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

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Proposed rule Custody of Funds or Securities of Clients by Investment Advisers
File No. S7-09-09

Dear Ms. Murphy:

Ernst & Young LLP is pleased to respond to the request by the Securities and Exchange Commission (the Commission or the SEC) for comment regarding the proposed amendments to the *Custody of Funds or Securities of Clients by Investment Advisers* under the Investment Advisers Act of 1940 and related forms (Proposed Rule or Proposal).

We support the objectives of the Proposed Rule and believe that amendments to Rule 206(4)-2 (the Rule) are necessary to enhance investor protection and provide the SEC with better information about custodial practices of registered investment advisers.

Under the current provisions of Rule 206(4)-2, registered investment advisers are required to comply with the safekeeping rules as defined in section 206(4)-2a, provided they do not meet the exemptions within section 206(4)-2b. We have reviewed the proposed amendments to the Rule and we believe that adding clarification to the Proposed Rule will facilitate consistent application and improve compliance with the Rule. The following are general comments with regard to the Proposed Rule and our suggestions for additional considerations to be evaluated by the Commission in finalizing the Proposed Rule.

I. Application and reporting

a. Scope

We recommend clarification of the Commission's reference to "client assets", as defined in Rule 206(4)-2(c)(1) as client funds or securities, in order to avoid inconsistent application of the Rule. Further guidance is needed as to whether the term "client assets" solely encompasses cash and securities or whether it includes receivables, payables, prepaid assets, securities sold short, not yet purchased, repo and reverse repo agreements, as well as collateral pledged and received for these contracts, derivatives, investments in fund of funds, real estate interests (partnerships or real assets), unfunded commitments etc. To achieve consistency in practice, we recommend enhancing the definition of "client assets" to be considered in the scope of a surprise examination.

The Commission has specifically asked for commentary on the feasibility of requiring advisers to include privately offered securities in surprise examinations. The proposed amendments do not address the nature of the procedures the Commission may expect the independent auditor to perform to verify the existence of securities that are not held with a qualified custodian (i.e. privately held/ issued securities, derivatives, fund of fund investments, real estate, etc). In many cases, such securities are not held by qualified custodians on behalf of clients, such that verifying their existence might require performing confirmation procedures with numerous parties, including issuers, borrowers or transaction counterparties. In performing such procedures, it is likely that not all confirmation requests would receive a response, which would require consideration of alternative procedures to obtain evidence relevant to existence.

Without additional guidance regarding the specific scope and nature of procedures the independent auditor would be expected to perform as part of a surprise examination, estimating the cost of a surprise examination with precision would be difficult. Such costs will be influenced by several variables including a strong correlation of the cost of the examination to the complexity of the client's operations (number of entities subjected to the surprise examination procedures, number and type of assets subject to examination, number of brokers/counterparties, number of brokerage/ trading accounts, number of investors, etc.). As discussed further below, we recommend the Commission provide additional guidance to better clarify its expectations regarding the nature and extent of procedures expected to be performed in a surprise examination, in particular whether privately held securities, and other assets not held by qualified custodians are included in the scope of the surprise examination.

We do not believe the Proposed Rule gives appropriate consideration to the possibility of performing surprise examination confirmation procedures on a sample basis. Under the current Rule and existing guidance in ASR 103, the scope for confirmation procedures is 100 percent. The Commission recognized in its *"2003 Adopting Release"* implementing the current Rule that *"the accountant must perform the examination in accordance with U.S. Generally Accepted Auditing or Attestation Standards"*. In accordance with AU section 326, *"Audit Evidence", and* AT section 601 "Compliance Attestation" whether forming the audit opinion or performing procedures to provide reasonable assurance of detecting material noncompliance, it is at the professional judgment of the independent accountant to determine the procedures to be performed and evaluate the sufficiency of the evidence. In determining the procedures to be performed and sufficiency of the evidence obtained, the practitioner is encouraged to consider the guidance contained in AU section 350, *"Audit Sampling"*.

In evaluating the appropriate extent of confirmation procedures to be performed, the independent auditor could consider, among other things, the design and operating effectiveness of controls designed to safeguard client assets. The auditor also could consider the materiality of different classes of client assets (based upon attributes such as par value, market value, notional amounts, etc.). Furthermore, the Rule's requirement to confirm all cash, securities and client accounts as well as physically examine all securities, if applicable, does not give adequate consideration to other audit procedures that the independent accountant might perform to obtain audit evidence regarding the existence of client assets. We believe allowing independent auditors to exercise professional judgment in considering these factors in determining the nature and extent of confirmation procedures provides opportunities for surprise examinations to be performed more efficiently, while still achieving the Commission's overall objectives

We also believe current practices, in certain cases, limit the ability to obtain relevant audit evidence from confirmation procedures. For example, it is a common practice for an investment adviser to provide clients with a quarterly account statement. If the surprise examination is conducted as of a month-end different than the quarter-end, a client might not have up-to-date information available to allow for an unqualified response. Additionally, the client might respond to the confirmation by confirming the balance reported in previous quarter's statement rather than submitting a response as of the request date or might not respond due to the inability to confirm the relevant information. We believe that the Commission should give consideration to the challenges that may arise with investor confirmations.

