PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
400 Campus Dr.
Florham Park NJ 07932
Telephone (973) 236 4000
Facsimile (973) 236 5000
www.pwc.com

July 28, 2009

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

Re: Release No. IA-2876; File No. S7-09-09

Dear Ms. Murphy,

We are pleased to provide comments on the Securities and Exchange Commission's (the "SEC" or "Commission") proposed amendments to Rule 206(4)-2 under the Investment Advisers Act of 1940 (the Proposal), which governs the custody of client assets by registered investment advisers (RIAs).

The Proposal states that the amendments are designed to improve the safekeeping of client assets and would, among other things, require RIAs that have custody of client funds or securities to undergo annual surprise examinations by an independent public accountant to verify client funds and securities. In addition, the amendments require that, unless client accounts are maintained by an independent qualified custodian (i.e., a custodian other than the adviser or related person), the adviser or related person must obtain a written report from an independent public accountant that includes an opinion regarding the qualified custodian's controls relating to custody of client assets.

We support the objectives of the Proposal. We have included observations and recommendations below to assist the Commission in meeting its objectives and improve the operational and cost effectiveness of the proposed amendments.

We note that the proposed amendments would allocate a vast amount of resources to one specific area - the physical misappropriation and misreporting of securities owned - regardless of the potential risk of misappropriation, but would not address other potential schemes that may also harm investors. To address this, we recommend the Commission further consider the potential to utilize advisers' Chief Compliance Officers to provide enhanced safeguards of clients' funds and securities, a possible enhancement to Rule 206(4)-2 acknowledged by the Commission in the proposal.

Additionally, our observations and recommendations also reflect concerns about expanding security count requirements to a larger number of advisers without also revisiting the guidance in place for the performance of the counts, which as the Commission acknowledges in the release, has not been updated since 1966. Such an expansion would also require consideration of revisions to the Commission's independence rules to ensure that their literal application in certain situations would not result in restrictions to the adviser's ability to realize the benefits of efficiently utilizing independent public accountants for audit and non-audit services, including the surprise examinations required by the proposed amendments.

The following represent our observations and suggestions for further enhancement to Rule 206 (4)-2 to meet what we understand to be the Commission's goals. In these observations, we also address certain matters upon which the Commission requested comment in its proposing release.

Scope

The proposed amendments would expand security count requirements to a larger number of advisers without also revisiting the guidance in place for the performance of the counts, which as the Commission acknowledges in the release, has not been updated since 1966. As such, we recommend that the Commission revisit the existing guidance to ensure its continued relevance and applicability in light of the proposed amendments and the current economic environment. When doing this, we hope the Commission will continue to support the use of professional judgment in the application of the guidance by independent public accountants.

The Commission has proposed a requirement for surprise counts in all situations where an adviser is deemed to have "custody" under the Advisers Act, even when "custody" is based solely upon the adviser having the right to unilaterally obtain its fees from the client account. Prior to the 2003 custody rule amendments, the Commission permitted the use of an "independent representative" to approve the disbursement of fees as an alternative to a surprise count.

While we recognize the potential deterrent effect of a surprise audit, we believe that reinstating the use of an "independent representative" or a similar alternative, and having that person function in a safeguarding capacity for this purpose, would be a far more cost-effective method of providing assurance against misappropriation than a surprise audit.

We recommend that, in situations where advisers utilize an independent qualified custodian but still have the right to obtain fees from client accounts and/or have disbursement authority over client funds, the Commission provide the option for advisers to eliminate the surprise count requirement by obtaining an internal control report of the type contemplated for entities with custody of client accounts not maintained by an independent qualified custodian. This requirement should explicitly require the internal control reports to include tests of the operating effectiveness of controls directly related to the withdrawal and disbursement of funds from client accounts.

The Commission has also proposed eliminating the exception to the surprise count requirement for limited partnerships subject to annual audit under section 206 (4)-2(b)(3). While we understand the surprise count requirement will add additional comfort over the custody process, we question whether the benefit gained outweighs the cost of the additional examination.

We also question whether a true surprise count could be achieved, as many investment partnerships do not completely close their books on a daily basis, but only do so monthly or even quarterly, particularly those invested in highly illiquid private equity and venture capital securities. Thus, the times when a surprise audit could be most effective during a given year would seem to be limited, thereby making the timing of the surprise audit more predictable.

