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

SEC Release No. IA-2876; File No. S7-09-09
Custody of Funds or Securities of Clients by Investment Advisers

Dear Ms. Murphy:

We appreciate the opportunity to respond to the Securities and Exchange Commission's (SEC or Commission) proposed rule regarding *Custody of Funds or Securities of Clients by Investment Advisers* (the Proposal or the Proposed Rule). We support the regulatory efforts of the Commission to improve the effective safekeeping of investor assets in an efficient manner. We have structured our comments to provide insights as to those matters that may: 1) prove challenging for management and the independent public accountant; 2) require additional guidance; and/or 3) be able to be performed in a more cost-effective manner. Our comments and observations relate to the following areas:

- Nature, timing and extent of attestation procedures
- Form ADV-E filing requirements
- Accountant independence
- Effective date and transition period; and
- Estimated costs.

Nature, Timing and Extent of Attestation Procedures

Valuation of Funds and Securities

As part of the Proposed Rule, the Commission asked whether the accountant should perform testing on the valuation of securities, including privately offered securities, as part of the surprise examination. As noted in the Background section of the Proposed Rule, the focus of the surprise examination is on custody practices of registered investment advisers (Registered Advisers). While valuation of investments is important to investors, it is not as fundamental to safeguarding investor funds as custody practices that provide reasonable assurance that investments exist and that authorized transactions, such as investor contributions, withdrawals and trading activity, are accurately and completely processed and recorded. As a result, testing of compliance with these more fundamental custody practices has been the focus of the independent public accountant's surprise examination procedures in the past and we recommend that it continue to be.

Investors can readily determine the value of publicly traded investments and gain additional insights into investment values based on analyst reports and information provided in the annual audited financial statements. In addition, performing valuation testwork would significantly increase the scope of the Proposed Rule and would come at a significant cost. Thus, we recommend that the surprise examination and internal control audit requirements do not include testing the valuation of securities custodied by Registered Advisers or their related persons.

Privately Offered Securities

Privately offered securities as defined by rule 206(4)-2(b)(2) are currently excluded from the surprise examination requirement and all other aspects of the custody rule. The inclusion of privately offered securities in the scope of the Proposed Rule creates a number of operational issues for Registered Advisers and attestation issues for independent public accountants. The following examples illustrate this point.

- In many instances privately offered securities are not covered by standard custodial agreements between Registered Advisers and custodians. Furthermore, in certain instances, even if the custodian maintains a record of such privately offered securities, they have done little to nothing to verify the actual existence of such securities. This creates operational complexities for the Registered Advisers that lead to examination difficulties for the independent public accountants. For example, if a Registered Adviser is deemed to have custody over a private investment pool of private equity investments and this pool has 40 different investments for which no external custodian takes responsibility as to the accuracy and existence of the investments, the independent public accountant would need to confirm accuracy and existence of the securities with 40 different parties. In addition, since the confirmation process will likely be ineffective for many of these investments, alternative procedures would need to be performed to gain appropriate examination evidence.

  We recommend the Commission consider this situation when developing guidance on examination procedures discussed later in this letter. In addition, we note that such procedures could increase the cost of the examination and could also have an adverse impact on meeting the proposed requirement to file the Form ADV-E within 120 days and on the costs estimated by the Commission to perform an examination.

- Based upon our discussions with Chief Compliance Officers of Registered Advisers (CCOs) and legal professionals, we are concerned about whether the definition of a privately offered security is legally clear. If this is indeed the case, it seems that guidance should be provided to clarify what types of investments should be considered privately offered securities. Absent clear guidance, independent public accountants would need to have robust discussions with CCOs and legal counsel of the Registered Adviser to determine which investments are deemed to be privately offered securities. Furthermore, if the definition is not clear it is likely that various Registered Advisers and legal counsel could have differing opinions as to which investments are privately offered securities.

Surprise Examination Matters

Frequency of the Surprise Examination

The Commission has raised the question as to whether an annual surprise examination is of sufficient frequency. We believe that an annual examination provides an appropriate balance between cost and benefit and would not recommend increasing the frequency of the examination.

