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July 28, 2009

By E-mail

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

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

Ladies and Gentlemen:

The Private Equity Council (“PEC”)<sup>1</sup> appreciates the opportunity to comment on the Proposed Rule on Custody of Funds or Securities of Clients by Investment Advisers (the “Proposed Rule”),<sup>2</sup> which proposes amendments to Rules 204-2 and 206(4)-2 of the Investment Advisers Act of 1940 (referred to herein for convenience as the “Custody Rule”), and related amendments to Forms ADV and ADV-E, with the intention of improving the safekeeping of client assets.

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<sup>1</sup> The PEC is a trade association representing the nation’s leading private equity firms. The purpose of the PEC is, among other things, to promote a broader understanding and appreciation of the nature and benefits of the international private equity industry and to advocate on behalf of the nation’s leading private equity firms before U.S. and international regulatory and legislative bodies. Founded in 2007, PEC members include: Apax Partners; Apollo Global Management LLC; Bain Capital Partners; The Blackstone Group; The Carlyle Group; Hellman & Friedman LLC; Kohlberg Kravis Roberts & Co.; Madison Dearborn Partners; Permira; Providence Equity Partners; Silver Lake; and TPG Capital (formerly Texas Pacific Group). For additional information, please consult our website at [www.privateequitycouncil.org](http://www.privateequitycouncil.org).

<sup>2</sup> Proposed Rule: Custody of Funds or Securities of Clients by Investment Advisers, Release No. IA-2876 (May 20, 2009), 74 Fed. Reg. 25354 (May 27, 2009) (the “Proposing Release”).

The PEC generally supports the Commission's goal of helping to ensure protection of client assets. We are writing to comment specifically on the application of the Proposed Rule to registered investment advisers to private equity funds.

## **Background**

Although there are a number of forms that a private equity fund may take, at its most basic, a private equity fund is a pooled investment vehicle. The members of the Private Equity Council, directly through their affiliates, typically act as an investment adviser to and sponsor of the pooled investment vehicle, and investors subscribe for interests in the pooled investment vehicle. The subscription process occurs prior to or shortly after commencement of the fund, and typically no additional investors may be admitted to the fund with new capital commitments after the initial subscription period has closed. Investors in the private equity fund receive an interest in the fund (which interest is often uncertificated), and agree by contract to commit capital to the private equity fund, in specified maximum amounts, typically over a five to six year commitment period. Generally, investors have no right to redeem their interests in the fund and cannot transfer such interests without consent of the sponsor. Capital will be called from investors from time to time during the commitment period as needed to fund expenses or investments of the private equity fund in a manner consistent with the investment strategy or guidelines of the fund. At such time, investors will be apprised of the reason for the capital call and will be required to make capital contributions to the fund. In general, the private equity fund does not hold large cash balances. Invested capital is typically immediately deployed; in some cases, investors may be directed to deposit funds to an escrow account specifically established for a particular investment transaction that is not controlled by the fund manager.

An investment adviser to the private equity fund provides advice about investments to be made on behalf of the pooled investment vehicle, not the investments of individual investors in the pooled investment vehicle. In the classic private equity model, the private equity fund is used to acquire significant stakes in companies that have potential for growth. The sponsor will typically obtain rights to influence management, whether through board representation or otherwise, and will invest time, energy, talent and capital to improve the acquired company's performance and prospects. The private equity fund holds equity interests in the acquired companies, and these interests may be represented by certificates or uncertificated. From time to time, the private equity fund may receive distributions on those equity interests, or may sell its equity interests in the acquired companies and receive proceeds from such sales. Cash received by the private equity fund as a consequence of distributions or sales is generally distributed to investors upon receipt. Sometimes, the applicable fund agreements allow expenses and fees to be deducted from the amounts to be distributed to investors prior to distribution.

## Comments to the Proposal

### 1. Elimination of the Audit Exception to Surprise Audit Requirement

The Custody Rule currently provides an exception from the surprise audit requirement for an adviser to a pooled investment vehicle that is audited and delivers its audited financials to investors within 120 days.

The Proposed Rule would eliminate this exception, so that all registered investment advisers with custody of client assets would be required to engage an independent public accountant to conduct an annual surprise examination. The independent public accountant conducting the surprise examination would be charged with independently verifying *all* client funds and securities of which an adviser has custody, including those maintained with a qualified custodian and those that are not maintained with a qualified custodian, such as certain privately offered securities and mutual fund shares.

