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Davis Polk & Wardwell LLP
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Re: **File No. S7-09-09**

July 28, 2009

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

Dear Ms. Murphy:

We are writing in response to the Commission's request for comments on proposed amendments to Rules 206(4)-2 and 204-2, Form ADV and Form ADV-E (the "**Proposed Rule**")[1] under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"). The Proposed Rule would modify Rule 206(4)-2 (the "**Custody Rule**") to, among other things, require registered investment advisers with custody of client funds or securities to (i) undergo an annual surprise examination by an independent public accountant to verify client funds and securities, (ii) if client accounts are not maintained by an independent qualified custodian, obtain an internal control report relating to the custody of client assets from an independent public accountant registered with and subject to regular inspection by the Public Company Accounting Oversight Board and (iii) have a reasonable basis for believing that qualified custodians send account statements at least quarterly to clients for which such qualified custodians maintain funds or securities. We appreciate the opportunity to comment on the Proposed Rule.[2]

We recognize the Commission's important role in protecting investors from the risk of fraud or misappropriation of assets they have entrusted to investment advisers. In addition, we appreciate the need for a comprehensive review of advisers' procedures for safekeeping such assets in light of recent events that have highlighted the risks of fraud and misuse of client funds. In several respects we believe the Proposed Rule will further the Commission's goals. However, we believe that certain portions of the Proposed Rule will place significant burdens on investment advisers without contributing substantially to the realization of the Commission's objectives.

We ask that the Commission consider the following issues and recommendations prior to adopting the Proposed Rule.

I. Summary of Recommendations

- Surprise examinations are expensive and time-consuming. In light of the practical problems

[1] Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2876, 74 Fed. Reg. 25354 (proposed May 20, 2009). Page references to the Proposed Rule herein are to the Proposed Rule as released in Commission Proposing Release IA-2876.

[2] The opinions expressed herein represent those of the undersigned and not necessarily those of our clients.

implicated in the performance of such examinations, we are not convinced that they are an effective tool in detecting and preventing potential fraud or misappropriation. In the event a surprise examination requirement is adopted, we urge the Commission to exempt investment advisers in situations in which (i) a surprise examination would result in duplicative compliance procedures or (ii) existing custody arrangements create a minimal risk of fraud or misappropriation of assets. We believe that such situations should include those in which (x) pooled vehicles are subject to annual audits by independent accountants and (y) account statements are sent directly to clients by qualified custodians.

- We propose to continue to except privately offered securities from surprise examinations as we believe that the risk of fraud or misappropriation of such securities is low.

- We agree with the Commission's decision not to include in the Proposed Rule a ban on the use of affiliated custodians altogether. Qualified custodians are subject to extensive regulation and oversight that provide the appropriate tools for preventing and detecting fraud and misappropriation. Such a ban may reduce the availability of certain investment options available to investors and result in increased costs arising as a result of the loss of economies of scale. We believe other methods may be able to reduce the risk of fraud and misappropriation of client assets at less cost.

- As we believe that certain arrangements involving affiliated custodians involve few of the risks with which the Custody Rule is concerned, we ask that the Commission consider whether the requirement to obtain an internal control report is necessary in all cases where an affiliate of the adviser custodies client assets or, alternatively, whether the scope of the requirement may be narrowed to target just those affiliated custodian situations in which such risks cannot be otherwise effectively mitigated.

- We believe that the Commission may underestimate the costs and market effects of the Proposed Rule in inferring that many aspects of the Proposed Rule would impose only minimal additional burdens on investors and advisers.

II. Surprise Examinations

A. Application of Surprise Examination to All Registered Investment Advisers with Custody of Client Assets

We urge the Commission to reconsider requiring an annual surprise examination for all registered investment advisers with custody of client assets. The substantial cost concerns and limitations of the surprise examination as a deterrent and enforcement tool that were relevant to the Commission's 2003 decision to dispense with the requirement for most registered investment advisers remain relevant today.[3] In addition, a blanket requirement applicable to all registered investment advisers may result in duplicative procedures and limited benefit in the case of many advisers whose existing custody procedures place investor assets at low risk for fraud or misappropriation.

