UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
INVESTMENT MANAGEMENT

December 23, 2010

Barry C. Melancon, CPA
AICPA President & CEO
American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

Re: Final Rule: Custody of Funds or Securities of Clients by Investment Advisers *[Release No. IA-2968; File No. S7-09-09j]*

In your letter dated December 9, 2010 the American Institute of Certified Public Accountants ("AICPA") requested that we consider an alternative mechanism for compliance with Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940. You indicated that section (b)(4)(ii) of the Custody Rule – which requires auditors of pooled investment vehicles subject to the rule to be registered with and subject to inspection by the Public Company Accounting Oversight Board ("PCAOB") – adversely affects certain CPA firms. You recommended that the AICPA's practice monitoring program be allowed to serve as an alternative to PCAOB registration and inspection.

Section (b)(4)(ii) of the Custody Rule specifically requires that the independent public accountant performing an audit of financial statements must be registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the PCAOB in accordance with its rules. Accordingly, we cannot state that we would not recommend enforcement action if an investment adviser engaged an independent public accountant that was not subject to regular inspection by the PCAOB.

However, we would like to inform you of a related matter concerning Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which was signed into law on July 21, 2010. The Dodd-Frank Act provides the PCAOB with authority to develop rules to establish a regular inspection program for auditors of brokers and dealers. In connection therewith, the staff has provided transition relief to investment advisers and auditors that audit brokers or dealers while the PCAOB develops its rules[1].

Robert E. Plaze
Associate Director

[1] See Letter to Seward & Kissel, October 12, 2010

American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

Via Electronic Mail December 9, 2010

Robert E. Plaze, Esq.
Associate Director
Regulatory Policy and Investment Adviser Regulation
Division of Investment Management
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: *Request for No-Action Relief under the Investment Advisers Act of 1940 (Section 206(4) and Rule 206(4)-2)*

Dear Mr. Plaze:

The American Institute of Certified Public Accountants ("AICPA"), the national professional association for over 350,000 CPAs, is writing on behalf of our members that audit pooled investment vehicles ("PIVs") managed by investment advisers subject to Rule 206(4)-2 under the Investment Advisers Act of 1940 (the "Custody Rule"). The majority of these investment advisers comply with the Custody Rule by obtaining annual audits of their PIVs pursuant to Rule 206(4)-2(b)(4)(ii) (the "Annual Audit Provision"). As recently amended by the Securities and Exchange Commission (the "SEC" or "Commission"), the Annual Audit Provision now requires that, in order for an investment adviser to PIVs to avail themselves of an exemption from the surprise examination requirement, the PIV must be audited by an auditor that is both registered with, and subject to inspection by, the Public Company Accounting Oversight Board (the "PCAOB").

Congress established the PCAOB in 2002 to oversee auditors of public company issuers and registered broker-dealers, not auditors of PIVs. As a result, many auditors with substantial expertise in auditing pooled investment funds are not registered with the PCAOB and subject to inspection by the PCAOB's inspection staff. Moreover, even if such auditors are PCAOB-registered, their PIV engagements are not subject to PCAOB

inspection because many PIVs are neither issuers nor registered broker dealers. Requiring investment advisers to retain new auditors to replace auditors that are not eligible to be inspected with the PCAOB is proving to be costly and disruptive, and we respectfully submit that the goals of the amended Custody Rule also can be met if a PIV's auditor participates in the AICPA's practice monitoring (or "peer review") program, subject to the conditions we describe in this letter.

As with a PCAOB inspection, a peer review examines a firm's system of quality controls for its audit practice and reviews a cross-section of the firm's audit engagements. Indeed, because a peer review opines on the system of quality control for the firm's non-issuer practice and under the conditions set forth in this letter, would specifically focus on a firm's quality controls related to PIV engagements, peer reviews of firms that audit non-issuer PIVs are more likely than a PCAOB inspection to review audit engagements involving non-issuer PIVs and to focus on the firm's related quality controls. Accordingly, we hereby request that the Staff of the Division of Investment Management confirm that, based upon and subject to the conditions described herein, it will not recommend that the Commission take enforcement action against investment advisers that rely upon the Annual Audit Provision when the PIV's auditor participates in the AICPA's practice monitoring program.[1]

I. <u>Background</u>

As recently amended, Section (b)(4)(ii) of the Custody Rule provides that an investment adviser may rely on the Annual Audit Provision, and thereby be deemed to have complied with the surprise examination requirement of the Custody Rule, only when the PIV's auditor is "an independent public accountant that is registered with, and subject to regular inspection" by the PCAOB. In its Adopting Release for the revised Custody Rule, the Commission expressed the view that requiring an auditor of a PIV to