A more cost-effective solution may be to require that annual audits of limited partnerships include, as a required audit procedure, 100% confirmation of all period-end investment positions with appropriate counterparties, and that the performance of this procedure be specifically stated in the audit opinion, similar to investment companies registered under the Investment Company Act of 1940. This requirement, while still subject to the difficulties inherent in the utilization of confirmation procedures, would be more extensive than the current requirement under U. S. generally accepted auditing standards, would provide assurance comparable to that achieved for registered investment companies, and would leverage the annual audit to provide additional cost efficiencies.

Our clients frequently have had difficulty in defining "securities", thereby triggering the self-custody and examination provisions of Rule 206(4)-2. Under the Advisers Act definition in Section 202(a)(18), the word "securities" has been interpreted by counsel to include, for self-custody and examination purposes, many financial instruments either not negotiable or only negotiable after obtaining additional legal documentation, such as assignments, that cannot be redeemed at the holder's option either for cash or negotiable securities. Examples of such instruments include equity and debt of privately-held companies and many limited partnership interests.

In these cases, however, the instruments appear to carry virtually none of the risks of misuse the Rule was intended to address since they could not be re-sold. Their non-negotiability creates a significant impediment to their use as collateral for borrowings. Accordingly, we believe that non-negotiable securities should specifically be excluded from the Rule's application. This exclusion would have the particular benefit of substantially reducing, or even eliminating, the burden of the Rule's application on investment managers who are general partners of limited partnerships specializing in venture capital or other private equity investments where securities acquired typically are non-negotiable. This could be addressed by adding a definition of "securities" to the Rule along the following lines:

> "Securities" has the meaning of "Security" as stated in Rule 2 (a) (18) of the Act, except that, for purposes of this Rule, securities that are not negotiable and cannot be redeemed for cash or negotiable securities at the option of the holder are excluded.

In addition to the "self-custody" or related-party situations contemplated in the proposal, we recommend the Commission consider other situations that could constitute self-custody by an adviser and may warrant advisers obtaining internal control reports. Such situations may include instances where securities are physically held by an independent qualified custodian on an omnibus basis with the adviser maintaining detailed allocations of the positions to individual accounts. Because only the adviser, not the custodian, can prepare detail reports of positions and transactions by individual client, we believe this would result in a form of self-custody that should be addressed in the proposal.

Count Procedures

As the Commission noted in its Proposal, the primary guidance to accountants for the performance of securities counts, Financial Reporting Policies Section 404.01.(b) (formerly Accounting Series Release 103), *Nature of Examination and Report by Independent Public Accountants - Investment Advisers,* was issued in 1966.

At that time, central depositories (such as Depository Trust Company, or DTC) had not been formed and most securities held were physical certificates. "Passive" investment strategies replicating indices with potentially thousands of securities held (e.g., Russell 2000/3000) did not exist, nor was there significant investment in foreign securities on any basis, including index-replication strategies or in emerging markets. Most derivative instruments - even common ones such as exchange-traded equity options and interest rate futures - also did not exist.

Over time, accountants and advisers have found it increasingly difficult to apply the outdated provisions of FRP 404.01(b) to security counts. Updating FRP 404.01(b) is essential to support a substantial expansion of count requirements without widespread confusion on how to apply the rules, inevitably causing inefficiency, and likely inconsistent and ineffective performance. Additionally, we recommend coordinating changes in Rule 206 with similar requirements for other financial institutions, such as Rule 17f-1 and 17f-2 under the Investment Company Act of 1940 (SEC FRP 404.01a, formerly Accounting Series Release 27, issued in 1941). We believe the following areas are in particular need of review:

a. Currently, Funds and customer accounts invest in public and private securities, as well as numerous types of derivative investments. Derivative investments include instruments that may change between an asset and a liability during the holding period. Certain types of securities, such as loan participations or assignments, are represented by a contract, rather than either a physical or book entry security. In many cases, these and derivative instruments are not truly held by a qualified custodian and are usually tested by auditors by confirming the terms of the supporting agreement with the relevant counterparty (or by validating subsequent liquidations).