Practical problems hinder the ability of surprise examinations to detect and prevent potential fraud. Accountants performing surprise examinations are required, among other things, to confirm with each investor the funds and securities recorded with respect to such investor in the adviser's client accounts and to reconcile the adviser's records with the records of the custodian. Accounting firms that regularly perform such examinations have noted that many clients do not respond to confirmation requests or they possess

[3] The Commission acknowledged that annual surprise examinations have "limited deterrent effect" even though they impose significant costs on advisers. Specifically, the element of surprise is not a sufficient protection against fraud because advisers would be required to undergo a surprise examination only once a year, providing fraudsters with a sufficient window of time and opportunity to misappropriate funds without detection. In addition, surprise examinations may not prevent an adviser from committing a fraud by fabricating client account statements. *See* Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2044, 67 Fed. Reg. 48579, at 48583 (July 25, 2002).

insufficient information about their own accounts.[4] Based on our experience, we believe that advisory clients do not always maintain current records and keep abreast of day-to-day trading activities, especially when they have delegated investment discretion to an adviser. Particularly given the growing number of clients per adviser,[5] client confirmations are time-consuming and likely to be ineffective. In addition, we understand that surprise examinations are often, as a matter of practice, likely to occur only at certain times of the year, thus reducing the impact of the "surprise" nature of the examination. For example, it is our understanding that the timing of the surprise examination must essentially correspond to the adviser's distribution of its client account statements to enable the accountant to check the adviser's records against these statements. When the adviser sends client statements only on a quarterly basis, available dates for surprise examinations are fairly limited.[6]

In most cases, the surprise examination requirement is unnecessary because the nature of the relevant custody arrangements present a low level of risk of fraud or misappropriation. For example, (i) pooled vehicles that are subject to annual audits by independent accountants and (ii) accounts with respect to which statements are sent directly to clients by qualified custodians are unlikely to derive substantial incremental benefit from a surprise examination.

Annual audits of pooled vehicles, like surprise examinations, are intended to verify books and records for such vehicles maintained by the adviser. Further, annual audited financial statements provide investors with important information regarding the financial condition of the pooled vehicle and the strength of its internal controls. While we recognize that annual audits lack an element of surprise and may rely on auditor spot-checking of assets and securities (rather than verification of *every* security), we do not believe these additional procedures outweigh the costs of the redundant procedures for audited pooled vehicles, particularly given the likelihood that the same auditing firm would perform both the surprise examination and the annual audit.[7]

Similarly, we believe that if an adviser places client assets in the custody of a custodian and such custodian distributes quarterly statements directly to investors, a surprise examination will likely provide investors little additional protection against misappropriation or fraud. Reconciling the records of the custodian and clients in such a case against the books and records of the adviser through a surprise audit would seem to add little value in terms of investor protection while increasing costs ultimately borne by investors.

If the Commission determines that the surprise examination should be adopted, we suggest modifying the surprise examination procedures to improve their efficiency and reduce the burden of obtaining such an examination. For example, we question the necessity of confirming client account activity with all clients. Random sampling, performed consistent with established accounting procedures, should be sufficient to provide comfort regarding the absence of fraud or misappropriation with respect to an adviser's client accounts. Such modification could reduce burdens for advisers and investors, while not significantly diminishing the efficacy of the examination. In addition, the scope of any required surprise examination should be narrowly tailored to address the concerns that the Custody Rule is intended to reach. Specifically, we note that the release announcing the Proposed Rule requested comment on whether an accountant, in performing a surprise examination, should perform testing on the valuation of securities, including privately offered securities. While we believe ensuring that investment advisers accurately value their clients' securities in accordance with appropriate procedures is of great importance,

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[4] *See, e.g.*, PricewaterhouseCoopers LLP, Comment Letter to Release IA-2044 (Sept. 25, 2002).

[5] *See* Proposed Rule, 41, n.79 (*i.e.*, the Commission currently estimates an average of 1,092 clients per adviser) and Proposed Rule, 39 (*i.e.*, the Commission estimated an average of 670 clients per adviser in 2003).

[6] Further, in the case of audited pooled investment vehicles, we understand that surprise examinations are unlikely to occur at year-end.

