MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

July 28, 2009

<u>Via Electronic Mail</u>: rule-comments@sec.gov

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

Re: File Number S7-09-09; Custody of Funds or Securities of Clients by Investment Advisers

Dear Ms. Murphy:

Managed Funds Association ("MFA")[1] appreciates the opportunity to comment on the Securities and Exchange Commission's proposed amendments to the custody rules for registered investment advisers.[2] The safekeeping of client assets is a fundamental obligation of an investment adviser, and we support the Commission's efforts to enhance Rule 206(4)-2 under the Investment Advisers Act in light of recent events. The fraudulent activities of a single unscrupulous manager can cause widespread damage to investor confidence in the alternative investment industry, and MFA and its members strongly support efforts to prevent, detect and punish fraudulent conduct.

Registered investment advisers, including those that serve as managers to certain privately offered investment pools, which rely on the exclusion from the definition of "investment company" under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act ("hedge funds"), are subject to Rule 206(4)-2 if they are deemed to have custody of client funds or securities.[3] Under the definition of custody adopted by the Commission in 2003,[4] advisers that do not physically hold client funds or

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[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

[2] Custody of Funds or Securities of Clients by Investment Advisers, SEC Release No. IA-2876 (May 20, 2009), 74 FR 25354 (May 27, 2009) ("Release").

[3] Rule 206(4)-2 does not apply to investment advisers that are neither registered, nor required to be registered with, the Commission. In addition, offshore advisers are not subject to Rule 206(4)-2 with respect to non-U.S. funds or clients. *See Uniao de Bancos de Brasilerios S.A.*, SEC No-Action Letter (July 28, 1992); Registration Under the Advisers Act of Certain Hedge Fund Advisers, SEC Release No. IA-2333 (Dec. 2, 2004), 69 FR 72054 (Dec. 10, 2004*); American Bar Association*, SEC No-Action Letter (Aug. 10, 2006).

[4] Custody of Funds or Securities of Clients by Investment Advisers, SEC Release No. IA-2176 (Sept. 25, 2003), 68 FR 56692 (Oct. 1, 2003).

securities are nevertheless deemed to have custody if they, or a supervised person,[5] serve as general partner or managing member of a pooled investment vehicle and have legal ownership of or access to the funds or securities,[6] or if they are authorized to withdraw client funds or securities maintained with a custodian.[7] Hedge fund managers typically are subject to the Rule pursuant to one of these definitions.

The proposals would impose a new requirement on hedge fund managers subject to the Rule -- each manager would be required to engage an accountant to perform an annual "surprise exam" of client assets. We strongly support the objective of the SEC in enhancing the safekeeping of client assets in light of recent fraudulent activity. For the reasons discussed below, however, we believe that the implementation of an annual surprise exam for pooled investment vehicles advised by registered investment advisers would be overly burdensome, inefficient, and unresponsive to investor demands. A surprise exam requirement would also be redundant for most hedge funds that already have an independent annual audit.

We recommend that, instead, the Commission amend Rule 206(4)-2 to require registered investment advisers to pooled investment vehicles with custody of client funds or securities to arrange for each pooled investment vehicle to be subject to an annual audit conducted by an independent public accountant registered with, and subject to inspection by, the Public Company Accounting Oversight Board ("PCAOB"), and to distribute audited financial statements, prepared in accordance with generally accepted accounting principles, to each investor in the fund. The requirement should apply to all advisers subject to the Rule that manage pooled investment vehicles, except in cases where an adviser does not have the authority to require an audit.[8]

Mandatory Annual Audit for Pooled Investment Vehicles

Under current Rule 206(4)-2(a)(3), a registered investment adviser must either direct a qualified custodian to send an account statement, at least quarterly, to each client for which it maintains funds or securities, or itself deliver a quarterly account statement to each client and arrange for an annual surprise exam by an independent public accountant. Rule 206(4)-2 provides that an adviser to a pooled investment vehicle that is subject to audit at least annually,[9] and distributes its audited financial statements, prepared in accordance with generally accepted accounting principles, to

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[5] "Supervised person" means any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser. Advisers Act § 202(a)(25).

