COALITION OF PRIVATE INVESTMENT COMPANIES

July 31, 2009

The Honorable Mary L. Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. S7-09-09; Rel. No. IA-2876
Amendments to Investment Advisers Act Custody Rule

Dear Chairman Schapiro:

The Coalition of Private Investment Companies ("CPIC")[1] is pleased to submit its comments regarding the above-referenced proposal of the Securities and Exchange Commission ("SEC" or "Commission") to amend the custody rule, 17 C.F.R. § 275.206(4)-2 ("Custody Rule") under the Investment Advisers Act of 1940 ("Advisers Act") and a related definition and reporting form.[2] We understand the Commission is seeking to address weakness in the current Custody Rule highlighted by several recent enforcement actions involving misappropriation or other misuse of investment adviser client assets. We support the Commission's proposed amendments to the Custody Rule with certain further revisions that we believe will address gaps in the current proposal in order to better protect investors in private investment funds.

I. CPIC Supports Enhancement of Advisers Act Custody Rule

CPIC has supported and continues to support a number of reforms related to the regulation and supervision of private investment funds and their investment managers and other service providers. Requiring custody of fund assets to be held at a bank, trust company or broker-dealer is among the most important safeguards to protect the interests of investors in private investment funds.

We previously have advocated strengthening the custody requirements applicable to private investment funds.[3] Independent custody provides several important controls that reduce

[1] CPIC is a coalition of private investment companies who are diverse in size and in the investment strategies they pursue. Established in 2005, CPIC informs policy-makers, the media and the public about the private fund industry and its role in the capital markets.

[2] SEC, Proposed Rule, Custody of Funds or Securities of Clients by Investment Advisers, Rel. No. IA-2876, 74 Fed. Reg. 25354 (May 27, 2009) (the "Release").

[3] *See, e.g.*, Prepared Statement of James Chanos, President, Kynikos Associates, U.S. Securities and Exchange Commission Roundtable, Panel 5 - Hedge Fund Strategies and Market Participation (May 15, 2003), *available at*

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415 Second St., N.E. ◇ Suite 200 ◇ Washington, DC 20002 ◇ tel 202-715-0840 ◇ fax 202-543-5781

the risk of investor loss. First, it provides a means to hold the assets in safekeeping away from the investment manager, which prevents unauthorized persons from accessing and stealing them. Second, the custodian is a separate party reviewing the transactions and the account on a real-time basis and may be in a position to detect irregularities. Third, it creates a paper trail and a clear record of what assets are really in the account and what transactions have occurred in the account, which greatly simplifies review by the client, or the auditors and examiners, and thus increases the probability that irregularities or missing assets will be noticed.

The adoption of the current version of the Custody Rule in 2003[4] was an important step in protecting clients of registered investment advisers. There are, however, a number of significant gaps in the rule, some of which are addressed by the Commission's proposed amendments. CPIC supports amendment of the Custody Rule to further strengthen the safeguards that it provides, and urges the Commission to consider additional changes to the Custody Rule as part of this rulemaking to more effectively close those gaps and protect investors in private investment funds.