[7] Furthermore, recent cases have shown that cases of major fraud often go undetected over many years. This suggests that the regularity of an annual audit or a surprise audit is not necessarily an effective tool for the protection of investors against fraud.

we do not believe that testing whether securities have been valued appropriately should be inserted into a process intended to verify the existence of those securities. Valuation issues are separate and apart from custody issues, and they are not unique to advisers that have custody with respect to client securities.

B. New Requirements for Commission Reporting with Respect to Surprise Examinations

To the extent surprise examinations are required under the Custody Rule, we generally agree with the new and modified proposed requirements for Commission reporting in connection with such examinations. However, the requirement for an independent public accountant performing surprise examinations to submit a Form ADV-E to the Commission upon such accountant's "resignation or dismissal from, or other termination of, the engagement, or upon [its] removing itself or being removed from consideration for being reappointed" should be modified to clarify the cases in which such filing will be required. For example, in a case in which an investment adviser manages more than one account or pooled vehicle, may it begin using a different accountant for accounts or pooled vehicles established in the future without triggering a requirement to file Form ADV-E? The requirement should also be amended to clarify that the dissolution of a pooled investment vehicle will not itself trigger a requirement for the vehicle's accountant to file Form ADV-E.

C. Privately Offered Securities

Under the Proposed Rule, the scope of surprise examinations would be extended to cover privately offered securities. The Commission reasons that such expansion would provide greater assurance that such securities are properly safeguarded. We believe the risk of fraud or misappropriation of such securities is low and that a surprise examination covering privately offered securities may present practical difficulties in many circumstances. Surprise examinations require that the auditor confirm with the custodian all cash and securities held by the custodian. However, because ownership of privately offered securities (as defined in the Custody Rule) is recorded only on the books of the issuer or its transfer agent, such securities cannot be held by a custodian. Other attributes of privately offered securities (*i.e.*, that they are uncertificated and non-negotiable, or only negotiable after obtaining consent of the issuer or the issuer's shareholders) further minimize the risk of fraud or misappropriation because privately offered securities cannot be easily transferred or used as collateral for borrowing. For example, an adviser would not be able to transfer such a security from a client account to its personal account without obtaining appropriate legal documentation. If expectations for a surprise examination with respect to privately offered securities include requiring the accountant performing the examination to confirm ownership with the issuers of such securities, careful attention should be paid to the additional burden and cost associated with such procedures. We ask that the Commission clarify its expectations in this respect.[8]

III. Alternative of Requiring an Independent Qualified Custodian

In response to the Commission's request for comments regarding the regulatory alternative of prohibiting the use of affiliated custodians in all cases, we agree with the Commission's decision not to include such a ban in the Proposed Rule. We believe that mandating the use of independent custodians in all circumstances is not a desirable regulatory alternative because (i) qualified custodians are, and will continue to be, subject to extensive regulation and oversight that provide appropriate tools for preventing and detecting fraud and misappropriation, (ii) the use of affiliated qualified custodians may, in many cases, generate significant benefits and substantial cost-savings for investors and (iii) some arrangements among

[8] In addition, we propose that the Commission limit the scope of the requirement for custody of securities by a qualified custodian to exclude those securities the safekeeping of which carries little risk of misappropriation or fraud. For example, many of our firm's clients that manage private equity investments hold share certificates evidencing clients' interests in such privately held companies. These share certificates are not freely negotiable or transferrable, yet would not meet the current definition of "privately offered securities" under the Custody Rule because they are not uncertificated. In such cases, we believe the expense investors would bear to have such securities held by a qualified custodian is not warranted, and we also understand that qualified custodians may decline to hold such securities in their custodial capacity.

affiliated financial service providers pose little risk of the dangers the Commission seeks to avoid.

A. Existing Oversight of Custodian Entities

Advisers and their affiliates that are permitted to maintain custody of investors' funds and securities are limited to a select group of entities, including broker-dealers and banks, that are already subject to wide-ranging regulation with regard to safekeeping of clients assets.