Considering these factors, we recommend the Commission evaluate revising the Proposed Rule to allow for confirmations performed on a sample basis where, in the independent auditor's judgment, such an approach is appropriate.

b. User considerations

We do not believe the Proposal's requirement for clients or investors in pooled investments to be identified as users of the surprise examination report is an appropriate modification to be made to the Rule. We believe this requirement creates a risk to the Commission, the independent accountant and the registered investment adviser that distribution of the surprise examination report results in inappropriate reliance being placed on the procedures in the examination by clients or investors in pooled investments. Including those individuals as users of the surprise examination report runs the risk that such a user would misunderstand the requirements or scope of such reporting, the nature of the procedures being performed and/ or the results reported. We suggest the SEC evaluate whether the benefits attained by providing the surprise examination report to the clients or investors of the pooled investment achieves the objectives of the protection against misuse of client assets and improves the custodial practices of the industry.

II. Custody by advisers and their related persons

We support the requirement within the Proposal for advisers who use the custodial services of qualified custodians that are "related persons" to obtain or receive an internal control report for the "related person" custodian. Certain types of internal control reports provide the users of such report with an understanding of the entity's internal control, including the control objectives and related controls, a summary of the tests performed to assess the effectiveness of the processes in place to prevent misappropriation of assets, and a conclusion on the effectiveness of the controls (in this case a Type II SAS 70 Report). We believe the issuance of an internal control report would achieve the Commission's objectives. The Proposal is clear that the accountant performing the internal control engagement be independent within the meaning of Regulation S-X, Rule 2-01. The Proposal also indicates that the internal control engagement be conducted by an independent public accountant registered with the PCAOB. We believe it is unclear whether the PCAOB's independence standards would be applicable to such engagements. The Commission should clarify that, unless the PCAOB were to adopt independence standards specific to engagements other than financial statement audits, the PCAOB's independence standards would not be applicable to the engagements required by the Proposed Rule.

We do not believe the issuance of the internal control report over the custodial practices of a related custodian exempts the registered investment adviser from the requirements of a surprise examination. We believe that the internal control report further enhances the surprise examination procedures by authenticating the reliability of the confirmations obtained from the custodian.

The SEC should consider including procedures within the surprise examination that require the independent accountant to obtain the internal control report from any "related person" with custodial responsibility, if available, and to identify and consider the implications of any user exceptions cited in such report that might be relevant to the "user auditor" (i.e. the independent accountant conducting the surprise examination).

In strengthening custodial practices, the Commission should further define the areas within the scope of the internal control report, as well of the control objectives for such areas. We believe there is value to the user of an internal control report that evaluates the effectiveness of internal controls within the areas of technology, processing of investor and securities transactions, reporting of cash and security positions, regulatory and compliance. Examples of control objectives that should be covered in the internal control report, in addition to those cited in the Proposal, include but are not limited to:

- Accounts are opened and accessible only by authorized individuals;
- Online access to account information is only permissible by authorized individuals with appropriate user names and passwords;
- All wire transactions are supported by documentation and approved by multiple signatories;
- System maintenance and change management controls are properly segregated.

III. PCAOB registration

We are in agreement with the Proposal's requirement that if an independent custodian does not maintain client assets but the adviser or a related person instead serves as a qualified custodian for client funds or securities under the Rule, the related person must provide the adviser with a written report, no less frequently than once each calendar year, which includes an opinion on internal control from an the independent accountant registered with, and subject to inspection by, the PCAOB. We believe this recommendation enhances protection of clients who invest assets with registered investment advisers that have "related persons" providing custodial functions.

Additionally, the Commission has asked for comment as to whether all surprise examinations under the Rule should be conducted by an independent public accountant registered with, and subject to regular inspection by, the PCAOB. We believe that requiring the independent accountant performing the surprise examination to be registered with, and subject to inspection by, the PCAOB provides greater confidence in the quality of the surprise examination and establishes a regulatory framework for the PCAOB to regulate the practices of independent accountants for the performance of these engagements.

