CENTER FOR AUDIT QUALITY
Serving Investors, Public Company Auditors & the Markets

July 28, 2009

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

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

Dear Ms. Murphy:

The Center for Audit Quality (CAQ or the Center) is an autonomous public policy organization serving investors, public company auditors and the capital markets. The CAQ's mission is to foster confidence in the audit process and to aid investors and the markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty and trust. Based in Washington, D.C., the CAQ is affiliated with the American Institute of CPAs. The CAQ appreciates 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). This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual or CAQ Governing Board member.

I. Procedures to be performed in the Surprise Examination:

Currently, surprise examinations to verify client funds and securities generally include procedures to test the existence of such funds and securities and the balances of the client accounts. The procedures are developed to provide a reasonable basis for an opinion that the investments that the investment adviser is representing to its clients are being held on their behalf.

The primary procedures performed in such engagements focus on confirmation of custodied assets and ultimate ownership of such assets. Guidance for the surprise examination procedures currently performed can be found in ASR 103 which states that the "…independent public accountant shall verify by actual examination all funds and securities of clients held by an investment adviser." Many have interpreted this statement to require the accountant to verify through physical examination or confirmation 100% of all investments held and 100% of the client accounts. Unless stated otherwise, we would expect that the guidance of ASR 103 would continue to exist for the surprise examinations presented in the Proposed Rule. Although the guidance provided by ASR 103 in 1966 would have been appropriate when issued, the evolution of investment trading practices and auditing literature should be considered in developing guidance as to what is to be verified and the procedures to be followed.

It is expected that the Proposal will subject a much broader and more diverse group of investment advisers to surprise examination procedures than previously have been subject to such procedures. Specifically, many of the advisers that will now be subject to the surprise examination procedures have operations that are significantly different than those advisers that previously have been subject to the requirement. Such differences include: 1) investment advisers with larger number of investment accounts; 2) an increase in the number of pooled investment vehicles that were previously excluded from the count requirements; 3) the number of investments to be verified; and 4) the types of investments to be verified (which might not be custodied in the same manner as those associated with the advisers currently subject to the examinations). For example, securities firms, in particular, carry a much broader array of investment products than investment advisers that had been subject to the rule in the past. We believe that these factors will affect the nature, timing and extent of the independent public accountant's procedures, which will affect the effort required to conduct the surprise examinations.

The nature and extent of the evidence supporting the existence of investments can vary significantly based on the types of the investments. For example, funds invest in public and private securities and investments, as well as numerous types of derivative instruments, certain of which may be deemed to be securities. Derivative instruments include instruments that may change between an asset and a liability during the holding period. Certain types of investments, such as loan participations, investments in other funds, or other private investments, are represented by a contract or a record on the investee's transfer agent, rather than either a physical security or a record of existence maintained by a qualified custodian. Other examples of situations where the nature and extent of evidence to verify the existence of investments can provide challenges to the examination are as follows:

- Certain investments may require different consideration, as they may be custodied differently than publicly available securities (e.g., the trading practices of such securities may not require “delivery” of a security for the settlement of an investment transaction and therefore the available documentation may not be evidence of existence of the investment; relevant documents may be held in a vault or other multiple locations; the form of the documentation may vary widely and potentially be significantly different in substance).

- Documentation held by the custodian might not be evidence of the ownership of the investments, as the ownership rights may be altered, changed or lack substance due to subsequent transactions or agreements that the custodian may not be aware of or may not have been party to.

- The ownership of certain investments, such as those derivative instruments which qualify as securities, might only be verified through the confirmation with the counterparty to the agreement.

As mentioned above, as a result of the broader group of investment advisers that will be subject to the surprise examination requirements, we believe these challenges will be more prevalent as procedures will have to be performed on an increased number of varying types of investments. Given the varying nature of the evidence to support the existence of the investments, we believe that the SEC should consider whether existing guidance is sufficient to assist in the consistent application of the proposed examination requirements. In addition, we believe that these challenges will have a significant effect on the cost of the examination procedures, which should be considered in the SEC’s analysis of the cost and benefits of the proposed requirements.

In addition, we have identified the following areas that we believe the SEC should consider as it develops any amendments to Rule 206 related to the surprise examination based on the SEC’s Proposal:

- Whether the costs associated with the verification of 100% of the investments and confirmation of all client balances outweigh the benefits provided. Sampling techniques have been long accepted in the auditing profession in the execution of financial statement audits. In addition, the utilization of sampling techniques also can mitigate potential increases in costs as a result of the expansion of the number of investment advisers subject to the requirements and the increase in the types of investments subject to verification.