As the Commission points out in the Proposed Rule release, registered broker-dealers' financial statements must be audited annually by an independent public accountant in accordance with generally accepted auditing standards,[9] and such accountant must review the broker-dealer's procedures for safeguarding securities.[10] Specifically, this review covers the broker-dealer's practice and procedures in making quarterly securities examinations, counts, verifications and comparisons, and the scope of the review must be sufficient to provide reasonable assurance that material inadequacies do not exist in a broker-dealer's procedures for safeguarding securities.[11] In addition, all of the broker-dealer's records are subject to periodic and special examinations by the Commission.[12]

Similarly, banks are subject to comprehensive regulation and rigorous oversight of their custodial practices. Any national, state member or FDIC-insured bank or thrift engaging in custody activities is subject to supervision and examination by its federal (and, if applicable, state) banking supervisors with respect to those activities.[13] Any newly chartered bank seeking to engage in custodial activities is required to have a business plan including such activities approved by its banking supervisors prior to commencing operations.[14] With respect to national banks providing custody services, the Comptroller of the Currency will generally perform a full-scope, on-site examination of each national bank at least once during each 12- or 18-month period,[15] and will specifically evaluate the effectiveness of processes aimed at the proper safekeeping of custodied assets.[16] National banks providing custody services must also have accounting records and internal controls that ensure that custodied assets are kept separate from the assets of the custodian and maintained under joint control.[17] The Federal Reserve (which has supervisory authority not only over all bank holding companies that own national banks, but also over all bank holding companies that own state-chartered member banks) will verify during its examinations that a bank holding company adequately supervises the custody services of any subsidiary engaging in custodial activities, including confirming that such subsidiary has established and maintains procedures for proper administration of such services and that such services are reviewed regularly.[18] In its supervision and examination of state non-member banks, the FDIC will verify that procedures for proper administration of custody services are established and reviewed frequently.[19] Further, a substantial proportion of custodial services are now

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[9] 17 C.F.R. § 240.17a-5(e)(1).

[10] 17 C.F.R. § 240.17a-5(g).

[11] *Id.*

[12] 15 U.S.C.S. § 78q(b)(1) (LEXIS 2009).

[13] *See Bd. of Governors of the Fed. Reserve Sys., Div. of Banking Supervision and Regulation, Bank Holding Company Supervision Manual*; *Office of the Comptroller of the Currency, Comptroller's Handbook – "Custody Services*" (2002); *Federal Deposit Insurance Corporation, Risk Management Manual of Examination Policies*.

[14] *See, e.g.,* Business Plan Guidelines issued by the Office of the Comptroller of the Currency, http://www.occ.treas.gov/corpbook/forms/business%20plan.pdf (last visited July 28, 2009).

[15] Banks must meet certain conditions to qualify to be examined only once each 18-month period. *See Office of the Comptroller of the Currency, Comptroller's Handbook – "Supervision Process*" 12-13 (2007).

[16] *See Office of the Comptroller of the Currency, Comptroller's Handbook – "Custody Services*" 55 (2002).

[17] *Id.* at 15.

[18] *See Bd. of Governors of the Fed. Reserve Sys., Div. of Banking Supervision and Regulation, Bank Holding Company Supervision Manual* § 2010.11.5.2 (2006).

[19] *Federal Deposit Insurance Corporation, Risk Management Manual of Examination Policies* § 8.1-27 (2004).

provided by a concentrated group[20] of prominent financial institutions that provide an array of different services to businesses and individuals. In addition to the legal consequences of violating applicable laws, banks would face severe operational and reputational risks if they were to exercise unsound business conduct in connection with their custodial practices.

In light of the extensive oversight of broker-dealers and banks with respect to safekeeping of assets, we believe any potential harm associated with investment advisers using such affiliated entities as custodians can be best addressed within existing regulatory frameworks and prevented through rigorous enforcement of applicable rules and regulations.[21]

B. Benefits of Use of Affiliated Custodians

Investors are afforded significant benefits from the comprehensive services and flexible fee structures that are available as a result of an adviser's use of affiliated custodians. If advisers are required to engage third-party custodians to hold advisory client assets, many established arrangements such as wrap fee programs may become less viable, resulting in the reduction of investment options available to investors and the loss of cost-savings arising from the economies of scale made possible by such programs.