The Commission also has asked for comment as to whether the independent public accountant that performs the surprise examination should be a different accountant than the accountant that prepares the internal control report. We do not believe there is a need to require that an investment adviser engage different independent accountants. There are many procedures that an accountant could perform during both the surprise and the internal control examinations that would provide synergistic benefits. The ability of the accountant to leverage procedures performed as part of the surprise examination or the internal control examination could be cost-beneficial to the investment adviser. In addition, requiring investment advisers to use two different accountants, both needing to maintain independence under Rule 2-01 of Regulation S-X, would unnecessarily limit the adviser's choice of qualified practitioners that the adviser, and the adviser's affiliates, can engage for non-attest services. We believe that the current requirements under Rule 2-01 that govern the independent accountant's procedures to monitor and maintain independence provide sufficient quality control for one accounting firm to perform both the surprise examination and the internal control examination procedures and reporting in a high quality manner.

IV. Effective date for adoption

The adoption of the Proposed Rule will have differing effects on each registered investment adviser. In determining the effective date for the Proposed Rule, the SEC should provide for reasonable periods of transition to allow for the appropriate implementation to be undertaken by the registered investment adviser. It is our recommendation that the Commission consider rolling out the adoption of the final rule in the following phases:

Phase	Surprise examination	Internal control report
I	Within 120 days of the finalization of the Rule, the registered investment adviser appoints independent accountant. If the Commission requires the independent accountant performing the surprise examination to register with the PCAOB, the Commission may want to require that the registered investment adviser formally communicate to the PCAOB the independent accountant selected.	Within 120 days of the finalization of the final rule, the registered investment adviser using a "related persons" for custodial responsibilities appoints an independent accountant who is registered with the PCAOB to perform the internal control examination. The Commission may want to require that the registered investment adviser formally communicate to the PCAOB the independent accountant selected to perform the internal control examination.
II	Within 12 months of the effective date of the final rule, the independent accountant has at a minimum commenced the surprise examination. This phase may have to be extended to 18 months depending on the timing of the effective date of the final rule.	We would also recommend that the SEC evaluate allowing the registered investment adviser which employs a "related person" for custodial services to complete a Type I internal control report within 12 months of the effective date of the final rule. Our recommendation for a Type I internal control report provides the "related person" custodian with a transition period resulting in the independent accountant issuing a report identifying control objectives and control processes. The Type I internal control report will grant the custodian the opportunity to implement enhancements to the infrastructure or control environment that may be necessary as a result of any control objectives that are mandated in the final rule. This phase may have to be extended to 18 months depending on the timing of the effective date of the final rule.
III	All subsequent surprise examinations are performed no later than 12 months from the date of the last surprise examination report.	Within 24 months of the effective date of the final rule, all "related person" custodians would be required to have an independent accountant registered with the PCAOB issue a Type II internal control report. As mentioned above, the 24 month deadline may require an extension depending on the final rule's effective date.

V. Additional consideration

The Commission has asked for comment on what alternative procedures to the mandated surprise examination should be considered in the Proposed Rule. We believe that one alternative to the surprise examination for registered investment advisers that have pooled investment vehicles would be for the Commission to permit the registered investment adviser to engage an independent accountant to issue an annual internal control report ("Type II SAS 70 report") on the adviser's internal control surrounding the safeguarding of client assets and investor accounts. Similar control objectives to those referenced above would be covered in the internal control report for the adviser. An option to conduct a Type II SAS 70 engagement provides the adviser with the ability to evaluate whether there are greater benefits experienced by its organization, its clients and its investors in obtaining a comprehensive report detailing the organization's control objectives and the independent accountant's observations on the operating effectiveness of the adviser's controls related to the custodial function over a defined period of time while still satisfying the SEC's objectives. We believe the more complex registered investment advisers with many clients or investors in pooled investment vehicles may achieve more value in having an independent accountant conduct a Type II SAS 70 examination. Given that 9,575 advisers report to have custody of client assets that would be subject to the Proposed Rule, a large percentage of these advisers may find it more cost effective to have an independent accountant perform the surprise examination. In summary, we do not believe there is a one-size-fits-all approach to whether or not a Type II SAS 70 report is appropriate for organizations of differing sizes and sophistication and therefore, recommend that the Commission permit the investment adviser the discretion to determine whether to comply with the custody rules through a surprise examination or an internal control examination.

Conclusion

In summary, we believe that the proposed amendments to the Rule are important to enhancing investor protection and to monitoring the custodial activities of investment advisers. A commitment by the SEC to enacting the proposed amendments to the Rule as of a date certain would provide an impetus for associated changes to the financial reporting, regulation, and compliance under the Rule. We encourage the Commission to make that commitment to establish immediate timeframes around effective transition so the registered investment advisers and the independent auditors can commence planning for the successful adoption of the Proposed Rule. We thank the Commission for providing us with the opportunity to comment on the Proposed Rule and we hope that you find our comments helpful in the achievement of its objectives.

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We would be pleased to discuss our comments with the Commission or its staff at your convenience.

Very truly yours,

Ernst & Young LLP