[6] Rule 206(4)-2(c)(1)(iii).

[7] Rule 206(4)-2(c)(1)(ii).

[8] For example, when an adviser provides investment advice to a hedge fund through a third-party platform arrangement, the third-party entity would typically have such authority.

[9] The accountant performing the audit must meet the standards of independence in Rule 2-01 of Regulation S-X.

each investor in the fund is not required also to deliver account statements under subsection (a)(3) of the Rule.[10]

A substantial proportion of hedge fund managers, whether or not they are registered with the Commission, provide independently audited financial statements of the fund to investors. Current SEC rules do not require managers to provide investors with audited financial statements, and yet managers provide them to investors primarily as a result of the demands of their investors. Hedge fund investors are typically sophisticated institutional or high net worth clients that perform extensive due diligence prior to investing with a particular manager. It is our understanding that most investors will not consider investing in a private fund unless they receive independently audited financial statements regarding that fund. Providing annual audited financial statements to investors is a long-standing best practice in the hedge fund industry, and is recommended in both the Report of the Asset Managers' Committee to the President's Working Group on Financial Markets ("PWG Report"),[11] and MFA's *Sound Practices for Hedge Fund Managers 2009 ("Sound Practices")*.[12] This practice is a result of the competitive environment of the hedge fund industry, which requires fund managers to meet the demands of their highly sophisticated investors.

Because most hedge fund managers provide audited financial statements to investors in accordance with Rule 206(4)-2(b)(3), most managers are not subject to the account statement delivery or surprise exam requirement in Rule 206(4)-2(a)(3)(ii). We believe building upon and enhancing the widely used independent audit process would be the most effective means for the SEC to provide investors with protection against the risk that an adviser would intentionally misuse client assets. We recommend therefore that the Commission require investment advisers to pooled investment vehicles with custody of client funds or securities to arrange for each pooled investment vehicle to be subject to an independent annual audit by a qualified audit firm and to distribute audited financial statements, prepared in accordance with generally accepted accounting principles, to each investor in the fund. To enhance safekeeping of client assets through a rigorous and robust audit process, we believe the Commission should include the following requirements in its rules.

First, the accountant performing the audit must be sufficiently independent from the investment adviser. As currently required for a pooled investment vehicle relying on the audit exception in Rule 206(4)-2, the accountant should be required to meet the independence standards adopted by the Commission.[13] Such a requirement would establish a consistent, uniform standard for accountants performing audits of hedge funds and other pooled investment vehicles. Currently, hedge fund managers that are not subject to Rule 206(4)-2 may engage accountants to audit funds they manage that comply with different independence standards, such as those set out by the AICPA.[14] If Congress enacts legislation this year that would significantly narrow or eliminate the exception to

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[10] To rely on this exception, the adviser must deliver the audited financial statements within 120 days of the end of a fund's fiscal year, or within 180 days of the end of the fiscal year of a fund of fund.

[11] The PWG Report is available at http://www.amaicmte.org/Public/AMC%20Report%20-%20Final.pdf.

[12] MFA's *Sound Practices* is available at http://www.managedfunds.org/files/pdf's/MFA_Sound_Practices_2009.pdf.

[13] *See* Rule 2-01 of Regulation S-X.

[14] *See e.g., Deloitte & Touche LLP*, SEC No-Action Letter (August 28, 2006).

registration with the SEC upon which many investment advisers rely,[15] as widely expected, many hedge fund managers would become subject to the Rule. Under our proposal, each registered manager would be required to subject funds it manages to an annual audit performed by an accounting firm that complies with the SEC's heightened independence standards.

