Pershing®
AN AFFILIATE OF THE BANK OF NEW YORK MELLON

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Via Electronic Filing

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

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

Dear Ms. Murphy:

Pershing LLC ("Pershing") appreciates the opportunity to comment on the Securities and Exchange Commission's (the "Commission") recent proposal to amend the rules applying to investment advisers who maintain custody of client assets. We agree that the Commission should take affirmative steps to protect investors from potential investment adviser fraud involving the misappropriation of client funds and securities. We believe, however, that the proposed amendments, particularly the proposed definition of "custody," could be better served by enhancing regulatory oversight and transparency and by leveraging existing practices in the marketplace. We are also concerned that the proposed amendments do not give due consideration to the substantial additional burdens the proposed amendments would place on broker dealer custodians that are already regulated by federal law and self-regulatory organizations ("SROs"). Accordingly, we respectfully urge the Commission to more narrowly tailor the proposed amendments to their intended purpose.

Pershing LLC

Pershing (member FINRA/NYSE/SIPC) is a leading global provider of financial business solutions to more than 1,150 institutional and retail financial organizations and independent registered investment advisers who collectively service approximately five million active investors with assets of over $715 billion. Located in 20 offices worldwide, Pershing and its affiliates are committed to delivering dependable operational support, including clearing and custody services, trading services, flexible technology, investment solutions and practice management support. Pershing is a member of every

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major U.S. securities exchange and its international affiliates are members of the Deutsche Börse, the Irish Stock Exchange and the London Stock Exchange. Pershing is a subsidiary of The Bank of New York Mellon Corporation and a broker-dealer affiliate of (and clearing firm for) Pershing Advisor Solutions LLC ("PAS") which provides services to unaffiliated investment advisers. Pershing also provides clearing and custodial services for two registered investment adviser affiliates, Lockwood Capital Management, Inc. and Lockwood Advisors, Inc., which provide services to Pershing's introducing brokers and PAS' investment adviser customers.

As a leading provider of securities clearing and custody services to more than 1,150 introducing brokers and investment advisers, Pershing can provide a unique perspective on the issues raised in the Proposing Release. Our affiliate, The Bank of New York Mellon, also has taken the opportunity to share with the Commission its perspectives on some of the issues raised by the Proposing Release for those investment managers who are affiliated with a bank that operates a large securities custody operation.

The Proposed Amendments

The Commission conducted a comprehensive review of the rules regarding the safekeeping of investor assets in response to a number of recent enforcement actions against investment advisers alleging, among other things, misappropriation of client assets.[1] The Proposing Release suggests two major changes to Rule 206(4)-2 under the Investment Advisers Act of 1940, as amended (the "Custody Rule") intended to address perceived shortcomings relating to the safekeeping of client assets.

First, the Commission proposes that all registered investment advisers who are deemed to have custody under the Custody Rule be required to submit to an annual surprise examination by an independent public accountant.[2] The surprise examination would be designed to verify the existence of client funds and assets held in the investment adviser's custody. According to the Proposing Release, the Commission believes such a surprise examination would provide "another set of eyes" on client assets, and perhaps detect misuse of funds or securities earlier than might otherwise be the case, reducing client losses.[3] Second, the Commission proposes to expand the definition of "custody" to include cases where a "related person" of an investment adviser "holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services" the investment adviser provides to clients.[4] In those cases, the investment adviser would have to obtain or receive from the related custodian, no less frequently than once per calendar year, an internal control report, which includes an opinion from an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB").[5] A "Type

1 Proposing Release, 74 Fed. Reg. 25354, at 25355.
2 Id.
3 Id. at 25356.
4 Id. at 25375.
5 Id. at 25358-9.

II SAS 70 Report" ("Report") conducted in accordance with PCAOB standards would satisfy this requirement.[6]

Enhanced Oversight Through Transparency

We are in general agreement with those commenters who believe subjecting investment advisers to a surprise annual examination solely because they have the authority to debit fees will impose undue costs on those advisers and custodial brokers without a corresponding benefit to investors. Indeed, the Proposing Release does not address the potentially significant costs that would be borne by custodial brokers as a result of this change. Generally, however, it is our position that investment advisers who are deemed to have custody by virtue of their ability to debit fees from client accounts should be exempt from the surprise annual examination requirement. Alternatively, the Commission may want to consider requiring clients to submit letters of authorization relative to the adviser's debiting of fees, either on a standing instruction or a per occurrence basis, with a "debit advice" being sent to clients by the custodian reflective of the fee in the form of a statement or other notification as a mitigating control. This control process, along with other risk control tools should be tested through annual (if appropriate) regulatory, risk-based exams, in lieu of the proposed annual surprise examination.

Further, the Commission may want to consider requiring that reporting be made to the Commission by the custodian reflective of the fees debited by the adviser as a percentage of assets under management on an overall or per account basis. Such reporting may serve as a framework by which the SEC can consider which advisers should be subject to more frequent or tailored regulatory examinations based upon the Commission's evaluation of overall risk. We believe, such reporting would result in the Commission having additional transparency, which would enhance investor protection, while eliminating the need for surprise examinations (for those advisors deemed as having "custody" under the Proposing Release).

Leverage Existing Practices To Enhance Controls

Generally, we urge the SEC to maintain and enhance the current regulatory scheme and exempt from the proposed amendment investment advisers that hold client assets with affiliated custodians, to the extent that they are regulated by the SEC or a recognized banking regulator. Specifically, with respect to broker custodians and their affiliated investment advisers, we believe that the respective regulatory oversight structures (including federal and state regulators and self-regulatory organizations) provide significant, adequate safeguards. Strong internal procedures at affiliated custodians and investment advisers also provide significant safeguards against malfeasance.