Footnote continued from previous page
www.sec.gov/spotlight/hedgefunds/hedge-chanos.htm; Testimony of James Chanos, President, Kynikos Associates, at U.S. Senate Committee on Banking, Housing, and Urban Affairs, *Hearing on Regulation of Hedge Fund Industry* 108th Cong., 2nd Sess. (2004); Comment Letter from James Chanos, President, Kynikos Associates (Sept. 15, 2004) regarding Rel. No. IA-2266 (proposed rule on registration of certain hedge fund advisers), *available at* http://www.sec.gov/rules/proposed/s73004/s73004-52.pdf ; Comment Letter from James Chanos, Chairman, CPIC (Mar. 9, 2007), regarding Rel. Nos. 33-8766, IA-2576 (proposed rule on prohibition of fraud by advisers to certain pooled investment vehicles), at 17-18, *available at* www.sec.gov/comments/s7-25-06/s72506-541.pdf (suggesting that Commission use its anti-fraud rulemaking authority under Section 206 of the Advisers Act to require all investment advisers, whether or not required to be registered, to place private investment fund assets in custody of a bank or broker-dealer and undergo an annual independent audit); Testimony of James Chanos, Chairman, CPIC, at U.S. House of Representatives Committee on Financial Services, *Hearing on Hedge Funds and Systemic Risk in the Financial Markets* (Mar. 13, 2007), at 19-20, *available at* http://www.house.gov/financialservices/hearing110/htchanos031307.pdf (same); Testimony of James Chanos, Chairman, CPIC at U.S. Senate Committee on Banking, Housing and Urban Affairs, *Hearing on Enhancing Investor Protection and the Regulation of Securities Markets--Part II* , (Mar. 26, 2009), at 4, 14, *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=7d3cbeca-241a-4bee-8ff6-a858c6902d69 (Advisers Act custody rule has gaps as applied to private investment funds that may put investors at risk); Testimony of James Chanos, Chairman, CPIC, at U.S. House of Representatives Committee on Financial Services, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, *Hearing on Perspectives on Hedge Fund Regulation* (May 7, 2009), at 8, *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/testimony_-_chanos,_cpic.pdf (Advisers Act custody provisions exclude certain types of instruments that are commonly owned by private investment funds, which deprives investors in those funds of the protection that a custody requirement provides); Testimony of James Chanos, Chairman, CPIC, at U.S. Senate Committee on Banking, Housing and Urban Affairs, Subcommittee on Securities, Insurance, and Investment, *Hearing on Regulating Hedge Funds and Other Private Investment Pools* (July 15, 2009), at 14, 18 *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=bb23c9d2-0eec-4248-a236-1b6a0bc07390 (the SEC's custody rules under the Advisers Act are insufficient to protect private investment fund assets from theft or fraud).

[4] Custody of Client Funds or Securities of Client by Investment Advisers, Rel. No. IA-2176 (Sept. 25, 2003), 68 Fed. Reg. 56692 (Oct. 1, 2003).

II. Tailor Custody Rule to Different Types of Investment Advisers

One of the serious shortcomings of the Advisers Act as applied to private investment funds is that it was drafted long ago for other purposes. Its principal focus is on separately managed accounts of individuals. Its provisions are designed to work best in this context. As applied to other contexts, including private investment funds with multiple, non-controlling investors, the Advisers Act and many of the rules adopted under it either do not appropriately protect investors in private investment funds or impose unnecessary burdens upon the operations of private investment funds that do not further investor protection.

We note that many of the comments submitted thus far in the Commission's rulemaking docket on the Custody Rule amendments have been submitted by investment advisers whose client base is made up of individual clients. Several of these commenters have made the point that the proposal imposes undue burdens upon small advisors to individual clients. While this is a fair point, we believe the appropriate response is not to abandon or scale back the proposal, but instead to tailor the proposal further to fit the context and regulate the custody aspects of different categories of advisory relationships in different ways.

Section 211(a) of the Advisers Act provides the Commission with authority to adopt rules with different requirements for different categories of advisory relationships. In adopting the Custody Rule, the Commission drafted certain provisions to address the context of private investment funds in a different way than the Rule addresses other categories of investment advisory clients. We believe that the amendments to the Custody Rule can also be tailored to the context. Our proposals for additional refinements that are outlined below are intended primarily for the context of custody of assets of private investment funds.

III. Gaps in the Custody Rule As Proposed to be Amended

The Custody Rule, even as the Commission proposes to amend it, contains serious gaps in coverage that may pose a risk to investors in private investment funds. Each gap, and our suggested change to the rule, is outlined below.

A. The Rule Applies Only to Registered Investment Advisers

The Custody Rule applies only to investments advisers that are registered or required to be registered under the Advisers Act. While many advisers to private investment funds are registered with the Commission under the Advisers Act, many are not. Therefore, unless Congress amends the Advisers Act to narrow or eliminate the "private investment adviser" exemption in Section 203(b)(3) of the Act to regulate all investment advisers, this gap will remain and unregistered advisers will not be covered. Even if, however, Congress were to narrow that exemption, there are a variety of categories of investments that are not "securities." These include real estate, various types of derivatives, loans, and bank deposits. Managers of investment funds limited to those categories of assets, and managers of U.S. government

securities, are not within the definition of "investment adviser" under the Advisers Act. As a result, the Custody Rule, even as proposed to be amended (and even if Congress adopts legislation to narrow or eliminate the Section 203(b) exemption), does not apply to such private investment funds and their managers.