Second, the firm performing the audit should be subject to the highest standards of the accounting industry, and be sufficiently knowledgeable and capable of performing a comprehensive and rigorous audit. This is an important requirement to ensure that advisers are properly safeguarding client assets, and we believe that such a requirement would significantly reduce the ability of an unscrupulous adviser to engage in fraudulent activities. It is especially important for accountants performing audits of hedge funds, which frequently engage in sophisticated investment techniques, to employ highly experienced personnel with extensive knowledge of the industry. Accordingly, we support the SEC's proposed requirement that an independent public accountant under Rule 206(4)-2 be registered with, and subject to inspection by, the PCAOB, and recommend that the Commission amend the Rule to require that accountants performing audits of pooled investment vehicles meet this standard. We further encourage the SEC to work with the PCAOB to consider developing any additional standards for firms to meet that perform audits of pooled investment vehicles.

Third, the firm should meet generally accepted auditing standards ("GAAS") in terms of verifying a percentage of client funds and securities to ensure the safekeeping of client assets. Auditing standards currently require an accountant preparing financial statements in accordance with GAAS to verify a substantial proportion of client assets during audits of pooled investment vehicles, including hedge funds.[16] As a result, an appropriate same of hedge fund assets are verified on an annual basis. We believe that an accountant verifying a substantial amount of assets during an annual audit is an effective measure to detect any misuse of client assets. A requirement for registered investment advisers to pooled investment vehicles with custody of client funds or securities to arrange for each pooled investment vehicle to be subject to an annual audit conducted by an independent public accountant registered with, and subject to inspection, by the PCAOB, and to distribute audited financial statements, prepared in accordance with GAAS, to each investor in the fund, would ensure that hedge fund assets are appropriately verified by an experienced, independent accountant.

Accountants conduct annual audits following the end of the fund's fiscal year, whereas accountants would perform surprise exams at an unannounced time that varies from year to year. We do not believe that the unpredictable timing of a surprise exam would provide greater protection for client assets. It is unlikely that the timing of an exam would be completely unpredictable, since a manager would be actively involved in approving the engagement terms of the accountant and scope of the examination, identifying the locations of client assets, and providing access to client accounts.

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[15] *See* U.S. Department of Treasury, Financial Regulatory Reform: A New Foundation, available at http://www.Financialstability.gov/docs/regs/FinalReport_web.pdf (June 17, 2009); Private Fund Transparency Act of 2009 (June 16, 2009); Testimony of Richard H. Baker, President and CEO, MFA, before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises (May 7, 2009), available at http://www.managedfunds.org/downloads/FINAL%20Written%20Testimony%20for%20May%207%20hearing.pdf.

[16] *See* Paragraphs 2.174 and 2.175 of the AICPA Investment Company Audit and Accounting Guide, May 1, 2009. Although not required, we understand some accountants nevertheless do verify all assets during annual audits of hedge funds.

For many hedge funds, particularly large funds with diversified investment techniques, an annual audit is a complex, lengthy process with accountants reviewing a fund for many months. As a result, accountants may be reviewing the fund at various times during the year, and a surprise exam could overlap with an annual audit. In addition, an annual audit conducted in accordance with GAAS already includes procedures necessary to confirm client assets, including those performed during a surprise exam. A mandatory, independent, effective annual audit for each pooled investment vehicle would serve as a substantial obstacle to an adviser attempting to misuse client assets.

We believe that a mandatory annual audit of a pooled investment vehicle by an independent accountant registered with, and subject to inspection by, the PCAOB would effectively deter and detect any fraudulent activity in connection with the custody of client assets. A requirement that each registered investment adviser to a pooled investment vehicle, including managers to hedge funds and other private funds, engage an accountant to perform an annual audit performed in accordance with GAAS would standardize audit practices across the industry and promote investor confidence. While most hedge funds distribute audited financial statements already, our proposal would have a significant effect on those managers that engage accountants that fall below industry standards or that advise funds that are not subject to annual audits, and are more vulnerable to fraudulent conduct.