[1] We also request that this relief apply as well to the auditors of the PIVs in such circumstances.

be subject to PCAOB inspection would "provide greater confidence in the quality of those audits."[2]

Since the PCAOB's creation in 2002, only registered public accounting firms that audit issuers, or play a substantial role in such audits, have been subject to periodic inspection by the PCAOB. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), enacted earlier this year, provides the PCAOB with additional authority to inspect auditors of non-issuer broker-dealers registered with the Commission.[3] Even after this expansion of the PCAOB's role, however, accountants that have a non-issuer PIV client, but no issuer or broker-dealer clients, will be excluded from the PCAOB's inspection program because the PCAOB is not authorized or empowered to conduct inspections of such firm's audit practices. Therefore, absent the requested relief, this gap in the PCAOB's statutory inspection authority (which we refer to herein as the "inspection gap") will prevent audit firms that do not audit issuers or broker-dealers from auditing the PIVs for investment advisers that wish to rely upon the Annual Audit Provision. This would be the case regardless of the number of PIV clients that an accounting firm serves, the firm's past experience and expertise in auditing the financial statements of PIVs, or the absence of any prior problems relating to the firm's PIV audits.

II. <u>Unanticipated Consequences of the Revised Rule</u>

In amending the Custody Rule to require PCAOB-registered and inspected auditors for PIVs of investment advisers that wish to rely on the Annual Audit Provision (and thus avail themselves of this generally utilized exemption from the Rule's surprise

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[2] *See* "Custody of Funds or Securities of Clients by Investment Advisers, IA Release No. 2968, 75 Fed. Reg. 1456, 1465 (Jan. 11, 2010) (the "Amended Custody Rule Release").

[3] Section 982 of Dodd-Frank authorizes, but does not require, the PCAOB to inspect auditors of broker-dealers. Section 982(e)(2)(D) also provides that auditors of broker-dealers that the PCAOB determines should not be subject to inspection will be relieved of any obligation to register with the PCAOB. The PCAOB has not yet proposed inspection rules for broker-dealers, but any such rules would not take effect until after the SEC approved such rules following a public notice and comment period.

examination requirement), the Commission noted that it did "not believe there will be a substantial dislocation of pooled investment vehicle auditors as a result of the amended rule."[4] While this may have been the SEC's expectation, we believe that the number of accounting firms and PIVs that are adversely impacted is considerably greater than the Commission may have anticipated. Indeed, the inspection gap that arises under the amended Custody Rule is already having a detrimental impact on numerous accounting firms that focus their practice on private funds, the investment advisers that currently retain these firms to audit their PIVs, and investors in the affected funds.

In particular, since the adoption of the revised Custody Rule, the AICPA has received correspondence from 17 small and medium-sized accounting firms whose practices are being affected due to the amended Annual Audit Provision.[5] In the aggregate, 14 of these firms audit at least 338 PIV clients with over $8.735 billion in assets under management. Six of these 17 firms, which collectively audit 61 PIVs with $1.621 billion in assets under management, currently have no issuer or broker-dealer clients and, therefore, will continue to fall within the inspection gap even if the PCAOB adopts rules that provide for the inspection of auditors of some or all registered broker-dealers. As a result, these firms, many of which have developed considerable expertise in auditing PIVs over many years, stand to lose long-standing engagements since the majority of investment advisers will continue to rely upon the Annual Audit Provision in order to avoid the duplication and cost that would otherwise occur with a surprise examination. Some of the AICPA's members have already begun to lose engagements and this trend will almost certainly accelerate in the upcoming weeks as fiscal year 2010 comes to an end for many PIVs.

In addition to preventing many firms with considerable experience in auditing PIVs from continuing to serve their clients, PIVs and their investors are also adversely

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4 *See* Amended Custody Rule Release, 75 Fed. Reg. at 1473.

5 We understand that many of these firms have contacted the Staff directly and informed the Staff of the adverse impact on their practices as a result of the "inspection gap" under the amended Custody Rule.