We believe that the Custody Rule should continue to except advisers from the surprise examination requirement with respect to client assets held in pooled vehicles that are audited at least annually. As the Commission notes in its Proposing Release, the annual audit involves an asset verification process, and thus serves a similar purpose as the surprise examination. A surprise examination requirement in such an instance, in addition to the regular audit, will be largely duplicative. We understand the Commission's intent in proposing the universal surprise audit requirement is to minimize opportunities for a bad actor who might otherwise prepare for a year-end audit. In the context of audited private equity funds, however, we do not believe that is a significant concern. Private equity funds acquire significant stakes in portfolio companies with a long-term hold strategy, which stakes are generally coupled with board seats or other management rights. As a result, most private equity funds have a limited number of holdings, thus allowing investors to readily keep track of which companies are owned by each fund. In addition, a fund's investments and dispositions of its interests in portfolio companies are promptly described in detail to its investors. Because acquisitions and dispositions of portfolio companies often take significant time to complete from start to finish, it would not be possible for a bad actor to prepare for an audit by acquiring or disposing of stakes in portfolio companies in anticipation of an audit. Furthermore, given the contractual inability of private equity funds to bring in new investors, the lack of redemptions by existing investors and the illiquid nature of portfolio company interests, custody manipulation concerns are not a significant risk for investors in private equity funds. The fundamental concern in the private equity fund context is whether the fund in fact owns the portfolio companies that it purports to own. We believe that the annual audit is certainly sufficient to evaluate that question, and a surprise audit will provide little, if any, additional protection to fund investors. In this regard, we note that the alleged fraudulent schemes that the Commission notes have prompted the introduction of this proposal have not involved our member firms.

As the Commission recognized in its 2002 Proposing Release in connection with the last set of amendments to the Custody Rule, investors in pooled investment funds "will have

established, by contract, a means to protect themselves from misuse of pooled assets.”<sup>3</sup> The contractual entitlement of fund investors to delivery of audited financial statements, which we do not believe is typical of most accounts managed by investment advisers, should obviate the need for annual surprise inspections.

We note that the Commission asks in the Proposing Release whether there are alternatives to the surprise examination that might provide similar protections to clients. For example, would an amendment to rule 206(4)-7, which requires advisers to adopt compliance policies and procedures administered by a chief compliance officer, requiring the chief compliance officer to submit a certification to the Commission periodically that all client assets are properly protected and accounted for on behalf of clients suffice? To the extent that the Commission concludes that the annual audit is not a sufficient investor protection for pooled investment vehicles subjected to annual audits, we believe that this alternative should be effective and sufficient for investment advisers to private equity funds in light of their nature and operations, and would be preferable to the costly, time consuming and duplicative surprise examination that would otherwise apply.

## 2. Guidance Regarding Surprise Audit Procedures

The Commission asks whether it should revise or expand the guidance it has provided regarding surprise examinations under the Custody Rule. Specifically, the Commission asks whether, as part of any such revised guidance, an accountant should be required to perform testing on the valuation of securities, including privately offered securities, as part of a surprise examination.

The PEC strongly believes that the surprise audit should not contain a valuation testing component. Valuation is not related to the existence or proper handling of client assets. Moreover, valuation of portfolio companies held by private equity funds is complex, would be expensive and likely would substantially delay the completion of a surprise audit. In addition, in respect of any fund subject to an annual audit, the valuation process would be duplicative of the valuation processes performed in connection with the annual audit of the fund’s financial statements. Given that private equity firms benefit primarily upon realized asset sales and generally are not compensated based on year-to-year valuation marks, a costly and duplicative valuation testing component would provide little benefit to investors. Rather, any surprise audit should focus solely on an objective determination of custody.

We believe that additional guidance specific to the private equity fund context would be appropriate. For example, the Proposed Rule would charge the accountant conducting a surprise examination with independently verifying *all* client funds and securities of which an adviser has custody, including those maintained with a qualified custodian and those that are not maintained with a qualified custodian, such as certain privately offered securities and mutual

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<sup>3</sup> See Proposed Rule: Custody of Funds or Securities of Clients by Investment Advisers, Release No. IA-2044 (July 18, 2002), at text following n.49.

fund shares.<sup>4</sup> Application of this requirement in the private equity fund context may be unclear in a number of respects. For example, many sponsors of private equity funds will establish separate holding companies under the private equity fund to finance and hold their interests in individual portfolio companies. In fact, it would not be uncommon for a global private equity fund to employ dozens of corporate structures to effectuate all of its investments. If the Proposed Rule were adopted, would the accountant be required to confirm custody only of the interests in the underlying operating companies that the fund owns, or would it require confirmation of custody of all securities in the chain of ownership (*i.e.*, confirmation for all of the legal entities that form a part of the ownership chain leading back to the pooled investment vehicle)? Requiring the accountant to examine uncertificated interests in a chain of ownership that could include multiple holding companies would not be practical and would present significant additional administrative burden and cost. Furthermore, confirmation of the chain of ownership is specifically provided by each fund's regular audit. For purposes of surprise audits, if they are required, we believe the Commission should instruct the accountant to focus solely on the ultimate economic interest held by a private equity fund in each of its operating companies.

The PEC also believes that, in light of the variety of uncertificated methods of representing equity and other interests in portfolio companies and other investments in the United States and throughout the world, the Commission should expressly direct the staff to be available to provide guidance and to develop an effective process by which those issues may be addressed by investment advisers, accountants and the staff during the course of surprise audits. The PEC believes such a process will serve to enhance the value of surprise audits and diminish the likelihood that unnecessary (and nonexistent) "discrepancies" will engage the time and efforts of advisers and the Commission staff.

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<sup>4</sup> The Custody Rule currently excepts from the requirement of maintaining client assets with a qualified custodian mutual fund shares and privately offered securities. Rule 206(4)-2(b)(1) and (2). ("Privately offered securities" are defined as securities, acquired from an issuer outside of a public offering, that are uncertificated (and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client) and transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.) As a result of this exception – which would remain in the custody rule as proposed to be amended – mutual fund shares and privately offered securities may not be reflected on the qualified custodian's account statements.

### 3. Elimination of Alternative Delivery Option

The Custody Rule currently requires that an investment adviser with custody of client assets have a reasonable belief that the qualified custodian holding those assets provides account statements directly to clients, or investors in pooled investment vehicles, at least quarterly. If clients do not receive account statements directly from the qualified custodian, the investment adviser must deliver quarterly account statements to clients and engage an independent public accountant to verify the client assets in a surprise examination that must occur at least once during each calendar year.

An adviser to a pooled investment vehicle is not required to comply with the rule's account statement delivery requirement if the pooled investment vehicle is audited at least annually and distributes its audited financial statements to investors in the pool within 120 days of the end of its fiscal year. An adviser to a pooled investment vehicle that does not provide audited financial statements to investors and that does not have a qualified custodian send account statements to pool investors may follow an alternative delivery option, pursuant to which an investment adviser may send reports to its clients if it undergoes a surprise examination by an independent public accountant at least annually.

The Proposed Rule would eliminate the alternative delivery option for investors in funds that are not audited but are subject to a surprise examination. Instead, the proposal would require that the custodian, rather than the investment adviser, send any account statement. The PEC recognizes that the Commission's intent in eliminating the alternative delivery option and requiring direct delivery is to provide greater assurance to clients of the integrity of account statements, especially in light of instances of recent frauds which have come to the Commission's attention. However, we believe that elimination of the alternative delivery option should be reconsidered.

Requiring private equity funds to route their quarterly financial statements and reports through an intermediary creates an added layer of complexity, cost and confusion. Investors in a private equity fund have invested with the sponsor, have negotiated the type of reporting they will receive from the sponsor and its affiliates, and have no expectation that they will receive fund-related communications from any party other than the sponsor or its affiliates. If clients of the investment adviser receive statements from parties with whom they have no relationship, it would lead to confusion. The basic problem would be compounded in respect of private equity firms that have a number of funds in which the investors do not require an annual audit, such as co-investment vehicles. The problem would also be compounded in respect of funds that use a number of custodians on a world-wide basis. Clients of the investment adviser in such a scenario potentially could, under the Proposed Rule, receive a number of statements from a number of custodians, which would amplify the potential for confusion. Requiring the custodian to mail the statements would not provide any value to investors, but it would increase the cost and complexity associated with sending those statements. In addition, as the Commission recognizes, the proposed requirement also implicates client privacy issues. Many investors in private equity funds do not want their information shared with parties other than the sponsor with whom they have agreed to invest and its affiliates.

If the Commission insists on eliminating the alternative delivery option in general, we nevertheless believe that the Commission should clarify that the requirement does not apply to require separate delivery by the custodian to investors in a pooled investment vehicle where the asset in question is held by a custodian for the benefit of the pooled investment vehicle, such as a private equity fund, and the individual investor's interest in the asset is derivative of its interest in the pooled investment vehicle.

#### 4. Material Discrepancy

The existing Custody Rule requires an auditor conducting a surprise examination to notify the Commission within one business day of "finding any material discrepancies." The Commission recognizes in the Proposing Release that an independent public accountant may first take reasonable steps to establish the basis for believing a material discrepancy exists, but also recognizes that the term is not defined, and asks for comment whether the term "material discrepancy" is widely understood by independent public accountants in the surprise examination context, or whether it should be defined.

The PEC is concerned about the lack of guidance as to the meaning of "material discrepancy", especially given the heightened emphasis on protection of customer assets that the Proposed Rule represents. We believe that the Commission should provide clear guidance to the auditors performing surprise examinations that the one business day period within which any "finding" of a "material discrepancy" by an auditor must be reported to the Commission begins to run only after the auditor, based upon a review of the facts and circumstances, which may include consulting with the adviser or ascertaining additional information, has reason to believe that a material discrepancy exists. The note in the Proposing Release that an auditor "may" first take reasonable steps to establish the basis for believing a material discrepancy exists, does not offer enough clarification that a "finding" of a material discrepancy should require a significant level of confidence, for example, a "more likely than not" belief, after due investigation and inquiry. Clarifying the requirement in this manner would help to ensure that the Commission does not receive reports of material discrepancies that have not been thoroughly evaluated by the accountant and that do not have a sound basis.

We note also that the Commission seeks comment whether the accountant's certificate that would be required to be filed with the Commission within 120 days of the time chosen by the accountant for the surprise examination, which would state that the accountant has examined the funds and securities and describing the nature and extent of the examination, should be required to be provided to clients or investors in pooled investment vehicles. We do not believe that provision of this certificate is necessary. Given the low risk of custody manipulation in the private equity context and the nature of private equity fund assets, the certificate is not likely to provide information that is useful to investors, who already typically receive an audit or other reporting as to fund assets established by relevant fund documents. To the extent that the Commission is contemplating that the certificate would be provided to investors directly by the accounting firm, we believe the privacy and potential confusion issues identified above under "Elimination of Alternative Delivery Option" would be implicated. To the extent that the Commission decides to require that the certificate be provided to investors in pooled investment vehicles, we believe that an alternative delivery option should be available –

the investment adviser should be permitted to provide a copy of the certificate directly to its clients.

## 5. Internal Control Report

If the investment adviser or a “related person” of the investment adviser serves as a qualified custodian for client assets in connection with advisory services the adviser provides to clients – as opposed to use of an independent custodian – the Proposed Rule would require the adviser to obtain (or receive from its related person), an “internal control report” that includes an opinion from an independent public accountant registered with and subject to regular inspection by the Public Company Accounting Oversight Board (“PCAOB”) in respect of the adviser’s or related person’s controls relating to custody of client assets. The Commission notes in the Proposing Release that a report on the description of controls placed in operation and tests of operating effectiveness – commonly referred to as a “Type II SAS 70 Report” – conducted in accordance with PCAOB standards would satisfy the internal control report requirement. The Proposed Rule would also require that the internal control report include an opinion of an independent public accountant that is registered with and subject to regular inspection by the PCAOB, in accordance with the rules of the PCAOB.

The PEC is concerned that the proposed rule does not provide sufficient flexibility in respect of offshore private equity funds and investments that may be held offshore. With respect to offshore custody, the requirement that the reviewer be PCAOB-registered and inspected may be problematic. We suggest that the Commission provide appropriate flexibility, for example, by providing in any final rule that a non-PCAOB-registered member of one of the “Big Four” international accounting firms could provide the report that would be required.

The PEC also believes that a “Type II SAS 70” report should not be necessary in every case. It would be preferable if the Commission were to specify in any final rule what control objectives it believes are important in respect of custodial operations, and to provide flexibility to tailor the controls report to the nature of the controls implicated in any particular case.

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We appreciate the opportunity to comment on the Commission’s proposed revisions to the custody rule. Please do not hesitate to contact us if you require additional information.

Sincerely,



Douglas Lowenstein  
President