In some cases, funds may hold thousands of these instruments. Verification of such instruments with counterparties can be very time intensive and costly, as can follow-up and reconciliation of confirmations. Counterparties may not respond to confirmation requests in a timely manner, requiring auditors to perform alternative procedures, such as validating subsequent liquidations. Confirmations of foreign securities held by custodians in other countries can take additional time to receive and analyze due to differences in time zones and languages. Additionally, due to the surprise nature of the examination, advisers will be unable to plan and/or prepare confirmations in advance of the count date, unlike financial statement audits. As such, we recommend the Commission allow physical confirmations to be performed on a sampling basis using auditor judgment.

b. The requirement for positive confirmations from all active clients is also time-consuming and demanding of both accountant and adviser personnel, in both the preparation of confirmations and the follow-up and resolution of responses, particularly as major investment advisers may manage 1,000 or more individual client accounts. In our experience, common response rates are only 30-50% of confirmations mailed. This low response rate requires the independent public accountant to perform alternative procedures.

We recommend that the revised Rule permit independent public accountants to confirm annually on a positive basis a randomly selected sample of client accounts as of the quarterly statement date closest to the date of the surprise count. If the examination date is not the quarterly statement date, the accountants would also be required to test, on a sample basis, transactions in the accounts between the two dates.

Permitting the confirmation procedure to conform to a regular statement mailing would, we believe, improve both client familiarity with balances being confirmed and their responsiveness to the confirmation request. Further, by requiring a random sample, the adviser would be unable to determine which clients would be subject to confirmation and thus could not easily take steps to conceal a misappropriation.

c. With the common use of DTC, Federal Reserve, and other central depository facilities, custodians now rarely hold significant physical securities so that a "count and reconciliation" no longer is a physical count but simply an electronic matching of reported custody positions with adviser records. FRP 404.01.b seems to suggest that an auditor must inspect each position individually and ensure that it has been matched, or reconcile each difference. Auditors should be allowed to test these reconciliations, which have typically been performed by the client, by gaining assurance as to the proper functioning of the systems for their performance, rather than through individual inspection of each position.

As another alternative to the 100% confirmation requirement for active clients, we recommend the Commission consider eliminating the confirmation requirement when an Adviser obtains a SAS 70 Type II report (or alternative internal control report - see "Internal Control Reporting") covering controls relating to the custody of client assets and accounts. Such a report would include a description of the processes in place, the controls implemented, and related tests of their operating effectiveness. A SAS 70 Type II report will also include coverage of the general, entity level control environment and information systems controls.

PRICEWATERHOUSECOOPERS

Cost Analysis

An examination as contemplated by the Proposal must meet applicable professional standards. Any such engagement must be carefully planned, coordinated with the client, properly performed and documented, and finally reported to the appropriate body - in this case the Commission. It is not unusual for clients to manage hundreds or thousands of accounts, and also not unusual for a fund to have hundreds or thousands of positions. Accordingly, we believe the cost estimates for surprise counts identified in the proposal are unrealistically low and do not reflect fully the cost, particularly in terms of the time that will be needed to properly plan, coordinate, perform and document the counts.

Internal Control Reporting

The Proposal requires that a qualified custodian maintaining client assets, but who is not independent of the adviser, obtain at least annually an internal control report. This report would include an opinion from a PCAOB-Registered Accountant with respect to the internal controls related to custody of client assets. Such a report would typically follow the criteria set out in SAS 70 and cover both the design and operating effectiveness of relevant controls (Type II report).

While we support the Commission's objective in this area, SAS 70 Reports are designed for user auditors, not as a general attestation report. We recognize that the Commission only requires the adviser to obtain the report and maintain it within its records. However the proposed revisions to Form ADV explicitly includes a question as to whether the control report contained an unqualified opinion[1].

Since the response to that question will be publicly available, we believe clients and prospective clients of an adviser may ask to review the SAS 70 report (some may include this as a standard due-diligence procedure, particularly as a result of the events of the past year). We therefore question whether such a report is appropriate for this purpose given that the primary intended user is not clients and prospective clients. We believe a form of controls attestation report, potentially based on the AICPA Statements of Standards for Attestation Engagements section 101, "Attest Engagements" or AT 501 "Reporting on an Entity's Control over Financial Reporting", would be appropriate.