American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

impacted. Contrary to the Commission's goals in adopting the revised Custody Rule, the clients of investment advisers with custody of client assets may actually have less, rather than more, confidence in the quality of the audits performed, if an experienced auditor is replaced with a new auditor who may have limited, if any, prior experience auditing PIVs. Moreover, forcing PIVs to transition to new auditors will require them to incur significant transition costs. Specifically, at the outset of a new engagement, the PIVs may receive less efficient auditing services as their new auditors are required to take time to become familiar with a PIV's operations and financial statements. Indeed, there is a general consensus that the greatest risk of an audit failure, or the failure to detect a misstatement in the financial statements of a client, exists in the first year of an audit.[6] In addition to these short-term costs arising from a forced transition to new auditors, PIVs may also face long-term increases in their annual audit fees, due to the anti-competitive effect of reducing the number of audit firms that are eligible to audit PIVs. As the costs of PIV audits increase due to the consolidation of work among a smaller number of audit firms, those additional audit fees are likely to be passed on to PIV investors.

In some instances, audit firms affected by the inspection gap might attempt to retain their PIV clients by registering with the PCAOB and taking on a new issuer or registered broker-dealer client. This option, however, would not be available to all firms. Moreover, under existing Staff guidance, an investment adviser apparently would *not* be able to rely on the Annual Audit Provision with respect to a PIV whose auditor had been

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[6] Moreover, both the SEC and the Government Accountability Office previously have declined to impose or recommend a requirement that public companies or other SEC-registered entities periodically rotate their audit firms. *See* Strengthening the Commission's Requirements Regarding Auditor Independence; Final Rule, 68 Fed. Reg. 6006, 6018 (Feb. 5, 2003) (declining to require mandatory audit firm rotation and noting the GAO study required under Section 207 of the Sarbanes-Oxley Act); PUBLIC ACCOUNTING FIRMS: REQUIRED STUDY OF THE POTENTIAL EFFECTS OF MANDATORY AUDIT FIRM ROTATION, GAO-04-216 (November 2003) (concluding that the likely costs of mandatory audit firm rotation outweighed the potential benefits). In practice, the amended Custody Rule requires that many private funds that are exempt from registration under the federal securities laws replace their auditors.

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1455 Pennsylvania Avenue, NW
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engaged to perform the audit of one or more broker-dealers, but did not register with the PCAOB until after July 21, 2010.[7]

We submit that Congress never intended such a significant dislocation of accounting firms serving PIV clients. Congress established the PCAOB for the express purpose of overseeing auditors of issuers and registered broker-dealers, not auditors of non-issuer PIVs. Indeed, the PCAOB's inspection program, which is undoubtedly rigorous, is currently devoted to auditors of issuers. While Dodd-Frank now authorizes the PCAOB to expand its inspection program to cover auditors of registered broker-dealers, the PCAOB is not currently authorized to inspect the audits of non-issuer PIVs and the Commission's Staff expressly confirmed to us in a recent meeting that the PCAOB will not be inspecting such audits[8]. Moreover, the PCAOB has no particular expertise in reviewing audits of PIVs, and the skills required to review those audits are quite distinct from those needed to review audits of issuers or broker-dealers. In particular, audits of PIVs follow specific AICPA standards and guidance, not PCAOB standards and guidance, and PCAOB inspectors may not be well versed in those standards, in comparison with peer reviewers under the AICPA's program.

As we have discussed, if our proposal is accepted, audit engagements of firms that audit non-issuer PIVs are, in fact, more likely to be reviewed. Accordingly, as discussed below, the Commission's desire to promote greater confidence in the quality of audits performed on PIVs can be better and more efficiently accomplished without requiring PIVs to change auditing firms.

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7 *See* Robert Van Grover, Esq. SEC No-Action Letter (Oct. 12, 2010).

8 Since the PCAOB will not include non-issuer PIV audits in its inspection program, one might question how much comfort logically could be derived under the amended Custody Rule from the fact that a firm's non-issuer PIV audits (for some firms, more than 100 engagements) had been performed properly, if the PCAOB's inspection was limited to the firm's single audit engagement for an issuer. In comparison, the enhanced peer review program we have described would specifically target these PIV audits for review.

III. <u>Proposed Conditions to No-Action Confirmation</u>

The AICPA supports the Commission's desire to promote greater confidence in the quality of audits performed on PIVs. This goal can be accomplished, however, without precluding audit firms that fall under the inspection gap from continuing to serve PIV clients or forcing PIVs to retain new auditors. In particular, the AICPA requests that an investment adviser be allowed to continue to rely upon the Annual Audit Provision in the Custody Rule, so long as (1) the auditor of its PIVs participates in the AICPA's practice monitoring (or "peer review") program, (2) the AICPA implements the enhancements to its peer review program described below to focus additional attention on PIV audits; and (3) the adviser provides written notification to each investor in each PIV prior to the distribution of the financial statements that the PIV's auditor participates in the AICPA's peer review program, and is not subject to regular inspection by the PCAOB.

