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J.P.Morgan

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OFFICE OF THE SECRETARY

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

Re: File Number S7-09-09
Proposed Amendments to Rule 206(4)-2 of the Investment Advisers Act of 1940
Custody of Funds or Securities of Clients by Investment Advisers

Dear Ms. Murphy:

JPMorgan Chase Bank, N. A. ("J.P. Morgan") appreciates this opportunity to comment on the Securities and Exchange Commission's (the "Commission" or "SEC") proposed amendments to Rule 206(4)-2 relating to the custody of client funds and securities by registered investment advisers (the "Proposal").

This letter will focus on particular elements of the Proposal that are pertinent to custodial services provided by banks to affiliated investment advisers and their clients. J.P. Morgan is a global industry leader through its Worldwide Securities Services ("WSS") division in providing innovative securities services, including custody, fund accounting and administration. It has more than $13 trillion in assets under custody and $3.7 trillion in assets under administration. J.P. Morgan provides these services to the world's largest institutional investors, alternative asset managers and debt and equity issuers.

J.P. Morgan supports the Commission's stated goal to reduce losses arising from fraud and the misuse of investor assets, especially in light of recent industry scandals. However, we believe that effective safeguards currently are in place at banks which provide custody services as a separate line of business and at prime brokers (particularly those which are subsidiaries of bank holding companies) which can demonstrate financial strength and a strong control environment. These "stand-alone" custody providers already afford adequate protections to investors. Accordingly, several aspects of the Proposal will simply result in additional costs and administrative burdens to custodians and their affiliated investment adviser clients without enhancing protection of investor assets. In addition, J.P. Morgan strongly supports the Commission's current approach of not requiring the use of an independent qualified custodian, for reasons that are described in more detail below.

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General Background

J.P. Morgan believes that the risk of misappropriation of or fraud involving investor assets by a registered investment adviser is greatly reduced when an investment adviser maintains custody of customer assets in segregated accounts held at well-established, highly regulated, and well-capitalized banks, having departments devoted to and with expertise in delivering custody and safekeeping services. Such custodians are closely supervised by numerous regulatory authorities that examine controls, policies and procedures intended to prevent the possibility of fraud by internal staff or clients, whether affiliated or not. For example, J.P. Morgan's custody activities and services are subject to oversight by the Federal Reserve Bank of New York, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation. As a bank, we also are subject to rigorous minimum capital requirements to provide assurance that we are able to meet liabilities, including those that may arise out of our custody business. Furthermore, certain activities, e.g., transfer agency services are also subject to SEC rules and examination.

Bank custodians also typically meet the U.S. Statement on Auditing Standards No. 70 (SAS 70) and have their registered independent public accountants issue annual SAS 70 reports. Obtaining a SAS 70 report that has an opinion from a registered public accountant requires functioning controls that are intended to manage and control risks related to custody of client assets. To support these controls, J.P. Morgan's Risk Management function articulates risk policies and procedures and sets standards for measuring and monitoring significant risk. J.P. Morgan's WSS Operations Control Management and Internal Audit groups test, monitor and examine controls that are intended to manage and control risks related to custody of client assets that are reviewed in connection with the issuance of the SAS 70 report. Cash and securities positions reported to customers are reconciled frequently – and in some instances daily – against the bank's omnibus holdings. The risk of a substantial shortfall arising due to any reason, let alone fraud, is slight. In the event that losses occur for which the bank is responsible, customers can take substantial comfort that a well capitalized bank, such as J.P. Morgan and most of its competitors, will be able to make the customers whole.

It's important to note that leading custody banks such as J.P. Morgan typically operate custody as a separate line of business distinct from its asset management business. Thus, J.P. Morgan and, we expect, other established custody banks generally maintain a full segregation between their custody and asset management businesses. At J.P. Morgan, they have separate management chains as well. This means that with respect to the key aspects of safekeeping, security and control, J.P. Morgan's custody business deals with its affiliated registered investment advisers in the same way that it deals with unaffiliated investment managers with whom we do business. J. P. Morgan's investment adviser affiliates have no access to custody books and records and cannot alter transactions or maintain bogus holdings on custody systems. Also, J.P. Morgan's investment advisor affiliates cannot control the contents of custody statements that are sent to customers. They have no greater ability than any other asset manager with whom J. P. Morgan does business to take possession or control of assets held in custody.