Independence

In its proposal, the Commission has questioned whether the independent public accountant that performs the surprise examination of client funds and securities in the custody or possession of an investment adviser should be different than the independent public

[1] Proposed revisions to Form ADV, Section 9(c), question 6.

accountant that issues the related report on internal control. We do not believe there is a need for two separate independent public accounting firms to perform this work for it to be effective. The requirement that the firm be independent is sufficient to assure objectivity in the performance of either or both assignments. The interrelationships that exist between the examination of internal controls relating to custodial services, including the safeguarding of funds and securities held on behalf of clients of the investment adviser and the surprise examination would seem to support this notion, i.e., that engaging one independent public accountant, who would have the benefit of seeing the "big picture," rather than two, would be the optimal approach.

Further, given the broad reach of entities that, under the SEC's independence rules, are considered to be affiliates of an audit client, combined with the need for independent public accounting firms to have business relationships with financial institutions to run their businesses (e.g., financing needs), there would likely be an adverse impact on market choices for larger investment advisers, limiting the availability of assurance and consulting services to such institutions in that two auditing firms, rather than one, would be required to be independent of these entities and their affiliates. For purposes of applying the affiliate rules, the Commission may also want to consider limiting the scope of entities that are deemed affiliates of the adviser for the fund (in the case of the "audit exception") for purposes of applying these rules. Since the adviser (or fund) is not itself an issuer, we believe that the entities for which the auditor should be subject to the independence requirements should be limited to the adviser (or fund) and any entities they control.

Impact on Other SEC Regulations and Other Regulatory Regimes

We recommend that the Commission consider the impact and interaction of the proposed amendments on other SEC regulations and other regulatory regimes. For example, broker dealers are already subject to customer asset-protection rules under SEC rule 15c3-3. Under these rules, customers' securities and cash are subject to extensive segregation and protection in "good control" locations as defined in that rule. These rules and their application have been the subject of amendment and interpretation for more than 30 years and recognize many of the unique aspects of broker dealer operations.

In addition, under SEC rule 17a-5, the requirements of auditors under the Commission's rules including 15c-3 are delineated. Amendments to and questions about these requirements are discussed with and vetted by the AICPA's Stockbrokerage and Investment Banking Expert Panel with regulatory, including Commission, personnel in attendance. If the Commission believes that changes to the audit requirements for broker-dealers are needed, they should be proposed and discussed in this venue.

We do not believe that surprise counts are economically efficient or reasonable for most clearing broker-dealers due to the large number of customers, control locations, and other counterparties including: stock borrow / loan; and repurchase and reverse repurchase transactions. We also note that broker-dealers are already required, under recent regulatory changes, to have a PCAOB-registered accounting firm.

Additionally, national banks, federal savings associations, and other U.S. banking institutions are subject to extensive regulation and oversight. These institutions must receive approval and authorization to obtain trust powers (12 USC 92), establish trust departments, and take custody of client assets. Under existing banking laws and regulations (12 CFR 9, 12 CFR 550), these institutions are required to establish controls over the custody and access of these assets. These controls include accounting records and internal controls to ensure that the assets of each custody account are kept separate from the assets of the custodian and maintained under joint control.

In addition, they are expected to have adequate internal control and systems in place to identify, measure, monitor, and control risks in the custody services area. These institutions are required to perform an annual vault audit and an audit of significant fiduciary activities, and are already subject to annual regulatory examinations and on-going oversight.

We recommend that the Commission consider, to the extent not previously done, the impact of this proposal on other SEC regulations and coordinating this proposal with other U. S. regulators to avoid imposing additional mandates that may substantially increase compliance costs but may not provide equivalent benefits regarding misuse under existing regulatory requirements.

Form ADV / Reporting

The following comments are in response to the questions in proposed Section 9.C. related to the independent public accountant.

> a. The proposed instructions state, "You must complete the following information for each independent public accountant *engaged* to perform a surprise examination, perform an audit of a pooled investment vehicle that you manage, or prepare an internal control report" (emphasis added). The instructions are unclear as to whether the adviser should identify the prior year or current year accountant, which may not be the same, and this should be clarified (with possibly both reported). Assuming that the Commission is referring to the current year accountant, we note nowhere in the proposal - particularly for a surprise examination - any explicit requirement to engage the independent public accountant before the commencement of the annual examination period; the only such requirement appears to be the sole word "engaged" in this heading, as, presumably, an accountant that has not been engaged should not be reported.