By way of background, the AICPA has substantially enhanced its practice monitoring program in recent years.[9] Under the current program, AICPA member firms must undergo a peer review once every three years. Firms that perform, among other things, engagements under the AICPA's Statements on Auditing Standards or audits of non-SEC issuers performed in accordance with the PCAOB's standards are required to obtain peer reviews called "System Reviews." A System Review focuses on a firm's quality control policies and procedures relating to its accounting and auditing practice for non-SEC issuers and tests a cross-section of the firm's engagements performed in the year covered by the peer review, with an emphasis on higher-risk engagements.[10] At the

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[9] The AICPA's current standards for performing and reporting on peer reviews were adopted in October 2007 and are effective for peer reviews commencing on or after January 1, 2009. These detailed standards are set forth in PRP Section 1000 of the AICPA Professional Standards and are supplemented by an extensive body of interpretations that provide additional guidance to both the national and state bodies that administer practice monitoring programs and those who perform peer reviews of reviewed firms. *See* PRP Section 2000, Peer Review Standards Interpretations.

[10] *See* PRP Sections 1000.37 and 1000.59.

end of a peer review, the findings are shared with the reviewed firm, which may be required by a peer review committee to take corrective action to address "deficiencies" or "significant deficiencies" found to exist in its quality controls.[11] Firms that fail to take appropriate corrective action, or which are identified as having recurring quality control issues, are subject to having their enrollment in the peer review program terminated, with public notice of the termination of the firm's enrollment (*See* PRP §§1000.144 -.145 *and* http://www.aicpa.org/ForThePublic/PeerReviewPublicFile/DownloadableDocuments/Firm%20Terminations.pdf [list of firms whose enrollment in the peer review program has been terminated since February 2009]). State boards of accountancy, which have access to all peer review reports, could take further action, including license revocation and practice limitations on the firm. It should be noted that since substantially all states require peer review for licensure to practice, a firm terminated from the peer review program is unable to practice further.

Individuals serving as peer reviewers must be currently active in public practice at a supervisory level in a firm's accounting or auditing practice. In addition, they must have current knowledge of the applicable accounting and auditing guidance relevant to the clients of the firm being reviewed, including knowledge of the "current rules and regulations" applicable to "the industries of the engagements that the individual[s] will be reviewing."[12] Accordingly, individuals on the peer review team for member firms that audit PIVs must be knowledgeable of the relevant guidance for auditing PIVs, including the AICPA Audit and Accounting Guide for Investment Companies.

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[11] *See* PRP Sections 1000.140 and 1000.143. A "deficiency" is "one or more findings that the peer reviewer has concluded, due to the nature, causes, pattern, or pervasiveness, including the relative importance of the finding to the reviewed firm's system of quality control taken as a whole, could create a situation in which the firm would not have reasonable assurance of performing and/or reporting in conformity with applicable professional standards in one or more respects. PRP Section 1000.70(c). A "significant deficiency" is "one or more findings that the peer reviewer has concluded results from a condition in the reviewed firm's system of quality control or compliance with it such that the reviewed firm's system of quality control taken as a whole does not provided the reviewed firm with reasonable assurance of performing and/or reporting in conformity with applicable professional standards in all material respects. PRP Section 1000.70(d).

[12] *See* PRP Section 1000.31.

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1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

Federal and State regulators have repeatedly recognized the benefits of the AICPA's peer review program by permitting or requiring audits of regulated entities or programs to be performed by audit firms that participate in a peer review program that satisfies the AICPA's standards.[13] In addition, current requirements of the Federal Deposit Insurance Corporation (the "FDIC") for audits of FDIC-insured depository institutions require the auditors to have received *either* a peer review performed in accordance with the AICPA's current requirements *or* a PCAOB inspection.[14]

The AICPA believes a similar approach would be appropriate here; however, subject to the receipt of the no-action relief requested herein, the AICPA would implement the following steps to place greater attention on PIV audits in its peer review program:

- **National Administration of Peer Review of PIV Auditors.** Various state entities (including state CPA societies) currently administer the peer review program for the majority of the AICPA's members, unless a member is required to or chooses to have the peer review administered by the National Peer Review Committee (the "NPRC").[15] A firm is required to have its peer review administered by the NPRC if it either (1) is required to be registered with and is inspected by the PCAOB or (2) performs audits of non-SEC issuers pursuant to the standards of the PCAOB. On a prospective basis, the AICPA will also require administration by the NPRC of all firms performing PIV audits in situations where a PIV's investment adviser relies on the Annual Audit Provision. The proposed change to national administration will allow

[13] *See, e.g.*, 7 C.F.R. 1773.5 (requirements adopted by the Department of Agriculture for audits of the financial statements of borrowers from the Rural Utilities Service); 13 C.F.R. 120.643 (requirements adopted by the Small Business Administration for audits of the financial statements of SBA Supervised Lenders).