Further legislation may be required to address this gap, aimed not at securities "investment advisers" but specifically at private investment funds and their managers regardless of whether the adviser is registered. In the alternative, the Commission may wish to consider using its existing anti-fraud rulemaking powers under Section 206(4) of the Advisers Act to extend the custody and audit requirements for unregistered investment advisers.[5]

B. The Rule Applies Only to Custody of Certain Categories of Assets

The Custody Rule, even as proposed to be amended, excludes from coverage broad categories of investments that are neither "funds" nor "securities." These include real estate, precious metals, many swaps and other derivatives, loans, and privately-placed, non-certificated securities that are restricted as to transfer.[6] In effect, the Custody Rule allows any investment adviser to keep evidence of these assets in a desk drawer at its place of business, and does not restrict access by the investment adviser and its personnel to the asset, or require a central control location to assist in assuring that the assets of the investment fund really exist.

This gap leaves potentially vulnerable to mischief a wide variety of asset classes of private investment funds, including funds-of-funds, feeder funds, venture and private equity funds, real estate funds and certain derivatives funds.

We believe it would be appropriate to amend the rule to require that all assets be subject to a form of custody requirement appropriate to the relevant class of assets. For non-certificated privately issued securities, one means would be to require that the issuer of the security title them in the name of the investor "in custody of [name of custodian]" and require that all cash flows and other distributions in respect of the security be sent to the client's account at the custodian, rather than to the client care of the investment adviser. A similar requirement could be imposed

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[5] The antifraud rulemaking powers under Section 206(4) extend to both registered and unregistered investment advisers. As originally adopted by the Commission in 1962, the custody requirement was an anti-fraud provision that applied to both registered and exempt advisers. *See* Adoption of Rule 206(4)-2 under the Investment Advisers Act of 1940, Rel. No. IA-123 (Feb. 27, 1962), 27 Fed. Reg. 2149 (Mar. 6, 1962). CPIC has previously made this suggestion as a means to address this gap. *See also* Comment Letter from James Chanos, Chairman, CPIC (Mar. 9, 2007), regarding Rel. Nos. 33-8766, IA-2576 (proposed rule on prohibition of fraud by advisers to certain pooled investment vehicles), at 17-18, *available at* www.sec.gov/comments/s7-25-06/s72506-541.pdf; Testimony of James Chanos, Chairman, CPIC at U.S. House of Representatives Committee on Financial Services, *Hearing on Hedge Funds and Systemic Risk in the Financial Markets* (Mar. 13, 2007) at 17-20, *available at* http://www.house.gov/financialservices/hearing110/htchanos031307.pdf.

[6] Under the Custody Rule, for private investment funds, a custodian is not needed for the privately-placed non-certificated securities if the fund provides annual audited financial statements to its investors. 17 C.F.R. §275.206(4)-2(b)(2)(ii).

on the terms of loans and swap agreements, in order to require that payment by the borrower or counterparty be sent only to the custodian. For real estate, the recording in county land records of a notice of an interest in favor of the custodian could accomplish much the same protection.

To reduce the risk of diversion of assets, all assets of private investment funds should be held at a custodian bank or broker-dealer, and all payments to or from the fund and transfers of fund assets in respect of assets should occur only through that custodian bank or broker-dealer.

C. More Guidance Needed on Access Controls at Adviser and Custodian

However, simply having assets held through a bank or broker-dealer does not fully protect the assets from diversion. As we outline below, there should be in place sophisticated access controls to supplement the actual custody of the assets. In addition, there should be a custody agreement with a bank or broker-dealer that agrees to serve as a central custodian for the customer's account (or the private investment fund account) and through which all assets are held and all funds flow. Having some of the client funds in a bank deposit, some at a mutual fund, and some at a broker, none of which has agreed to perform the function of client account custodian, and where all of the accounts are accessible without restriction by the adviser and its personnel, does not provide much protection. The custody agreement should incorporate prudent controls on access to the assets.

Client securities held in custody at a bank or broker-dealer may be subject to the authority of the adviser and its personnel to order the assets delivered out. Similarly, client cash on deposit at a bank is, in a sense, in the "custody" of the bank—apparently satisfying the rule—even though the adviser and its personnel may have signatory authority over the deposit accounts. The same is true of assets invested in shares of mutual funds. Without appropriate controls, this can subject the assets to diversion either by the advisory firm (if the entire group is involved) or by individuals acting surreptitiously with the advisory firm.[7]

In the Release, the Commission raises this access control issue and asks whether the Commission should address it more broadly.[8] As proposed, the Amendment would only specifically address access controls if the custodian is an affiliate of the investment adviser.[9] The risks, however, associated with improper access and weak controls on access by advisory personnel to client assets held at the custodian bank or broker-dealer are not limited to affiliated custodians.