Registered Adviser Certification of Funds and Securities

The Commission asked whether the Proposal should require a Registered Adviser to certify a listing of funds, securities and client accounts that were examined by the accountant as part of the surprise examination. Such a certification seems to be appropriate if the Commission desires to meet objectives similar to those of the CEO and CFO certifications required under Rule 13A-14A of Regulation S-K regarding management responsibility for financial information.

Nature and Extent of Attestation Procedures on Client Balances

The Commission has raised questions as to the nature and extent of attestation procedures pertaining to client balances. Current requirements are that the independent public accountant confirms all client balances with the Registered Adviser's respective clients. We believe that there are significant questions regarding the cost-effectiveness of these mandated attestation procedures due to the following reasons:

- Sampling, which is a commonly employed audit and attestation approach is not allowed under current requirements;
- Client confirmation response rates are historically low and dictate the need for time consuming alternative attestation procedures which increases the time required for and cost of completing the attestation engagement; and
- Client confirmation of balances and holdings is an effective means of obtaining evidence for investments that are transparent to the client and where the client has authorized the purchase and sale transactions. However, this confirmation process is not effective in other situations, such as managed accounts where investment details are less transparent to the client and the client has given the investment adviser discretion to purchase and sell investments without specific client authorization of each transaction. This confirmation process is also ineffective for pooled investment vehicles where clients have direct knowledge of their contributions to and withdrawals from the vehicle but do not have first-hand knowledge of other investment activity impacting their account balance.

As a result of these observations, we suggest that the Commission consider whether cost-effectiveness can be enhanced through the use of sampling techniques. If sampling techniques are allowed, we recommend that the Commission provide guidance regarding required confidence levels, acceptable error rates and other factors to meet the objectives of the examination and provide a certain level of consistency amongst the independent public accountants.

In addition, we suggest that the Commission consider providing guidance for independent public accountants to use other substantive procedures in situations where it is determined that the confirmation process would be ineffective. An example of such procedures is to obtain a sample from a list of contributions and withdrawals and compare these amounts to evidence of authorization and money movement.

Extent of Funds and Securities Verification Procedures

The requirements also call for the 100% verification of funds and securities (inclusive of private securities). We recommend that the Commission consider whether the objectives of this requirement could be met in a more cost-efficient manner if statistically valid sampling approaches were allowed to be used by the independent public accountant. If sampling is allowed, additional guidance should be considered similar to the related matters noted above.

Commission Guidance on Examination Procedures

Given that the operations of Registered Advisers and the investment products offered has increased in complexity over time and that any rulemaking should be sufficiently flexible to address future financial innovation, we recommend that the Commission provide guidance that would address common examination questions and the Commission's expectation as to attestation procedures, including alternative procedures to be performed when confirmation procedures are not effective. We would further recommend that such guidance be periodically updated and that the Commission reach out to independent public accountants, Registered Advisers and their affected service providers to identify what matters should be addressed in this guidance.

Material Discrepancy

The Proposed Rule requires the independent public accountant to notify the Commission of "material discrepancies" found during the surprise examination within one business day. Since this is a compliance attestation engagement, we suggest that the term "material non-compliance" as used in AT Section 601.64-.67 of the PCAOB Standards and Related Rules be used to describe such matters instead of the term "material discrepancy". In addition, we believe guidance regarding qualitative and quantitative factors impacting the determination of "materiality" as described in AT Section 601.36 of the PCAOB Standards and Related Rules should be provided by the Commission that is consistent with the objectives of the compliance attestation.

Internal Control Report Matters

Timing of the Internal Control Report

The Commission has asked how the timing of the internal control report (i.e. a Type II SAS 70 report conducted in accordance with PCAOB Standards) would relate to the timing of the surprise examination. We recommend that the internal control report be required to be obtained once each calendar year and not be tied to the timing of the surprise examination.