[14] *See* 12 C.F.R. 363.3.

[15] The AICPA currently requires national administration only for members registered and subject to PCAOB inspection or those that perform audits of non-SEC issuers subject to PCAOB standards. *See* Peer Review Standards Interpretations, Interpretation 11-1.

the AICPA to better promote uniformity in the standards applied to peer reviews of members that perform such PIV audits.

- **Weighting PIV Audits During the Engagement Review Selection Process.** Audits performed on PIVs currently fall within the scope of engagements subject to being selected for review during a System Review. A representative cross section of engagements performed by the firm is reviewed. Thus, if PIVs represent a substantial portion of a firm's practice, more than one such engagement would be reviewed. In addition, to heighten the focus on PIV audits, firms administered by the NPRC will be required to specifically identify their PIV engagements and we will direct the firms' peer reviewers to review at least one such engagement (regardless of the number of audits of PIVs the firm performs) or justify the rationale for not doing so in writing. With such direction, it would be highly unlikely a firm would *not* have a PIV engagement reviewed during its peer review.
- **Enhanced Monitoring and Oversight of Peer Reviewers.** In determining how to complete a peer review, the NPRC evaluates the performance of the peer reviewer. This can be performed in a variety of ways including AICPA personnel or members with the appropriate qualifications conducting onsite monitoring of the peer reviewer. If serious weaknesses in a reviewer's performance on a particular review are noted, or a pattern of poor performance is identified, corrective action may be required before the reviewer is allowed to perform additional peer reviews (and, in some instances, a reviewer may be prohibited from performing future peer reviews).[16] On a prospective basis, the AICPA will also specifically target its oversight of reviewers who perform peer reviews of firms that audit PIVs in order to monitor the appropriate selection of PIV engagements for review and

[16] *See* PRP Sections 1000.148-.151.

the performance of engagement reviews in accordance with applicable standards.[17]

In addition, the no-action relief requested in this letter would be limited to situations where the investment adviser provides written notification to each investor in each PIV prior to the distribution of the financial statements that the PIV's auditor participates in the AICPA's peer review program and is not subject to regular inspection by the PCAOB.

We respectfully submit that, under these circumstances, an auditor's participation in the AICPA peer review program will provide PIV investors with a degree of assurance that is equal, if not greater, to the protections afforded when a PIV auditor is subject to periodic inspection by the PCAOB.[18] Moreover, it will permit accountants who have experience in auditing PIVs, but who fall within the current inspection gap, to continue to serve their clients, while avoiding the increased costs to PIVs and their investors that will otherwise inevitably arise.

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[17] Detailed guidance to peer reviewers on performing engagement reviews is contained in PRP Sections 1000.102-.116.

[18] In particular, we note that , there is no reason to believe that, even after the PCAOB adopts inspection rules for broker-dealer auditors, the PCAOB would revise its practices and select any of a registered firm's audit engagements that involved *PIVs* for review. In comparison, the AICPA's peer review program currently includes PIV audits within the scope of a peer review, and the AICPA's proposed modifications to the program would increase the likelihood that PIV audit engagements will be reviewed during a peer review and enhance the oversight of the reviews performed on PIV auditors. Accordingly, the Commission's Staff can grant the requested relief without any concern that making this alternative available to investment advisers that wish to comply with the annual audit provision would detract in any way from the goals of the amended Custody Rule.

American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

IV. Conclusion

For the foregoing reasons, the AICPA requests that the Staff confirm that, subject to the conditions described in this letter, it would not recommend enforcement action against an investment adviser to a PIV (or against the PIV's auditor) when an adviser elects to comply with the Custody Rule through the Annual Audit Provision by having the financial statements of its PIVs audited by an auditor who participates in the AICPA's peer review program but is not eligible to have its practice inspected by the PCAOB.

If you have any questions, please do not hesitate to contact James Brackens, Vice President of Firm Quality and Practice Monitoring at (919) 402-4003. We appreciate the SEC Staff's attention to this issue.

Sincerely,

Barry C. Melancon, CPA

AICPA President & CEO