Similarly, customers of broker-dealers that are affiliated with bank holding companies will benefit indirectly from similar rigorous capital requirements imposed on the holding company. Many broker-dealers, such as J.P. Morgan's affiliated prime broker J.P. Morgan Clearing Corp. ("JPMCC"), have operating controls that are equivalent to those of their affiliated banks and obtain SAS 70 reports as well. In many cases, including JPMCC, there is a similar segregation from the activities of its affiliated investment advisers as there is between these advisers and the bank.

Surprise Independent Audit and Internal Control Report Requirements

The Commission has proposed that advisers that are or that use affiliates as custodians be required to obtain both an annual surprise audit conducted by an independent public accountant and an internal control report ("Internal Control Report Requirement") which includes an opinion from an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB") with respect to controls relating to custody of client assets.[1] The Commission has noted that a Type II SAS 70 report would satisfy the Internal Control Report Requirement. As described in more detail below, adequate independent reviews of the controls related to custody are well established at stand-alone custody providers which provide adequate assurances to investors without the need for additional surprise audits that will entail significant costs to such custodians without appreciable additional protections to investors.

We believe that, in the case where the qualified custodian that is a bank or a prime broker affiliated with a bank, requiring investment advisers to obtain an annual surprise examination and an annual SAS 70 report with respect to controls relating to custody of client assets would be duplicative and costly. As a major bank custodian affiliated with a leading investment adviser, J.P. Morgan will have to respond to a substantial number of auditor verification requests arising out of the surprise audit and will likely be required, for relationship reasons, to spend meaningful amounts of time in facilitating this process. If, as we assume would be the case under the proposed rule, the auditor must verify every item held in the account and transactions conducted for the account, the enterprise will

[1] J.P. Morgan does not interpret the SEC's proposal as requiring that an adviser be treated as having custody in all cases where an affiliate happens to be custodian of assets which the adviser is managing. For example, sponsors of large pension plans typically retain the trustee/custodian after a rigorous search and separately retain one or more investment managers. In our view, custody in this case should not be treated as being "in connection with" the advisory services an affiliated adviser is providing and, particularly given the special fiduciary obligations under ERISA of a plan trustee or custodian to control the plan assets, the affiliated adviser should not be treated as having any authority to obtain possession of the custodied assets. A contrary interpretation which would impose a surprise audit requirement in these circumstances would be a major change to existing practice. The cost of the audits would need to be passed back to the plan in the form of higher fees, which would act as a disincentive for a sponsor to use an investment manager if the manager happened to be affiliated with the trustee/custodian for the plan. If the SEC decides to implement the surprise audit requirement as a general matter when an investment manager causes its bank affiliate to acts as custodian, we urge that it expressly acknowledge that this is not intended to be required when the bank is separately retained to act as custodian and the adviser has no right to take control of the custodied assets.

require a huge time commitment from the custodian's personnel.[2] We do not believe that the additional costs to qualified custodians of such surprise audits have been adequately analyzed.

We also have strong doubts that the verification of assets held in custody at a bank or a prime broker affiliated with a bank would offer significant benefits to investors and do not believe that the limited benefits that might be obtained would outweigh the costs and other burdens associated with the surprise audit process. For the same reason, we also question the need for such a surprise audit for pooled investment vehicles subject to an annual audit requirement. Instead, as suggested by the SEC in the release, we believe that the SEC should not apply the surprise audit requirement in cases where there is full segregation between the operations of the adviser and its affiliated bank custodian provided that the bank custodian meets applicable regulatory capital requirements and is able to demonstrate, through a SAS 70 or other means, that it maintains a strong control environment.

The above discussion is focused on cases where a bank custodian or prime broker is affiliated with a registered adviser. However, we also believe that the burden of conducting a surprise audit substantially outweighs the benefits in cases where an unaffiliated investment adviser uses a bank or a prime broker as a qualified custodian. Accordingly, we suggest that the Commission exclude from the surprise audit requirement any case where assets held in custody by a registered investment adviser are placed with a custodian bank or a prime broker that is affiliated with a bank holding company if the custodian bank or a prime broker can demonstrate financial strength and provide a SAS 70 report demonstrating a robust control environment.