As noted in the Release, the Commission has proposed these changes to prevent fraudulent conduct and increase the likelihood that an accountant or an investor would detect an adviser's misuse of client assets earlier than under the current Rule. We expect that if the Commission adopts the rule as proposed to require a surprise exam, most advisers to hedge funds would still continue to arrange for an accountant to perform an annual audit of their funds, in addition to the surprise exam because investors will not accept less. Most funds, therefore, would receive verification of their assets by an accountant twice per year, which would substantially increase cost burdens. We believe that a mandatory annual audit by an independent accountant registered with, and subject to inspection by, the PCAOB would be more effective in preventing fraudulent activity than a surprise exam.

In addition, if the SEC adopts the surprise exam requirement as proposed, we are concerned that substantial implementation challenges could arise. According to the Release, last year only 190 investment advisers were subject to a surprise examination, while approximately 9,575 advisers would receive a surprise exam if the proposals are adopted.[17] As noted above, it is widely expected that Congress will enact legislation this year that would significantly narrow or eliminate the exception to registration with the SEC upon which many investment advisers rely, and as a result a substantial number of hedge fund managers would become subject to Rule 206(4)-2.[18] As described below, we are concerned that accounting firms and fund managers would be uncertain how to comply with the existing surprise exam guidance.

[17] Release at 25363.

[18] Following such legislation, hedge fund managers would engage a significant number of accounting firms to perform both annual audits and surprise exams. We are concerned that the accounting profession may not have sufficient capacity to examine hedge fund assets twice per year, and as a result managers may be forced to engage less qualified accountants.

Recommended Changes to Surprise Exam Requirements

If the SEC determines to nevertheless require investment advisers to receive a surprise exam, we urge the Commission to review and update its surprise exam guidance. In the Release, the SEC requests comment on whether it should revise its guidance relating to surprise examinations.[19] As an initial matter, we note that, under current Rule 206(4)-2, most hedge fund managers arrange for accountants to perform annual audits of funds, rather than surprise exams. Significant changes have occurred in the ways in which investment advisers manage client assets and provide for safekeeping of those assets since the SEC issued the surprise exam guidance in 1966, and we are concerned that the existing guidance does not address these developments. For example, hedge fund managers typically enter into an agreement with a broker-dealer firm to act as a prime broker to the fund and perform a variety of services, including centralized clearing of transactions, financing, securities lending, and custody. In performing the custody services for hedge funds managed by registered advisers, prime brokers serve as qualified custodians and maintain fund assets in compliance with Rule 206(4)-2. Neither prime brokerage nor the hedge fund industry existed at the time the SEC determined the procedures for an accountant to conduct a surprise exam under the Rule. In this respect, we note that an accounting firm experienced in performing surprise exams previously indicated to the SEC that the surprise exam guidance "no longer recognizes current securities depositary, banking, or auditing practice," and if the SEC were to continue to require surprise examinations, even in limited circumstances, it was "essential" that it be updated.[20] Because the rule proposals would have such a significant effect on the hedge fund industry, we urge the Commission to review and update its surprise exam guidance. Below, we make recommendations with respect to a number of the existing surprise exam requirements.[21]

The SEC should require that an accountant conducting a surprise exam verify client assets in the same manner as required for an accountant to perform an annual audit and prepare financial statements in accordance with GAAS. As noted above, accountants preparing GAAS-compliant financial statements generally verify an appropriate proportion of, but not all, client assets during audits of pooled investment vehicles, including hedge funds. Verifying a high percentage of client assets gives the accountant sufficient assurance as to the appropriate treatment and safekeeping of the assets. Requiring an accountant to verify all assets over which an investment adviser has custody, as required by the SEC's guidance, is unnecessary and would be unduly burdensome in the case of many hedge fund managers. As described below, hedge funds invest in a wide variety of assets other than exchange-traded equity securities, including privately offered securities, bank loans, and derivative instruments, that present little potential for misuse but are typically held or recorded on a fund's books in a manner that would require an accountant to expend significant resources to verify. The surprise exam should allow for an accountant to verify an appropriate proportion of client assets, in keeping with current audit practice.

[19] Release at 25357.