We recommend that the Commission provide explicit guidance that a) only independent public accountants for which a signed engagement letter for the current period has been executed should be reported in Section 9.C. and b) independent public accountants must be engaged to perform surprise examinations prior to the beginning of the annual examination period.

Also, late engagement of an independent public accountant to perform a surprise examination allows the adviser a degree of control over examination timing by reducing the potential examination period. This would serve to undermine the objectives of the proposed amendments by creating a time period where advisers might not be subject to surprise examinations, thereby reducing the effectiveness of the proposed procedures. We recommend that the Commission state whether it would consider any accountant not reappointed to perform a surprise examination by the beginning of the annual examination period to have been substantively terminated, and thus subject to the notification provisions proposed elsewhere in the release.

b. As discussed in the Count Procedures section of this letter, verification of investments with counterparties can be very time intensive. The proposed requirement for investment advisers to have an independent public accountant conduct the surprise examination and submit Form ADV-E to the Commission (accompanied by a certificate stating that it has examined the funds and securities and describing the nature and extent of the examination) within 120 days of the time chosen by the accountant for the surprise examination may not be feasible. If the SEC adopts this requirement, we recommend extending the timeline, perhaps to 180 days from the day the adviser is notified of the examination.

Valuation and Other

The Commission has also questioned whether the surprise count requirement should cover other aspects of investments, such as valuation. At this time, we do not believe such an expansion should be undertaken. While we recognize that mis-valuation of securities carries risk of fraud and has been an area of Commission enforcement action, valuation is also a highly subjective exercise, particularly for illiquid securities, such as private equity and venture capital securities, thinly-traded securities, and OTC derivatives.

In these situations, the adviser is likely to update valuations only on a period-end basis. Auditors would generally require valuation specialists to assist them in their examination procedures. The auditor would likely need to review client support for valuations, including models and fundamental data, and engage in extensive discussions with client personnel to gain or update their understanding of their valuation procedures. A "surprise" examination of valuations is thus virtually impossible, and would inevitably result in substantially increased costs. Further, for private investment vehicles, this work would clearly duplicate much of what is performed in annual financial statement audits.

However, the Commission suggested an alternative in its proposal which we support, namely greater involvement of the adviser's Chief Compliance Officer (CCO) in the attestation process. The Commission adopted regulations requiring investment advisers to adopt compliance programs and appoint CCOs almost simultaneously with the Commission's last amendments to the custody rules in 2003.

The CCO's continuing oversight of day-to-day operations, including valuation procedures, places the CCO in a much better position to evaluate overall valuation controls than an annual point-in-time examination. Further, a CCO is in a position to evaluate other compliance controls that would be impossible for an auditor to evaluate through a securities count or other examination of investment positions, such as controls to prevent misappropriation through inappropriate brokerage commission arrangements (including misuse of "soft dollars" or outright kickbacks), misallocation of investment opportunities to proprietary accounts, "churning" of portfolios to generate brokerage commissions, or deliberate acquisition of unsuitable investments in exchange for excessive commissions or improper inducements.

CCO attestation as to the adequacy of client controls and procedures thus could cover far more ground than expansion of "surprise" audit procedures, and has the potential to be more cost-effective. We recommend that the Commission consider how CCO attestation could be adapted to further the Commission's objectives in reducing these risks.

Transition Timeline

The proposal does not indicate any prospective effective date of a final Rule, nor information on how the Proposal would apply during a transition period. If adopted in its current form, a significant number of advisers who were not previously required to have such examinations will need to arrange for them. Moreover, accounting firms will need to assess their resources to adequately provide such services to a much larger segment of their current practices, as well as potentially assist advisers who are not currently clients with such services. Some accountants may require additional time to meet SEC independence requirements with respect to their adviser clients.

Annual Surprise Examination

Considering the above, we recommend that this requirement become effective no earlier than twelve months after passage of a final rule by the SEC.

PRICEWATERHOUSECOOPERS

Internal Control Reports
If a firm must have a first time internal controls examination, they may need a significant amount of time to prepare. We would suggest a similar date as we have noted above for the surprise examinations.

We are pleased to have had the opportunity to comment on this proposal, and we look forward to final Commission action in the near future. If you have any questions regarding the contents of this letter, please contact John R. Hildebrand at (973) 236-4993.

Very truly yours,

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP