SULLIVAN & CROMWELL LLP

TELEPHONE: 1-212-558-4000
FACSIMILE: 1-212-558-3588
WWW.SULLCROM.COM

125 Broad Street
New York, NY 10004-2498

LOS ANGELES • PALO ALTO • WASHINGTON, D.C.
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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:

We are pleased to provide comments on the Proposed Rule on Custody of Funds or Securities of Clients by Investment Advisers (the "Proposed Rule"), 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.

We have discussed the proposed amendments of the IAA custody rule with a number of clients which provide a wide variety of investment products and services from facilities and affiliates both within and outside the United States and to clients both within and outside the United States. As a result of those discussions, we have three general concerns about the proposed amendments:

(1) *Participating Affiliates*. Under administrative interpretations and no action positions beginning in 1992,[1] U.S. registered advisers have extended the scope of their advisory services to U.S. clients through access to their non-U.S. operations by way of "Participating Affiliates" or non-U.S. affiliates which are registered under the Act for the purpose of serving U.S. clients without substantial prejudice to conducting their non-U.S. businesses for non-U.S. clients in accordance with otherwise applicable law. These arrangements have not, so far as we have been aware, been a source of custody risks similar to those giving rise to the proposed amendments. However, the proposed amendments have the potential for substantial expense, especially if SAS 70s, which might not otherwise be required, were required for either Participating Affiliates or non-U.S. client assets advised by registered, non-U.S. advisers relying on no action relief in effect for the segregation of their U.S. client and non-U.S. client businesses.

In light of the fact that these arrangements rely primarily upon administrative positions and therefore would not prompt evaluation of related rules in the rule-making proceeding, we suggest that the amendments when adopted be sensitive to the interplay between those administrative positions and the custody requirements, particularly either to provide clarity or to reduce the likelihood of duplicative effort and expense without commensurate benefit to investors. At a minimum, the rule should clarify that the new custody requirements do not apply to Participating Affiliates or U.S. registered investment advisors operating outside the U.S. to the extent they are servicing non-U.S. clients.

(2) *Controls Review*. Although by analogy, reference to Type II SAS 70 Reports has some appeal, we believe that the Commission should specify with greater precision what it expects of the controls within an adviser's or related person's custody operations, and not default either to the PCAOB or the various accounting firms which will evaluate the controls.

(3) *Surprise Audits*. (a) Issues concerning the appropriate custody of uncertificated interests have the unfortunate possibility of generating unnecessary conflict and confusion between investment advisers and the independent accountants conducting a surprise audit. In such circumstances we recommend that the Commission consider dedicating Staff resources to work with investment advisers on the implementation of the rules and practices, including dealing with, on an expedited basis, the numerous issues expected to arise in connection with uncertificated interests.

(b) We believe that current exception to the surprise audit for client assets held in pooled vehicles which themselves are audited should not be eliminated.

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[1] Uniao de Bancos de Brasileiros, SA (avail. July 28, 1992).

We are not aware of evidence suggesting that annual audits of pooled vehicles are inadequate to prevent or mitigate custody risk. In such circumstances, the cost and burden of surprise audits seem unnecessary.

Please call any of John Baumgardner (212-558-3866), Donald Crawshaw (212-558-4016) or Eric Kadel (202-956-7640) if you would like to discuss any of these comments.

Very truly yours,

SULLIVAN & CROMWELL LLP