From an economic perspective, custodial services are a standard part of the bundle of services offered to investors for a single fee under a wrap fee program.[22] Generally, portfolio managers with whom a wrap fee program sponsor has established advisory arrangements are compensated with a portion of such fee, and the rest of such fee is retained by the wrap fee sponsor. The economics of the program may be altered if the wrap fee program sponsor were required to contract with a third party to provide custodial services and pay such third party out of the portion of the fee that would otherwise be retained by the sponsor. An additional consideration may be the impact of such a requirement on wrap fee distribution arrangements, including existing compensation practices with respect to brokers who participate in the distribution of wrap fee products which often involve credit earned for "asset-gathering." Brokers may face reduced incentives for soliciting investors for wrap fee products to the extent such investors' identities would be provided to a third-party custodian who may be a competitor.

We also note the extent of the impact of such a ban: most wrap fee program sponsors are both (i) required to register as advisers under the Advisers Act[23] and (ii) deemed to have custody as a result of deducting fees from wrap fee accounts. Even in unusual circumstances where a wrap fee program sponsor was not deemed to be providing investment advice to wrap fee program investors, a third party custodian would still be required if the program used portfolio managers affiliated with the sponsor, as a result of the practice of deducting fees.

The resulting costs of requiring an independent qualified custodian would almost certainly be passed on to investors. Many of our clients sponsoring wrap fee programs provide access to professional asset management to smaller investors who may not meet minimum account size requirements that would otherwise apply. Similarly, many smaller investors pay a flat fee instead of individual commissions to receive comprehensive advice from their broker-dealer, dually registered as an investment adviser. The combined provision of advice, trade execution and custody is critical to the affordability of this service for many investors. If the option to invest through wrap fee and similar programs were eliminated, smaller

[20] *See Office of the Comptroller of the Currency – "Custody Services*" 1.

[21] We also note that Congress expressed an intent in enacting the Gramm-Leach-Bliley Act in 1999 to enhance competition among financial services firms by providing a framework for their affiliation. *See* Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102.

[22] Typically, a wrap fee program will provide investment advisory, brokerage, custody and administrative services for one fee based upon the size of the account.

[23] *See* Disclosure by Investment Advisers Regarding Wrap Fee Programs, Investment Advisers Act Release No. 1411, 59 Fed. Reg. 21657, at 21658, n.10 (Apr. 19, 1994).

investors may, in fact, face a riskier set of investment alternatives, given that (i) managers participating in wrap fee programs sponsored by national brokerage firms must meet such firms' stringent compliance requirements and oversight and (ii) fee arrangements based upon commissions (as opposed to assets under management) are generally considered to increase risks of conflicts of interest (*e.g.*, by creating incentives for brokers to overtrade).

C. Mitigation of Risks Posed by Use of Affiliated Custodians

Many of our firm's clients who operate both investment adviser and custodial business divisions have themselves implemented additional policies and procedures that successfully limit the risks of fraud or misappropriation of client assets by advisory personnel, including restricting access of advisory personnel to client property, providing for separate and independent chains of command with respect to the business lines and ensuring that the operations remain physically separate (*e.g.*, by housing the operations on different premises).

The Commission has recognized in many regulatory contexts, including its prior interpretation of the Custody Rule, that the segregation of businesses of an investment adviser and its financial services affiliates is an appropriate way to minimize risks to investors posed by arrangements among such entities. In determining whether an investment adviser has "custody" of client funds or securities when they are held in a custodian bank affiliated with the investment adviser, the Commission has cited several factors that may indicate that custody should not be imputed to the adviser, including whether (i) the clients' property in the custody of the affiliated custodian might be subject to claims of the adviser's creditors, (ii) advisory personnel have the opportunity to misappropriate clients' property, (iii) advisory personnel ever have custody or possession of or direct or indirect access to clients' property or the power to control its disposition for the benefit of the adviser or its affiliates, (iv) advisory personnel and personnel of the affiliated custodian who have possession or custody of, or control over, or access to, clients' property are under common supervision and (v) advisory personnel hold any position with the custodian or share premises with the custodian.[24] Similarly, the Commission allows multi-service financial institutions to engage in both advisory services and proprietary trading activities if the advisory services are performed by a separately identifiable department of such institution and the officers or employees of the adviser involved in securities trading in connection with such advisory activities are distinct from the institution's trading personnel trading securities for the institution's proprietary accounts. Further, in the context of requirements for reporting acquisition of beneficial ownership of securities, the Commission will not require an investment adviser to aggregate its holdings with the holdings of its affiliates if such entities are sufficiently segregated, such that they exercise voting and investment powers independently of one another. The Commission has suggested that such segregation may be implemented by establishing information barriers as well as written policies and procedures reasonably designed to prevent the flow of information, and by avoiding an overlap of officers and employees involved in the exercise of voting and investment powers.[25] We believe that the Commission's longstanding recognition that separation of affiliates' businesses and operations can effectively mitigate risks posed to the securities markets by affiliated arrangements should inform any revisions of the Custody Rule.[26]