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[7] *See* In the Matter of Wilmington Trust Co., Rel. No. IA-2261, Admin. Proc. File No. 3-11544 (July 12, 2004) (recordkeeping violations and asset diversions by adviser enabled in part by inadequate controls at custodian), *available at* http://www.sec.gov/litigation/admin/ia-2261.htm.

[8] Release, *supra* note 2, at nn. 19-20 & 42-48 and accompanying text, 74 Fed. Reg. at 25356, 25358-59.

[9] Release, *supra* note 2, at 25358-59.

In our view, the Commission should address this issue in more detail. The Release mentions several items for coverage in asset control policies, but not in much detail, and none of the listed items directly relate to access controls on adviser personnel or preventing diversion of assets.[10] In the 2003 rulemaking release adopting the Advisers Act compliance rule (17 C.F.R. § 275.206(4)-7) the Commission mentioned asset controls as an area that a compliance program should cover, but did not elaborate.[11] This is an area in which an interpretive release from the Commission, or a letter from the Staff detailing the considerations and outlining certain best practices, could be helpful in assuring appropriate controls are put in place to limit access by the investment adviser and its personnel (or unauthorized third parties) to assets held at a custodian bank or broker-dealer.

Some of the issues that could appropriately be addressed by the investment adviser in its access controls include:

(1) Perform and periodically update background checks and credit checks on adviser personnel.

(2) To the extent possible, separate the functions of adviser personnel. Investment decision-making, placement of orders, coordinating settlement and payments with the custodian, and internal audit functions, should have separate staffing. Particularly for smaller advisers whose staff is too small to allow for complete separation of functions, use of an outside administrator may be appropriate to provide a greater measure of separation than can be accomplished internally.

(3) Require "dual access" (two adviser persons required to authorize) to place certain types of instructions with custodian, such as address changes or any outbound transfers that are not simple delivery-versus-payment transactions in publicly-traded securities. Periodically rotate assignments among staff and change two person access teams.

(4) Have audit or compliance department carefully monitor and verify client account name and address changes, and verify with other bank or broker-dealer the ownership of any account receiving outbound fund or asset transfers.

(5) Restrict persons authorized to provide instructions to custodian in agreement with custodian. Impose a process on changes to the list of persons authorized to place instructions. Require custodian to use a call-back or other system for verifying authenticity of certain categories of instructions from adviser, such as address changes or any outbound transfers that are not simple delivery-versus-payment transactions in publicly-traded securities.

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[10] Release, *supra* note 2, at 25359.

[11] *See* Release No. IA-2204, Compliance Programs of Investment Companies and Investment Advisers (Dec. 17, 2003), 68 Fed. Reg. 74714, 74716 (Dec. 24, 2003), at Section II.A.1.

(6) Cross check custody statements against adviser's records of transactions.

Although the Commission does not regulate bank custodians, it is able to address the requirements to serve as custodian to an investment adviser by the way in which the term "qualified custodian" is defined in the Custody Rule. Some of the access control issues that could appropriately be addressed by the custodian include:

(1) Obtain written representations and warranties from the adviser regarding the adviser's compliance with the Advisers Act, the Custody Rule, access policies, and other relevant requirements and laws.

(2) Conform custody account statements to the requirements of the Custody Rule and to the Advisers Act books-and-records rules.

(3) Verify information regarding investments held in custody directly with the issuer, its transfer agent, or the clearing system. Impose additional diligence on private investments and higher diligence on investments that are related in some way to the adviser.

(4) Review valuation methodologies for accuracy, independence, currentness, consistency.

(5) Make sure the client statements are accurate and complete.

(6) Watch out for any red flags or information received and circumstances regarding the account that may be at odds with the information set forth in the account. Follow-up on any anomalies.

(7) Impose terms in the custody contract and steps in the operational arrangements that restrict adviser personnel access to client funds. Adhere to these restrictions.

(8) Make arrangements with issuers, counter-parties, depositories and subcustodians that preclude the adviser and its personnel from directly accessing the client's assets. For example, dividends and distributions, and the proceeds of redemptions or sales, by agreement with the issuers, counter-parties and subcustodians, should be sent only to the custodian.

