GE Asset Management

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Via Email (rule-comments@sec.gov)
Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: File Number S7-09-09; Proposed Rule Custody of Funds or Securities of Clients by Investment Advisers (Release No. IA-2876)

Dear Ms. Murphy:

GE Asset Management Incorporated (collectively, with its subsidiaries,"GEAM") appreciates the opportunity to submit this comment letter to the Securities and Exchange Commission ("SEC") in response to the recently proposed amendments to the custody rule referenced above (the "Amendments"). By way of background, GEAM is wholly-owned by General Electric Company and provides investment management services to institutional investors (via separate accounts and pooled vehicles) and retail investors indirectly through GEAM sponsored mutual funds. Assets under management are approximately $110 billion.

General Comment

GEAM is fully aware of the several enforcement actions the SEC has brought against investment advisers in recent months alleging fraudulent conduct, including misappropriation or other misuse of clients' assets. Enactment of regulatory changes reasonably designed to further protect investor rights and improve the safekeeping of investors' assets should always be encouraged. However, we believe, for the reasons more specifically set forth below, that the Amendments will not efficiently or effectively accomplish the goal of enhanced investor protection. We therefore urge the SEC to carefully reconsider the Amendments particularly with respect to the unannounced verification requirement specified in proposed Rule 206(4)-2(a)(4) (referred to as the "Surprise Examination" requirement).

Most fundamentally, GEAM respectfully submits that the Surprise Examination requirement should not apply to those advisers that merely have deemed custody of

clients' assets but which are actually maintained by a non-related (i.e., independent) "qualified custodians" within the meaning of Rule 206(4)-2. While there is the possibility that a corrupt adviser could misappropriate clients' assets under this structure, direct delivery of client statements from the clients' independent custodian on a quarterly basis as required under the Amendments should be a sufficient mitigant. Note that GEAM is not commenting on additional protections proposed under the Amendments when a party related to the adviser also acts as a qualified custodian, which we believe does clearly present enhanced investor risk.

In the case of client assets held at a non-related qualified custodian, the "surprise" timing of a Surprise Examination would not materially enhance investor protection because clients' assets would still be reviewed at only a single point in time. By relying solely on independent direct quarterly delivery of client statements as we suggest above, it is possible that an adviser motivated by ill intent could misappropriate assets during the period between quarterly statements but a Surprise Examination would not sufficiently deter such actions. An unscrupulous adviser could merely wait for the Surprise Examination and misappropriate the assets following such Examination which would not be expected to occur again until the next calendar year.

If the SEC nevertheless concludes that the "surprise" nature of the Surprise Examination truly adds protective or deterrent value, we would propose that in lieu of the Surprise Examination, the non-related qualified custodian distribute an additional special "surprise statement" directly to clients as of a month end, which did not fall at quarter end. In essence, we would suggest the uncertain timing of an independent reviewer of client assets as a deterrent to adviser fraud is equally effective whether the review is provided through a costly and disruptive auditor Surprise Examination or through distribution of statements on an unexpected basis by a non-related qualified custodian which would simply be extending and applying its standard quarterly investor reporting process. As support for our opinion, we are unaware that any of the recent fraud cases involved conspiracy of an adviser and non-related custodian.

If the SEC nevertheless determines to proceed with the Surprise Examination requirement, GEAM would suggest that assets managed for the adviser's affiliated institutional entities, and with respect to which the adviser has deemed custody, be exempt or excluded from such requirement. In this limited situation, we believe the risk of misappropriation is minimal. To the extent the affiliated group desired further protection, the group would best be able to assess the appropriate mitigation processes to be implemented by the adviser and whether a Surprise Examination procedure is appropriate.

Comment Regarding Pooled Vehicles

While GEAM submits that the Surprise Examination with respect to client assets maintained at a non-related qualified custodian should be superfluous and therefore

an unnecessary expense in light of the direct quarterly statement delivery requirement, we are not necessarily completely familiar with each type of adviser, investor and custodial structures and relationships that exist today. If the SEC nevertheless concludes that the Surprise Examination would further enhance investor protections without an undue burden, GEAM further respectfully contends that the current alternative to a Surprise Examination and direct delivery of quarterly client statements under the existing Custody Rule, which permits pooled vehicles for which an adviser has deemed custody to undergo an annual audit (which confirms all securities and cash) and distribute financials to investors, already provides sufficient investor protection and should be maintained. Again, this argument is premised on actual holdings of the pooled vehicle's securities by a non-related custodian.

To the extent a pooled vehicle undergoes an annual financial audit, it is not apparent to us how an additional Surprise Examination may add other than immaterial and redundant comfort. The annual financial audit should confirm all of the pooled vehicle's cash and securities. To the extent a financial audit merely samples such holdings, such audit could easily be extended to cover all holdings. Therefore, the Surprise Examination would serve merely as a second or additional verification of the assets of a pooled vehicle. For the reasons described earlier, GEAM does not believe that this additional review would act as an important or effective deterrent to an adviser's misconduct.

Costs

GEAM does acknowledge that a Surprise Examination would constitute "another set of eyes" as the SEC notes in the release proposing the Amendments. GEAM believes, however, that any benefit to be derived from his procedure would be non-substantive and would be far outweighed by the material associated costs. While the SEC has estimated that the average annual cost of a Surprise Examination to be just $8,100 per adviser, GEAM anticipates the cost to be much higher. GEAM currently pays approximately $4,000 per fund for each examination performed pursuant to Rule 17f-2 under the Investment Company Act of 1940. Based on our actual experience, we expect the actual annual cost to be many multiples of such estimated number.

It is important to consider that the costs associated with a Surprise Examination will likely be borne either directly or indirectly by the adviser's clients. In light of this consideration, we again submit that the limited potential investor protections obtained through Surprise Examinations undertaken at non-related qualified custodians would be overwhelmingly outweighed by the substantial costs – which the SEC has, we believe overly conservatively, estimated at over $77 million for all such Examinations – likely ultimately assessed on clients.

Additional Comments

To the extent the SEC decides to adopt the Amendments as proposed, GEAM would suggest that investors in pooled vehicles which are offered solely to accredited investors have the right to opt-out of the Surprise Examination and therefore the associated cost following appropriate disclosure from the adviser of the impact associated with that determination.

Finally, GEAM would like to respond to a question for which the SEC requested comment. To the extent a Surprise Examination is adopted under the Amendments, GEAM strongly recommends that such Examination not also include "testing of valuation of securities, including privately offered securities." Clearly this requirement is unrelated to the proposed intent of the Amendments; ensuring that securities and assets described on client statements are actually maintained at the qualified custodian. To the extent the SEC wishes to propose regulation related to the valuation of securities, we believe it should do so in a direct manner, not as an "add-on" to the Surprise Examination which as proposed under the Amendments will apply to some but not all SEC registered advisers. We do not believe there has been any indication that advisers subject to the Surprise Examination are more likely than advisers which are not subject to the Surprise Examination to have incorrectly valued client assets. In essence, we believe that a more fulsome dialogue of this issue outside of the Amendments is warranted. As a preview of just one of the serious concerns related to additional valuation requirements, the substantial additional costs related to those activities likely would far exceed the costs of the proposed Surprise Examination. For example, a substantial portion of the hours charged to mutual funds and private funds by independent auditors relates to verifying valuation of portfolio holdings. A better alternative would be to have an independent custodian specify in its account statements whether the values provided were based on information from the adviser or from independent sources.

Thank you for your consideration of our comments.

Very truly yours,

Matthew J. Simpson
Executive Vice President & General Counsel
GE Asset Management Incorporated