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[24] *See* Crocker Investment Management Corp., SEC No-Action Letter, 1978 SEC No-Act. LEXIS 1099 at *2 (Apr. 14, 1978).

[25] *See* Amendments to Beneficial Ownership Reporting Requirements, Exchange Act Release No. 34-39538, 66 SEC Docket 6, at 18-20 (Jan. 12, 1998).

[26] We note that the Commission has drawn distinctions among risk levels posed by various affiliated custodian arrangements, including in the context of regulation of registered investment companies. *See, e.g.*, Dean Witter World Wide Investment Trust, SEC No-Action Letter, 1988 SEC No-Act. LEXIS 407 (Mar. 14, 1988) (granting no-action relief with respect to Rule 17f-2 under the Investment Company Act of 1940, as amended, which requires certain additional safekeeping procedures in the case of self-custody of assets by a registered investment company). In *Dean Witter*, a registered fund's custodian became an affiliated person of the fund's adviser as a result of an acquisition of the custodian's parent company. No-action relief was granted on the basis that (i) the custodian and the adviser would not share personnel and would conduct their operations from separate locations, (ii) custodied assets would not be subject to claims of the adviser's creditors, (iii) the

We agree with the Commission's decision not to amend Rule 206(4)-2 to mandate the use of unaffiliated custodians. Any analysis of this regulatory alternative must recognize that the use of affiliated custodians often provides substantial cost savings to investors, and many investment advisers who have such arrangements in place have developed ways to successfully address and resolve any dangers posed.

IV. Internal Control Report[27]

The Commission reasons that a control report is a necessary additional check where the advisor or a related person of the advisor serves as qualified custodian with respect to client assets. We agree with the Commission that strong internal controls, along with their thorough testing, is of great importance. However, as discussed above, we believe that (i) not all affiliations between advisers and custodians covered by the Proposed Rule present a high risk of the dangers against which the Custody Rule is designed to guard and (ii) in many cases, a requirement to obtain an internal control report may be, to some degree, duplicative of testing and reporting that is already done, particularly in the case of broker-dealers and banks which are already subject to extensive oversight and regulation. In the event that the Commission determines that requirements to obtain internal control reports should be included in the revised Custody Rule, we request clarification with respect to the Commission's expectations for actions to be taken by an adviser in the event that an adviser receives an internal control report that is qualified.

V. Account Statement Delivery by Custodians

While we appreciate the advantages of direct delivery of account statements by qualified custodians, we are concerned that the reporting clutter that may result from the Proposed Rule's requirement may have the unintended consequence of diminishing the usefulness of account statements to investors. Many of our investment management clients utilize multiple prime brokers in the normal course of their operations, each of which may have custody of client assets. If, for example, a manager used four such prime brokers with respect to one account, and statements were delivered directly by these prime brokers, investors may receive up to four statements quarterly in connection with their investment in that account, where each statement would cover only those assets held by the particular prime broker issuing the statement. The receipt of multiple account statements may be confusing and burdensome for investors and is inconsistent with their expectations of investment advisers. Multiple statements may make it difficult for investors to determine the overall performance of their accounts, particularly investors who may not have the time or resources to wade through the paper necessary for active monitoring of their investments.

In addition, in many cases in which account statements would be required to be sent to clients by a number of custodians, it is likely that investment advisers will continue to find it necessary to prepare and distribute their own statements, summarizing the statements of the various custodians and, if applicable, including information regarding securities that are not required to be custodied with qualified custodians (*e.g.*, privately offered securities). We believe that many clients, in monitoring their investments, will rely on such "master" statements prepared by the adviser and will not reconcile the statements against one another, thereby diminishing the value of this additional check on fraud or misappropriation. In such cases, the requirement for custodial delivery of statements is likely to result in increased costs to investors with no significant corresponding benefit.