[20] Comments of PricewaterhouseCoopers LLP (Sept. 25, 2002) to 2002 Proposing Release ("PwC Letter").

[21] *See* Nature of Examination Required to be Made of All Funds and Securities Held in Custody of Investment Advisers and Related Accountant's Certificate, SEC Release No. IA-201 (May 26, 1966), 31 FR 7821 (June 2, 1966) ("Surprise Exam Release").

If the SEC determines to require investment advisers to receive a surprise exam, it should also clarify how an accountant would "make a physical examination of securities and obtain confirmation as appropriate" and "reconcile the physical count and confirmations to the books and records" for privately offered securities.[22] The rule proposal would eliminate the current exemption for privately offered securities, and subject them to the surprise examination requirement. Typically when a hedge fund invests in a privately offered security, such as an interest in another private fund or privately placed security, the hedge fund manager and the issuer, or their respective administrators, will each hold a copy of the subscription agreement. A requirement to physically inspect and reconcile the count for each privately offered security could impose significant compliance burdens on the accountant performing the surprise exam, if the accountant needed to receive a physical copy of the agreement from the manager, issuer or administrator. In the case of funds of funds, which invest in a large number of privately placed securities, or funds with many private fund investors, the requirement to physically confirm securities could be unduly burdensome. Moreover, because privately placed securities are subject to significant restrictions on transfer, they are less likely to be misused by an adviser. The Commission should adopt guidance, following GAAS requirements for performing an audit, for an accountant performing a surprise exam with respect to privately offered securities.

The SEC also needs to provide clear guidance on how an accountant performing a surprise exam should treat assets that are not securities, including swap arrangements and other derivative instruments.[23] Under a swap arrangement, a fund and a counterparty agree to make certain defined payments to one another over a set time period based on the value of an underlying asset. Typically, a hedge fund will post initial margin, usually cash or cash equivalents, to the counterparty at the time it enters into a swap, and may thereafter post additional margin to the counterparty depending on the change in value of the underlying asset. The documentation evidencing the swap arrangement is typically either a physical or electronic written confirmation of the transaction between the fund and the counterparty. Industry participants are actively working with regulators to develop and implement systems to enhance the existing confirmation process, and transition from physical confirmations to electronic confirmations. MFA and its members strongly support measures designed to improve documentation of derivatives transactions, and over the past several years we have played a key role in facilitating this process. We note, however, that, as in the case of privately offered securities, physical examination of each written or electronic confirmation of a swap agreement would be burdensome. If the SEC determines to require advisers to receive a surprise exam, it should explain how, if at all, an accountant performing a surprise exam should verify a percentage of assets other than securities. Because the surprise exam requirement and related guidance are designed to apply only to client funds and securities, we believe an annual audit would be more effective in providing assurance to investors with respect to assets other than securities held by a fund, and would minimize the costs to verify these assets.

In addition to the physical examination and reconciliation requirements, an accountant performing a surprise exam must obtain written confirmation from clients of their assets as of the date of the physical examination.[24] While we support the goal of seeking client participation in ensuring

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[22] Surprise Exam Release at 7821.

[23] Under proposed Rule 206(4)-2(a)(4), an adviser must arrange for client funds and securities for which it has custody to be verified.

[24] Surprise Exam Release at 7821.

the adviser properly safeguards client assets, we are concerned that an accountant would be unlikely to receive written confirmations from each investor in a pooled investment vehicle, and in fact may not obtain even a high percentage of responses.[25] Accordingly, if the SEC determines that client confirmations are necessary, it should establish guidelines concerning the appropriate proportion of client confirmations that would provide sufficient verification of client assets.