- Whether alternatives to confirmation, such as verification of existence through cash settlements, might provide a sufficient level of assurance.

- Whether, and to what extent, examination procedures should be required to cover transactions that occur between the prior count, or audit, and the current count.

- Whether it would be appropriate for the auditor to satisfy the security count requirements through the auditor's reliance and testing of an investment adviser's controls related to reconciliations with depository institutions (such as a Depository Trust Company, if applicable) or independent custody records.

- Whether changes to Rule 206 should be reviewed in association with other similar requirements elsewhere in the regulations for other financial institutions, such as Rule 17f-1 and -2 under the Investment Company Act of 1940.

- Whether privately offered securities (as defined by Rule 206(4)-2(b)(2)) that are currently excluded from the surprise examination requirements should be included within the scope of the surprise examination as would be required by the Proposed Rule. The inclusion of these securities creates a number of issues that the SEC should consider as it develops a final rule. For example, in many instances, privately offered securities are not covered by standard custodial agreements, which can affect both the effort required and the nature of the evidence available to support existence of these securities. In addition, we believe the SEC should consider whether the definition of a privately offered security is sufficiently clear such that it will be consistently applied in the context of the surprise examinations (and any other aspects of the SEC's custody rules).

- Whether special treatment should be considered for investments in non-registered pooled investment vehicles, such as hedge funds, which would only be able to confirm the balances held by their investors as of the day they close their financial records. Many of the funds only close their records on a periodic basis and therefore the confirmation requests could be processed no more frequently than month-end. As a result, the security count confirmation process could only be performed as of month-ends, which would limit the number of days in which security count procedures could be performed.

II. Consideration of Alternative Approach to Mandated Surprise Examinations – Providing the Option of Electing a SAS 70 Type II Internal Control Report

Based on the issues articulated above, we believe it may be appropriate to consider an alternative to the proposed mandated 100% confirmation security counts and 100% confirmation of client accounts under Rule 206(4)-2. We believe the application of a blanket procedural policy for all types of investment advisers may not be effective without due consideration of the circumstances and the nature of the adviser's business. As identified previously, the investments that would be subjected to the proposed count procedures differ in how they might be "custodied" and in their risk profiles to the investor. As such, the variety of the types of organizations that would be subject to the Proposed Rule complicates the effectiveness of mandating one approach. Therefore, in situations where investment advisers have engaged an independent custodian of funds and securities, but only have deemed custody as a result of the ability to deduct fees from an account or being a general partner (or general partner equivalent) to a partnership (or partnership equivalent), we believe that the Commission should consider allowing such investment advisers to elect either to have a SAS 70 Type II internal control report issued or to have a surprise examination performed. Such a SAS 70 report would need to be focused on those control objectives and controls relevant to deemed custody activities at the investment adviser. We would recommend the report also include coverage of the general, entity level control environment and information systems controls. Some potential advantages and disadvantages to this alternative are summarized as follows:

Advantages to Electing a SAS 70 Type II Report:

- An internal control report covers controls throughout the period, where surprise examinations are at a point in time. There would be greater value to the user of the reports if the operating effectiveness of the controls related to custody is tested for the entire period since the prior examination.
- Many service providers in the investment management industry are familiar with the usefulness and effectiveness of SAS 70 Type II reports, and investors have begun expressing interest in receiving this type of report.
- The report also will provide the added benefit of serving the traditional purposes of use by investor management in overseeing investment operations and by auditors in planning and executing the audits of the adviser's and related funds' financial statements.

Disadvantages to Electing a SAS 70 Type II Report:

- The performance of an internal control engagement may be more time-consuming and costly than surprise examinations.
- An internal control report may be cost-prohibitive for smaller advisers.
- SAS 70 reports typically are prepared for use by management or external auditors in situations where a company has outsourced certain functions to a service provider. Given that the likely "user" in these situations would be the adviser's clients, additional guidance may be needed to assist users in understanding and interpreting findings, including any exceptions identified in the report.

The option to elect either to have an internal control report issued or to have a surprise examination performed could be left to the determination of the investment adviser. The variety of the types of organizations that would be subject to the Proposed Rule complicates the effectiveness of mandating one approach. Providing options for compliance would allow the organizations to appropriately consider the size and complexity of their operations.