Control Objectives

The Commission has asked whether it should require that specific control objectives be addressed in the internal control report. We recommend that the Commission provide "minimum" control objectives within the internal control report focused on the objectives of the surprise examination. Otherwise, there is increased risk that the appropriate risk and related internal control objectives will not be addressed by specific reports. Considering our prior comments, we do not believe that control objectives related to valuation assertions should be in the scope of the internal control report.

Interaction between the Surprise Examination and a Related Person Custodian's Internal Control Report

We recommend that the Commission clarify how the internal control report for a Registered Adviser's related person custodian is meant to affect the nature, timing and extent of attestation procedures performed during the surprise examination. For example, the Commission might conclude that if the custodian has an unqualified internal control report, the independent public accountant performing the surprise examination must only confirm investments with the related person custodian (as opposed to with the depositories and sub-custodians).

Also, note that if it is determined that sampling would be allowed in confirming investments maintained by custodians, the independent public accountant may have to perform additional procedures to determine whether any changes have occurred to the custodian's internal control environment from the date of the internal control report through the date of the examination.

Guidance on Internal Control Reports Containing Significant Deficiencies or other qualifications

We recommend that the Commission provide guidance as to how Registered Advisers address significant deficiencies or other qualifications in a related person custodian's internal control report. Also, as noted above, we recommend that in these situations, guidance be provided as to how the Commission expects such findings to impact the nature and extent of the surprise examination procedures.

Foreign Related Person Custodian

The Commission has asked whether obtaining or receiving an internal control report presents additional issues if the related person custodian is located outside the United States. Our experience is that such instances have created operational difficulties in the past, however, they are surmountable. Also, note that Proposed International Standard on Assurance Engagements (ISAE) 3402 - *Assurance Reports on Controls at a Third Party Service Organization,* has been released by the International Auditing and Assurance Standards Board. This proposal provides standards for assurance reports on internal controls that service organizations such as foreign related person custodians would issue to user entities such as Registered Advisers and their auditors (Type B report). A Type B report would include management's assertions regarding the description, design, and operating effectiveness of controls at the service organization and would include a report by the service auditor with the objective of conveying reasonable assurance regarding management's assertions. This would provide a vehicle for foreign custodians to issue an internal control report under International Standards. If the proposed standard is enacted, we recommend that the Commission consider use of this report to meet the objectives of the Proposed Rule as they relate to the use of internal control reports for foreign related person custodians.

Applicability of the Requirement to Cash Accounts at Regulated Banks

In certain instances "funds" at the Registered Adviser may take the form of cash accounts held at banks which may not be maintained by a custodian, but rather are maintained through the bank's routine controls over deposit liabilities. Would such accounts, if held by a related person to the Registered Adviser, be subject to the internal control report requirement? If not, because of the significant amount of banking regulation to which the cash deposits are subject, are there banks in foreign jurisdictions that would not obtain such relief? We recommend that clarification as to these questions be provided in the final rulemaking or associated guidance.

Liquidation Audits

The Commission has asked if commenters agree that the requirement for liquidation audits to be performed for pooled investment vehicles would provide additional protection to investors in the pool. We agree that the requirement does provide additional protection to investors and is required already for Commodity Pools regulated by the CFTC.

Further there are questions that should be clarified with respect to a liquidation audit, such as:

- What is the timing of the liquidation audit – after liquidation of the investment portfolio but before final distributions are made to investors or after both the liquidation of the investment portfolio and final distributions?
- Is there an acceptable period of time from the last annual audit that would negate the requirement to have a liquidation audit?
- Would this requirement apply to a pooled investment vehicle that is being merged with another during the course of a year?

Form ADV-E Filing Requirements

Timeline

The complications and issues we have highlighted with respect to privately offered securities, as well as the fact that in certain instances the documentation evidencing ownership for these securities may be kept by different parties and at different locations, could jeopardize the ability to meet the 120-day deadline without operational changes made by Registered Advisers and their related person custodians. The Commission should consider whether providing additional compliance time for Registered Advisers who are deemed to have custody over significant amounts of privately offered securities is warranted.