Including client confirmations as part of a surprise exam also creates unnecessary complexity with little added benefit. Surprise exams by their nature must occur at irregular time periods, whereas advisers provide account information to hedge fund investors at regular periods, such as the end of a quarter. Clients generally do not have account information as of the date of the accountant's physical examination, and may not be able to provide confirmation in response to an accountant's request. Furthermore, many investors in private funds make their investments through brokers or other intermediaries, and prefer for these intermediaries to manage all aspects of their investments, including receiving account statements on their behalf and conducting other administrative tasks. Requiring an accountant to contact each investor and receive a confirmation of the investor's assets would be inconsistent with the expectations and preferences of many investors. Also, an investor that confirms its assets to the accountant conducting the surprise exam would do so on the basis of account statements provided by the fund manager. Such a confirmation may be of limited value to serve as an independent review of the investor's assets and ensure that a manager has not misused those assets.

Extending the surprise exam requirement to registered advisers with custody of client assets will affect a large number of advisers, and, if the SEC decides to require investment advisers to receive a surprise exam, it should identify precisely the appropriate procedures accountants must follow under the rule proposals.[26] In addition to issues associated with specific assets inspected during a surprise exam, the SEC should define and provide examples of activity that would constitute a "material discrepancy" under the Rule, as well as any "reasonable steps" an accountant may take to establish a basis for believing a material discrepancy exists.[27] Because of the significance of a finding of a material discrepancy to an adviser and its clients, an accountant should be given clear guidance in making this determination and reporting its finding to the Commission within one business day. Further, the SEC should consider clarifying its requirement that an accountant perform "additional audit procedures [as it] deems necessary under the circumstances" and describe whether anything came to the accountant's attention to cause it to believe the adviser had not been complying with the Rule prior to the exam.[28] We believe that the requirements should state that the accountant should

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[25] *See* PwC Letter. The SEC's Office of Compliance Inspections and Examinations also requests certain clients of investment advisers it examines to provide, on a voluntary basis, written confirmations of the total amounts of funds in their accounts. The SEC should consider the results of these requests in designing an effective confirmation process under Rule 206(4)-2.

[26] In determining the procedures to be followed during a surprise exam, the SEC should consult with the appropriate auditing bodies, such as the AICPA.

[27] Release at note 10.

[28] Surprise Exam Release at 7823.

perform any such additional audit procedures during a fund's annual audit, rather than during a surprise exam.[29]

In assessing the potential cost of a surprise exam, it is important to recognize that hedge funds utilize highly sophisticated investment strategies, trading operations, and risk management techniques. As described above, custody practices of hedge fund managers continue to evolve in response to investor demand and other market forces. The estimate for a surprise exam provided in the Release significantly underestimates the actual amount an accountant will charge a hedge fund manager to perform a surprise examination and file Form ADV-E.[30] Based on current hedge fund audit fees and recent conversations with accounting firms, a surprise exam by an experienced, independent public accountant would cost varying amounts depending on the type and complexity of the fund, but we expect the exam to be at a minimum $50,000, and estimates our members have received rise in some cases to well in excess of $1 million. As an example of the complexity of this task, many hedge fund managers engage multiple prime brokers to perform custodial and other services for a particular fund or client account. Managers diversify client assets across many prime brokers for a number of reasons, but primarily to mitigate risk. Counterparty risk is a key concern for managers in the current economic environment, and the PWG Report and MFA's *Sound Practices* recommend that managers actively monitor and manage such risk. The recent failure of Lehman Brothers, a significant prime broker for hedge funds, for example, and the ongoing ineffectual bankruptcy process for its U.K. affiliate, Lehman Brothers International (Europe), caused a number of funds to suffer substantial losses, leading in some cases to liquidation. In response, many hedge funds have sought to reduce their exposure to a single prime broker. We are concerned that hedge funds managers' use of multiple prime brokers as qualified custodians, as well as other industry developments, will create substantially more complexity for an accountant performing a surprise examination than the Commission anticipated when it issued its guidance. In this regard, the SEC recognized the cost of a surprise examination as a significant issue for advisers when it amended Rule 206(4)-2 to permit a pooled investment vehicle to be subject to an annual audit rather than a surprise exam.[31]

For these reasons, we recommend that the Commission amend Rule 206(4)-2 to require investment advisers to pooled investment vehicles with custody of client funds or securities to arrange for each pooled investment vehicle to be subject to an annual audit by an independent public accountant registered with, and subject to inspection, by the PCAOB, and distribute audited financial statements, prepared in accordance with generally accepted accounting principles, to each investor in the fund. The audit requirement should apply to all advisers subject to the Rule that manage pooled investment vehicles, except in cases where an adviser does not have the authority to require an audit.