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adviser's personnel would not have access to the fund's property held in custody and (iv) instructions to custodian banks holding the fund assets through foreign custody arrangements would be required to be initiated by officers of the fund, none of whom would be affiliated with the adviser or the custodian, such that no affiliate of the adviser or the custodian would have any authority to direct disposition of fund investments. While the Commission has generally limited no-action relief from the requirements of Rule 17f-2 to unique circumstances, and we believe a more inclusive view should be taken of reliable safeguards in the context of the Custody Rule, it is worthwhile to note that the Commission has recognized in other contexts that not every affiliated custody arrangement gives rise to the same risks of fraud and misappropriation.

[27] We understand that standards for internal control reports may vary in different jurisdictions, and foreign privacy rules may interfere with the adviser's ability to obtain such reports. To the extent the Commission establishes rules that require investment advisers to obtain internal control reports, we request that the Commission clarify how advisers may comply with such rules with respect to assets custodied outside the United States.

Separately, we also note that in order to qualify for exemption from the requirement relating to delivery of account statements directly by custodians under the Proposed Rule, pooled investment vehicles must distribute audited financial statements to all investors in the pooled investment vehicle within 120 days of the end of its fiscal year. We request that the Commission clarify that fund of funds will continue to be allowed 180 days to distribute audited financial statements, in recognition of the fact that preparation of such financial statements is dependent upon receipt of information from underlying funds.[28]

VI. Costs and Burdens of the Proposed Rule

We are concerned that the release issued in connection with the Proposed Rule may underestimate the costs of compliance. Ongoing compliance with obligations under the Advisers Act generates substantial costs for our investment adviser clients, including the opportunity costs of time spent away from management of investments and the costs of legal and other professional services. Our view is that such costs will substantially increase with the adoption of the Proposed Rule, and will in some form be borne, and diminish returns realized, by investors.

We believe that resources required in respect of (i) hiring auditing firms to conduct annual surprise examinations for all client accounts, (ii) amending contractual arrangements with such auditors and (iii) obtaining internal control reports would represent a sizeable new burden, particularly, with respect to the cost of surprise examinations, in light of the Commission's current estimate of an average of 1,092 clients per adviser.[29] The Proposed Rule may also underemphasize the increased burdens that would likely be assumed by investors in monitoring their investments if the volume of account statements delivered to them in respect of such investments dramatically increased. And, as outlined in Section III above, requiring the use by investment advisers of an unaffiliated custodian would not only result in increased costs likely to be passed on to investors, but also in the possibility of reduced availability of investment options widely available today, such as wrap fee programs, from which investors derive substantial benefit.

Finally, not addressed in the release relating to the Proposed Rule is the potential impact of recent legislative proposals that would have the effect of dramatically increasing the number of investment advisers required to register with the Commission. Given the substantial resources advisers would be required to devote to complying with the Proposed Rule in its current form, we are concerned that smaller advisers newly required to register may be particularly burdened by the necessity to concurrently establish Advisers Act compliance programs and implement the additional custody procedures required by the Proposed Rule. Such additional burdens, together with the increased strain on the Commission's resources that may result from such legislation and the possibility that the capacity of professional service firms may be insufficient to meet a sudden upswing in demand for such services, underline the need for a targeted approach to revising the Custody Rule that is based on sound risk assessments and careful cost-benefit analyses.

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[28] *See* American Bar Association, SEC No-Action Letter, 2006 SEC No-Act. LEXIS 570 at *7-11 (Aug. 10, 2006) (confirming that the Commission would not recommend enforcement action under the Custody Rule against an adviser to a fund of funds relying on the annual audit exception if the audited financial statements of the fund of funds were distributed to investors within 180 days of the fund of fund's fiscal year end).

[29] *See supra* note 5.

We appreciate the opportunity to respond to the Commission's request for comments and we hope that these comments and observations contribute to the important work of the Commission. If you have any questions with respect to the matters raised in this letter, please contact any of the undersigned.

Very truly yours,

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