for a 100% surprise examination of both investments and ownership accounts would greatly exceed that estimate.

We would be pleased to respond to any questions the Commission or its staff may have about these comments. Please direct any questions to either Bruce Webb (515-281-9240) or John Hague (312-634-3354).

Sincerely,

McGladrey & Pullen, LLP

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