Broker custodians are subject to frequent and rigorous regulatory oversight and specific customer asset control requirements, such as Securities and Exchange Act of 1934 Rule 15c3-3. They are also subject to supervision, internal control rules and quarterly asset

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6 Id. at fn. 42.

verifications. Some broker custodians obtain a Report from a PCAOB accounting firm designed to analyze the safeguards that are in place at the broker custodian. We believe this Report should be mandated for all broker custodians, rather than requiring a mandatory control review and surprise audit of affiliated registered investment advisers. The mandatory PCAOB review should ensure that adequate controls exist to detect and mitigate against misappropriation of customer assets by the affiliated adviser. This should help protect investors while minimizing the impact of burdensome requirements currently proposed to broker custodian affiliated advisers.

In our experience broker custodians are rigorously examined and regulated. In fact, broker-dealers currently are reviewed every three years and larger firms (including Pershing) that custodize the majority of investment advisor assets in the marketplace, are examined annually. We generally support existing regulatory oversight and examinations of broker custodians and investment advisers by the SEC. We believe that the examination programs could be enhanced in terms of frequency and rigor that currently fall in line with SRO model guidelines, and as such, the SEC may consider sharing their regulatory responsibility with a SRO-model regulator (overseen by the SEC) to bring the examination framework in line with the concerns raised in the Proposing Release. Furthermore, a coordinated examination approach by the applicable regulators of both affiliated securities brokerage custodians and investment advisers could further enhance the existing safeguards. If the coordinated examination approach were implemented (in conjunction with the proposed requirement of a Report), we believe that there would be sufficient reporting and controls in place at the respective institutions.

The Crocker Standard

Under the Custody Rule, an adviser has custody when it holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them. Interpreting that standard, the Commission staff issued a no-action letter correctly stating that the question of whether an adviser has custody is a question of fact, and listing a number of factors that would be taken into consideration to determine whether an adviser has custody when an affiliated entity holds the client's assets pursuant to a custodial agreement.[7] Under Crocker, whether an adviser has custody of a client's assets by virtue of an affiliated company holding such assets depends on the following factors:

1) Whether clients' property in the custody of the affiliated company might be subject, under any reasonably foreseeable circumstances, to the claims of the adviser's creditors.
2) Whether advisory personnel have the opportunity to misappropriate clients' property.
3) Whether advisory personnel ever have custody or possession of or direct or indirect access to clients' property or the power to control the disposition of such property to third parties for the benefit of the adviser or its affiliated persons.

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

4) Whether advisory personnel and personnel of the affiliated company who have possession or custody of, or control over, or access to, advisory clients' property are under common supervision.
5) Whether advisory personnel hold any position with the custodian or share premises with the custodian and, if so, whether they have, either directly or indirectly, access to or control over clients' property.[8]

The Crocker factors are a well-tailored method of addressing the Commission's concerns about situations in which an investor's adviser and custodian are affiliated because they go to the heart of the matter -- does the adviser actually hold or have any authority to obtain possession of the client's assets? Yet the Proposing Release states that the Commission would withdraw Crocker if it adopts the proposed amendment.[9] In essence, the Commission proposes to replace the finely-tuned tool of fact-based analysis with the inaccurate presumption – one that is based on a premise that we believe misses the mark. We respectfully suggest the Commission reconsider its proposal and return to a standard based on the facts rather than create a "one size fits all rule" that will put advisers affiliated with broker custodians at a competitive disadvantage.

Administrative Costs

While we strongly disagree with the imposition of surprise and control audits of affiliated advisers with respect to surprise audits for advisers generally, we also believe that the "100% verification" standard is overly burdensome to both the adviser and broker custodian involved in the audit. In fact, we believe that sophistication of current auditing tools has evolved to a point where statistical sampling is deemed a credible methodology for determining the characteristics inherent in the larger population. We question if a surprise audit adds value if a reputable auditing firm is being engaged to conduct that review. Contemplating the number of investment advisers Pershing supports, it would be almost impossible for Pershing to comply with the administration relating to the proposed surprise examinations and such practices would be extremely disruptive to our business. In fact, we expect that broker custodians will incur significant costs as a result of the proposed changes. The Proposing Release does not attempt to quantify such commercial costs, or the benefits that could be better leveraged through existing auditing practices. We believe the Commission should refine its cost-benefit analysis by considering these factors.

Conclusion

Pershing understands and agrees in principal with the Commission's desire to enhance the rules concerning the safekeeping of investor assets. However, we encourage the Commission to examine more closely the unintended consequences and burdens of its proposal on the regulated entities. We generally support existing regulatory oversight and examinations of investment advisers by the SEC and respectfully request that the SEC leverage existing practices to enhance controls in our industry. Secondly, the

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[8] Id.

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

Commission should maintain the fact-based standard set forth in the Crocker no-action letter. Lastly, the Commission should more fully explore the administrative costs custodians will be forced to bear under the proposed changes.

We appreciate the opportunity to present our views on this very important topic and would appreciate the opportunity to meet with the Commission to discuss how the comments we describe could serve to enhance investor protection while providing a balanced approach to regulation. If you have any questions concerning these comments, please contact the undersigned at (201) 413-2807 or Claire Santaniello, Chief Compliance Officer, at (201) 413-2741.

Sincerely yours,

Garry Lischin
General Counsel
Pershing LLC