(9) Carefully monitor and verify client account name and address changes, and verify with the other bank or broker-dealer the ownership of any account receiving outbound fund or asset transfers.[12] Verify where money and assets are being transferred. Never transfer client assets to the adviser or its personnel, other than for payment of documented adviser fees and

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[12] *Cf.* FINRA/NASD Conduct Rule 3012(a)(2)(B); Frank Gruttadauria, NYSE Disciplinary Action 2002-59 (Mar. 19, 2002), SEC Lit. Rel. No. 17590 (June 27, 2002); NASD Notices to Members 04-79, 04-71 (2004) (similar requirements for broker-dealers).

expenses (and then only if direct payment by the custodian is specifically authorized in the client's custody and advisory agreements and reflected in the statements sent by the custodian to the client).

(10) Document the personnel of the investment adviser who are authorized by the adviser to place trades or provide other instructions to the custodian for the client account, and use a call-back system or other methods to verify the identities of adviser personnel who provide certain categories of instructions to the custodian such as address changes or outbound transfers of funds or assets that are not delivery-versus payment transactions.

D. Impose PCAOB Auditor Requirements on Private Investment Funds

A requirement that the annual financial statements of a private investment fund be subjected to an independent audit is an important protection for investors and counterparties. The combination of an independent audit requirement with the requirement that assets be held in custody at a bank or broker-dealer, significantly enhances the level of protection beyond that provided by either of the two safeguards.

The Commission tacitly recognized this synergy between the protections provided by an independent audit and the protections provided by a custodian, when it adopted the Custody Rule. The Custody Rule currently requires that a private investment fund either (a) provide audited financial statements annually to its investors, or (b) cause the custodian to send quarterly reports to its investors. Most private investment funds have chosen option (a).

The Commission's proposed amendment to the Custody Rule would require that the accounting firm that conducts the surprise audit, and provides an annual report on internal controls, be registered with and subject to regular inspection by the Public Company Accounting Oversight Board ("PCAOB") if the custodian is an affiliate of the fund's investment adviser.

CPIC believes that the requirement to use a PCAOB registered independent accounting firm should apply to any private investment fund or group of private investment funds of significant size.

In at least two of the recent major fraud cases, the "independent" auditors were either purely fictional firms, or did not come close to meeting the standards required for PCAOB certification.[13] The auditors need to be independent, honest, competent and diligent. Requiring PCAOB certification provides an important quality check on the independent accounting firm that performs the audit. We see no reason why this important quality check should be limited to situations in which the custodian is an affiliate of the private investment fund's investment adviser.

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[13] *See* SEC Charges Madoff Auditors with Fraud, SEC v. David G. Friehling, C.P.A. *et al.*, Lit. Rel. No. 20959 (Mar. 18, 2009) and SEC v. Bernard L. Madoff, *et al.*, Litigation Release No. 20889 (Feb. 9, 2009); SEC v. Samuel Israel III, *et al.*, Lit. Rel. No. 19692 (May 9, 2006).

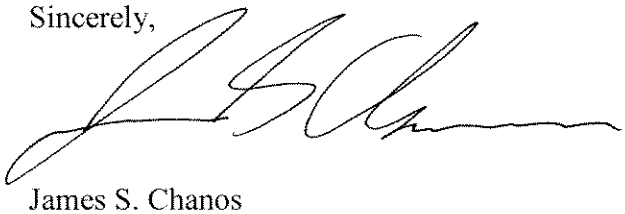
CPIC believes, however, that the addition of a surprise audit requirement for private investment funds that provide audited financing statements to investors would not add meaningful investor protections and would be both expensive and burdensome. Accordingly, we suggest that a surprise audit requirement not be imposed on private investment funds that provide audited financial statements to their investors.

IV. Conclusion

CPIC supports the Commission's proposal to amend and tighten further the Custody Rule. We believe that the additional changes suggested above would enhance further the investor protections provided by the Custody Rule.

We thank you for this opportunity to provide our comments. We would be happy to discuss them with you at your convenience.

Sincerely,



James S. Chanos
Chairman
Coalition of Private Investment Companies

cc: The Honorable Luis A. Aguilar, Commissioner
The Honorable Kathleen L. Casey, Commissioner
The Honorable Troy A. Paredes, Commissioner
The Honorable Elisse B. Walter, Commissioner
Elizabeth M. Murphy, Secretary
Andrew J. Donohue, Esq., Director
Division of Investment Management