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[29] For example, the Release requests comment on whether the proposed rule should require an accountant to perform testing on the valuation of securities, including privately offered securities, as part of a surprise exam. We strongly urge the Commission not to incorporate any valuation procedures in a surprise exam.

[30] The SEC estimates a surprise exam would on average cost $8,100. Release at 25365.

[31] Custody of Funds or Securities of Clients by Investment Advisers, SEC Release No. IA-2044 (July 18, 2002), 67 FR 48579 (July 25, 2002) ("2002 Proposing Release").

Internal Control Report

The rule proposals would require a registered investment adviser to obtain an annual internal control report from an independent public accountant registered with, and subject to regular inspection by, the PCAOB if it, or a related person, serves as a qualified custodian for any client funds or securities.[32] This proposal is extremely overreaching, and would impose costs on hedge fund managers and investors that would substantially outweigh any likely benefits. As part of the annual audit process conducted pursuant to GAAS, the accountant performing the audit must examine the controls in place to assess the financial statements. Once again, an audit performed by a qualified, independent accountant that prepares financial statements in accordance with GAAS should include the necessary procedures to ensure the safekeeping of client assets.

We appreciate that an adviser or a related person maintaining client assets could more easily misappropriate client assets than an adviser that engages an independent custodian, and that additional protections may be necessary. In determining the appropriate level of investor protection, the SEC should consider that an adviser, or a related person, serving as a qualified custodian under the Rule is subject to an additional set of regulatory requirements. For example, an adviser or a related person serving as a qualified custodian as a registered broker-dealer is itself subject to separate audit and internal control requirements. Any additional protections the Commission adopts should complement these existing requirements and address any existing gaps that could be exploited.

We also encourage the SEC to weigh the potential benefits and costs of an internal control report. In determining the benefits of a report, we believe the observations of investors in pooled investment vehicles would be particularly helpful. As noted above, certain investors currently request additional assurances from hedge fund managers concerning their custody practices. We believe that investors are well suited to provide the SEC with their views on the type of information that they would find to be most beneficial. Advisers required to obtain an internal control report would likely pass on the costs to its investors. Based on preliminary discussions with accounting firms, we believe that an accounting firm would charge a hedge fund manager approximately $500,000 for an internal control report, and over $1 million in some cases.[33] In its review, the SEC should also consider that the expected legislation to require managers to pooled investment vehicles to register with the SEC would likely increase the number of advisers required to obtain an internal control report.[34]

We are concerned that a manager may inadvertently become subject to the internal control report requirement if the fund it manages acquires certain investments that are not typically maintained with other assets. For example, hedge fund managers and other advisers invest in bank loans, which may be considered to be "securities" for purposes of the Advisers Act.[35] Bank loans, like certain other investments, are typically recorded on a fund's books, and may be difficult for a manager to maintain with an independent qualified custodian. These investments pose a low risk of misuse, but may not

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[32] Release at 25358.

[33] The SEC estimates that the average cost for an internal control report would be approximately $250,000 per year. Release at 25365.

[34] The SEC estimates that 372 investment advisers would be subject to the requirement. Release at 25370. It appears that this amount should also be referenced in Section VI.D of the Release.

[35] "Security" is defined in Section 202(a)(18).

fall within the exemption for privately offered securities in Rule 206(4)-2. The SEC should ensure that a fund manager would not be deemed to serve as a qualified custodian and subject to the provisions of subsection (a)(6) of proposed Rule 206(4)-2, including the requirement to obtain an annual internal control report, if it maintains bank loans and other similar assets.[36] The SEC should also confirm that assets that are not securities, such as swap arrangements and other derivative instruments, would not subject a manager to proposed Rule 206(4)-2.