III. Independence

The Proposed Rule would require that the independent public accountant conducting the annual surprise examination of client assets and the procedures involved in the preparation of the report with respect to the adviser's (or related person's) controls relating to custody of client assets 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 requested comment on whether the independent public accountant that performs the surprise examination should be a different accountant than the accountant that prepares the internal control report. While we believe that separate independent public accountants could perform each service, we do not believe such separation is necessary because the independent public accountant that performs both engagements would be held to the high standards of independence as set forth in Rules 2-01(b) and (c) of Regulation S-X under the Proposal. Additionally, we believe a requirement for such a separation would be inefficient given the familiarity that the accounting firm engaged to perform the internal control attestation would have with the Registered Advisers operations. Based on these factors, we believe that a requirement to have different independent public accountants could result in increased costs without providing any substantive benefit.

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.) It is unclear to us whether the PCAOB's independence rules would apply to certain of the engagements that are required by the Proposal, and if PCAOB independence rules are intended to apply to certain of the engagements, we suggest that the SEC clarify the applicable independence requirements in the final rule.

IV. Considerations with Respect to Requiring PCAOB Registration and Inspection

In situations where an adviser or a related person serves as a qualified custodian for the adviser's clients' funds or securities, the Proposal requires the surprise examinations and internal control engagements to be conducted by independent public accountants that are registered with the PCAOB and subject to regular inspection by the PCAOB. To the extent that the adviser's independent auditors are not registered with the PCAOB, either the audit firm would need to register or the adviser would need to engage different independent auditors, at least for these engagements. The SEC has requested comment on whether all engagements subject to the Proposal should be performed by independent public accountants that are registered with the PCAOB and subject to regular inspection by the PCAOB. Any decision to add such requirements to the final rule should consider the very large number of advisers and auditing firms that likely would be affected.

The Sarbanes-Oxley Act of 2002 requires the PCAOB to conduct inspections of registered public accounting firms in connection with their audits, the issuance of audit reports, and related matters involving issuers.[1,2] As such, the PCAOB does not have the authority to perform inspections of audits or other engagements related to non-issuers. Thus, unless the PCAOB is granted the authority to inspect the engagements required by the Proposed Rule, generally such engagements will not be subject to PCAOB inspection. In addition, for those firms that do not issue any audit reports for issuers, no individual engagements would be subject to PCAOB inspection. We note, however, that the inspection of individual engagements generally assists the PCAOB's evaluation of a firm's system of quality control, and suggest that further consideration be given to these matters.

[1] Section 104(a) of the Sarbanes-Oxley Act of 2002.

[2] Section 2(a)(7) of the Sarbanes-Oxley Act of 2002 defines "issuer" as an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that Act (15 U.S.C. 78l), or that is required to file reports under section 15(d) (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn.

V. Effective Dates and Transition Period

Annual Surprise Examination
We recommend that this requirement take effect no earlier than twelve months after final passage of a rule by the SEC. We believe that this proposed timetable will allow both investment advisers and accounting firms to adequately prepare for initial implementation of the surprise examinations.

Internal Control Reports
Given the fact that investment advisers have not previously been required to have an evaluation of their internal controls related to custody, we recommend that the transition period for implementing an internal control assessment requirement consider the fact that additional guidance may need to be developed to assist auditors in conducting the assessment. In addition, the transition period should also allow adequate time to allow both investment advisers and their independent auditors to plan and conduct an evaluation of internal controls as contemplated by the Proposal.

VI. Cost Considerations with Respect to the Proposed Rule

We believe the cost analysis reflected in the Proposed Rule does not adequately reflect costs resulting from the complexities discussed in Section I above, as well as the costs associated with changes in auditors that may be required as a result of the requirement for the independent public accountant conducting the surprise examinations and internal control assessments to be both registered with the PCAOB *and* subject to regular inspections.

VII. Timing of the Surprise Examinations

The SEC's Proposed Rule poses the question of whether the rule should require surprise examinations to be conducted more frequently than annually or alternately, on a regular periodic basis, e.g. semi-annually. We believe that the element of surprise would be enhanced if the independent public accountant has the freedom to choose a period starting from the last date of the previous official surprise examination, which would encompass no less than four months and no more than eighteen months. If the requirement for the surprise examination continues to be once each calendar year (as currently drafted in the Proposed Rule), the organization would be aware that once a surprise examination was completed they would not be subject to a further surprise examination until the first day of the next calendar year.

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We appreciate the opportunity to comment on the Proposal and would welcome the opportunity to respond to any questions you may have regarding any of our comments and recommendations.

Sincerely,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

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