In addition, the Proposed Rule provides no mechanism for reporting by either the Registered Adviser or the independent public accountant if the 120-day deadline will not be met. We recommend that a report mechanism be created to address such a situation similar to the mechanism provided by Rule 12b-25 of the Securities Exchange Act of 1934.

Reporting as a Result of Resignation, Dismissal or Termination

The Proposed Rule requests the independent public accountant to submit Form ADV-E to the Commission along with a statement regarding the cessation of our independent public accountant relationship and an explanation of any examination scope or procedure issues that contributed to such cessation matters within 4 business days of occurrence. While the communication timeline may be appropriate, we believe it is management's responsibility to initiate communications with the SEC regarding independent public accountant cessation matters, similar to the process required by Item 304 of Regulation S-K. The independent public accountant would take appropriate actions to communicate such matters to the SEC if management failed to communicate as required.

Accountant Independence

The Proposed Rule would require that the independent public accountant performing both the annual surprise examination of client assets and the internal control report of a related custodian be deemed to be independent consistent with the independence standards described in rule 2-01(b) and (c) of Regulation S-X. The Proposed Rule does not explain how the definition of an affiliate in Regulation S-X should be applied within the context of performing either the annual surprise examination for a Registered Adviser or the internal control attestation for a related person custodian. We believe the SEC should clarify which aspects of rules 2-01(b) and (c) of Regulation S-X are applicable in both situations. In providing guidance on the application of these rules we believe the SEC should consider providing illustrative examples of common situations in order to clarify and promote consistency of application by Registered Advisers and their independent public accountants.

The SEC has raised the question of 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 this is necessary since the independent public accountant would already be held to the high standards of independence as set forth in rules 2-01(b) and (c) of Regulation S-X. Although a Registered Adviser could engage separate independent accountants to perform each service, a requirement for such a separation could be costly and without significant benefit. Additionally, it would be inefficient to require separate firms to perform such engagements, as the accounting firm that prepares the internal control report would already be familiar with the company.

Currently, auditors of Registered Advisers that are not issuers comply with SEC independence rules (to the extent the audit reports are filed with the Commission) and AICPA independence rules (to the extent the audit reports are not filed with the Commission). As a result, when performing audits of an investment adviser's financial statements pursuant to AICPA independence standards, auditors are not currently required to follow PCAOB independence rules related to the provision of tax services, contingent fees, and communications with audit committees. (See PCAOB Rules 3501, 3502, 3520, 3521, 3522, 3523, and 3524.) While not explicitly addressed in the Proposal, the engagements pursuant to the SEC's Proposal are required to be conducted in accordance with PCAOB standards, which include the PCAOB's independence rules. We suggest that the SEC clarify this in the final rule, as well as its rationale for the requirement.

Effective Date and Transition Period

The Proposed Rule has several aspects that may require Registered Advisers and their affected service providers (inclusive of related person custodians) to implement new processes and procedures and enhance others. In some instances, the requirements for an internal control report will be new and take time to implement. In light of this, we would recommend that any requirements not be effective any sooner than 12 months from initial adoption of the final rule.

Estimated Costs

Based on our understanding of the time required to complete a compliance attestation without the ability to apply sampling for testing key risk areas, the need to execute alternative procedures for ineffective confirmation requests and other issues associated with items such as privately offered securities and foreign custodians, we do not believe the average fee estimate of $8,100 per audit is realistic when considering the wider and more diverse population of Registered Advisers that will be subject to a final rule.

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In closing we would like to reiterate our support of the regulatory efforts undertaken by the Commission to improve the effective safekeeping of investor assets in an efficient manner and we hope that our comments and observations will assist the Commission to that end.

We appreciate the opportunity to submit our comments on the Proposal. If you have any questions regarding our comments or other information included in this letter, please do not hesitate to contact Samuel J. Ranzilla, (212) 909-5837, sranzilla@kpmg.com, or Glen L. Davison, (212) 909-5839, gdavison@kpmg.com.

Very truly yours,

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