Similarly, the SEC should make clear that an adviser maintaining possession of privately offered securities in accordance with subsection (b)(2) would not be maintaining securities as a qualified custodian, and therefore would not be subject to subsection (a)(6). Subsection (b)(2) of proposed Rule 206(4)-2 would exempt an adviser from complying with subsection (a)(1) of the Rule, which requires that a qualified custodian maintain client funds and securities, with respect to privately offered securities. An adviser relying on this exemption may choose to maintain possession of such securities, rather than place them with a qualified custodian. We seek clarification that an investment adviser that chooses to maintain possession of privately offered securities would not be acting as a qualified custodian and would not be subject to the requirement to obtain an internal control report in subsection (a)(6).

Additional Comments

The rule proposals would preserve the exemption from the account statement delivery requirements for pooled investment vehicles that distribute financial statements to investors, but would reduce the time period allowed for funds of funds[37] to distribute audited financial statements to investors from 180 days to 120 days within the end of their fiscal year. This time period would be difficult, if not impossible, for funds of funds to meet.[38] Funds of funds are not able to complete their annual audits until they receive statements from the underlying funds in which they invest, and an underlying fund under Rule 206(4)-2 has 120 days after the end of its fiscal year to distribute its financial statements. The Commission should amend the rule proposals to continue to permit funds of funds to comply with audit provisions of Rule 206(4)-2 by distributing financial statements to investors within 180 days of the end of their fiscal year.

Many registered investment advisers, including hedge fund managers, perform advisory services for clients through managed accounts. Under the rule proposals, an adviser to a managed account would no longer have the option to deliver account statements to its client; the qualified custodian would be required to send the statements directly to the client. As noted above, hedge fund managers typically engage a number of prime brokers to act as qualified custodians, and it is not uncommon for a manager to use five or more. A manager may adjust the allocation of assets among them during a quarter to enhance the performance of the account. As a result, under the rule proposals, a managed account client would receive multiple quarterly account statements from prime

[36] We suggest that the SEC include an exemption for these assets, similar to the exemption included in subsection (b)(2) of the proposed Rule for privately offered securities.

[37] A fund of fund is defined as a pooled investment vehicle that invests ten percent or more of its total assets in other pooled investment vehicles that are not, and are not advised by, a related person. Rule 206(4)-2(c)(4).

[38] Comments to the 2002 Proposing Release also addressed this issue.

brokers, which may be significantly different from previous statements. Thus, an unintended consequence of the proposals may be that clients are not provided with clear, usable information about their accounts.

In the Release, the SEC requests comment on whether it should require, as a substitute to an annual surprise exam, a chief compliance officer of an investment adviser to submit a certification to the SEC that "all client assets are properly protected and accounted for on behalf of clients."[39] We do not believe such a requirement would be appropriate in the case of hedge fund managers. While a manager's compliance policies and procedures, as required by Rule 206(4)-7 under the Advisers Act, should address safeguarding of client assets, a chief compliance officer does not regularly perform verifications necessary to submit such a certification. A requirement for each chief compliance officer to do so would impose significant burdens on a manager, especially smaller managers with limited compliance personnel. The verification process is more appropriately done during an annual audit by an independent accounting firm with sufficient resources and expertise to confirm that a manager is properly safeguarding client assets.

Conclusion

We support the Commission's efforts to enhance the safekeeping of client assets under Rule 206(4)-2. We believe that requiring registered investment advisers with custody of client funds or securities to arrange for each pooled investment vehicle to be subject to an annual audit by an independent accountant would best accomplish this objective while reducing any unnecessary compliance burdens. We welcome an opportunity to further discuss any of the recommendations made above with Commissioners or its staff if it would assist in your rulemaking efforts. If the Commissioners or staff have any questions or comments, please contact Matthew Newell or the undersigned at (202) 367-1140.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President and Managing Director,
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[39] Release at 25356.