Ability to Audit Alternative Assets

Given the Commission's focus on the role of surprise audits and SAS 70 reports in providing assurances to investors on the existence of investor assets, J.P. Morgan would like to highlight the fact that custodians, affiliated or not, currently do not custody certain types of non-traditional assets such as loan participations, whole loans, OTC derivative and investments in private equity funds or hedge funds. While a custodian may record or "memo post" these types of assets to a client's account in the form of information reporting at the request of a client, such assets are not certificated or held at a central book-entry depository or clearing facility and therefore are not subject to the same type of controls that a custodian can put in place to serve as custodian for traditional assets such as stocks and bonds which are transferred, cleared and settled through established depositories and processes. Accordingly, J.P. Morgan believes that the concern with these assets is not self-custody per se, but the inherent issues in properly safekeeping these assets given the lack of a standardized custody environment. Unless and until a proper method of control is developed, which will enable stand-alone custodians such as J. P. Morgan to provide a full custody service regarding them, the imposition of a surprise

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[2] On the other hand, if the outside auditor concludes that it may conduct the surprise audit by examining custody controls and processes, and verifying samples of assets under custody, the surprise audit will in large part duplicate the analysis and findings of a SAS 70 report covering the same matters.

audit requirement will simply add to the cost of investing in these categories of assets, making them less attractive as investments. We do not believe that to be in the ultimate interest of investors.[3]

Use of Independent Custodians

The Commission has asked, whether, as an alternative to imposing additional requirements on advisers that serve as, or have related persons that serve as, qualified custodians for client assets, it should simply require the use of a custodian not affiliated with the adviser. We endorse the Commission's approach in not incorporating this alternative as part of the Proposal and strongly recommend that it not be considered further.

In institutions providing custody services on a stand-alone basis – i.e. where the custody and safekeeping and investment advisory services divisions operate as distinct businesses and/or legal entities with separation of controls and duties, and where the relationship is subject to formal written agreements, requiring the use of an independent custodian will provide little additional assurances to investors.

We note that in all key respects relating to risks and controls – systems, operations, risk management – as well as to business relationship and contractual perspectives, J.P. Morgan's custody business and its affiliated registered investment advisers deal with each other in the same way each deals with an independent third party. In many cases, mutual clients, such as a large investment management complex, or a public pension plan, not the affiliated adviser, will select J.P. Morgan as the custodian to hold client assets after performing due diligence on a number of competing providers and in full awareness of the affiliation between the adviser and custodian. For the reasons stated in this paragraph and earlier in this letter, any potential risks of fraud involving client assets that may arise as a result of the affiliation between an adviser and a bank custodian are negligible—close supervision and regulation, strong internal controls and oversight and separation of duties and locations between the adviser and the affiliated custodian, independent review by registered public accountants all serve to minimize misappropriation or destruction and loss of investor assets.

The practical, probably unintended, result of requiring the use of an independent custodian will simply be a mass shuffling of accounts and large scale migrations of assets (quite possibly in valued in the trillions of dollars) between major leading bank custodians that are affiliated with investment advisers. Ironically, such custodians are probably the least likely candidates to collude in fraudulent activities involving client assets with their affiliated investment advisers. This consequence would be extremely costly and would be highly disruptive to the very bank custodians that are best equipped to provide the safest and highest quality of custody services to registered investment advisers. We do not believe the significant costs, potential operational risks and the

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3 We note that even if the cost of an audit is incurred, it would at most give investors assurance that they in fact have indicia of ownership of an alternative investment. This does not necessarily mitigate the risk of loss due to fraud. For example, if the investment consists of units of an underlying fund, the assurance offered by the audit would not protect the investor against fraudulent investment activity by the fund – which is the type of loss incurred in the Madoff case.

distraction of such migrations and limiting the number of such highly qualified bank custodians that could be considered by investor clients, such as corporate and public pension plans, are offset by any enhanced protection of investor assets that are held by bank custodians affiliated with the investment adviser.

Again, we appreciate the opportunity to comment on the Proposal. If you have any questions about these comments or wish to discuss the proposed rules with us, please contact Jeff Hack at 212 552 5700.

Respectfully submitted,

Conrad Kozak
Chief Executive Officer
Worldwide Securities Services