

## Alert

### SEC Custody Rule Update for Private Fund Managers

August 15, 2013

The Securities and Exchange Commission's Division of Investment Management recently issued a Guidance Update<sup>1</sup> regarding the Custody Rule (Rule 206(4)-2 under the Investment Advisers Act).<sup>2</sup> The Guidance Update states that the Division will not require a registered investment adviser to hold certain certificated "privately offered securities" with a qualified custodian, thereby resolving a Custody Rule issue faced by many private fund managers. The Guidance Update should be evaluated in the context of other actions and statements on the Custody Rule recently issued by SEC staff.<sup>3</sup>

The SEC's National Examination Program<sup>4</sup> issued, in March 2013, a Risk Alert entitled "Significant Deficiencies Involving Adviser Custody and Safety of Client Assets."<sup>5</sup> The Risk Alert highlighted Custody Rule-related deficiencies found by the SEC's Office of Compliance Inspections and Examinations in a number of recent examinations,<sup>6</sup> which fell into four general categories:

- Failures by advisers to recognize that they had custody of client funds and securities;
- Failures to comply with the surprise exam requirement;
- Failures to comply with the "qualified custodian" requirement; and
- Failures to satisfy the requirements of the "audit exception."

The examination staff's findings have resulted in a number of actions, ranging from remedial measures taken by advisers to referrals by OCIE to the SEC's Enforcement Division.

<sup>1</sup> IM Guidance Update No. 2013-04 (August 2013), available at <http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-04.pdf>.

<sup>2</sup> This *Alert* focuses on advisers to private funds, but all registered advisers should consider their compliance with the Custody Rule. Advisers do not need to comply with the Custody Rule with respect to the account of an investment company registered under the U.S. Investment Company Act of 1940 (see Rule 206(4)-2(b)(5)), although Section 17(f) of the Investment Company Act (and related rules) imposes a separate custody regime for registered investment companies. The Custody Rule also does not apply to exempt reporting advisers or to other advisers not registered with the SEC.

<sup>3</sup> In addition to the Guidance Update and the NEP Risk Alert, in July, the United States Government Accountability Office issued a report on the requirements and costs associated with complying with the Custody Rule. The GAO report is available at <http://www.gao.gov/assets/660/655754.pdf>.

<sup>4</sup> The "National Examination Program" is the collective effort of the SEC's Office of Compliance Inspections and Examinations teams throughout the United States for carrying out the SEC's nationwide examination and inspection program for investment advisers and other financial industry participants and self-regulatory organizations.

<sup>5</sup> Available at <http://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf>.

<sup>6</sup> This report was based on over 400 recent OCIE examinations that found "significant deficiencies" in investment adviser compliance programs. Over one-third of these examinations reportedly revealed Custody Rule compliance issues.

It is clear from the SEC's recent activities that this renewed focus on compliance with the Custody Rule reflects an internal priority that will directly affect many private fund advisers. Custody Rule issues have become an area of significant focus and concern in recent examinations of advisers of various sizes and disciplines.

The prescription for *all* advisers was unambiguously set forth by the SEC staff in the March Risk Alert: "[a]dvisers should review their practices in light of the deficiencies noted in the NEP Risk Alert and their responsibilities under the Custody Rule to protect client assets." We have issued this *Alert*, not only to discuss the recent guidance on certificated privately offered securities, but also to remind and inform our clients of their obligations under the Custody Rule and — in light of the NEP Risk Alert — to provide our analysis of some of the more difficult issues facing private fund advisers in complying with the rule.

## I. A Brief Summary of the Custody Rule

The Custody Rule is a long-standing Investment Advisers Act rule affecting registered investment advisers that have, or that are deemed to have, "custody" of client funds and securities. The rule sets forth a number of requirements intended to safeguard client funds and securities from an adviser's misappropriation and to insulate client assets from an adviser's insolvency.

Under Rule 206(4)-2(d)(2), a registered investment adviser is deemed to have custody of client assets if the adviser or a "related person"<sup>7</sup> of the adviser holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them. While a private fund manager generally does not directly hold client funds or securities, usually relying on prime brokers, banks and other custodians instead, an adviser is often deemed to have custody because: (i) it is party to an arrangement (such as an investment management agreement) under which it has the authority to withdraw funds or securities from a client account (either as a general matter or to satisfy a management or performance fee payment obligation) or (ii) the adviser or a related person serves in a capacity, such as a general partner, managing member or trustee, that gives it or its supervised persons legal ownership of or access to client funds or securities.<sup>8</sup>

In the private fund context, the Custody Rule's key safeguarding requirements are as follows:<sup>9</sup>

- **Maintenance of client funds and securities with a qualified custodian.** All registered advisers must maintain client funds and securities with a "qualified custodian"<sup>10</sup> either: (i) in a separate account for each client in that client's name or (ii) in accounts that contain only client assets and are titled in the name of the investment adviser as "agent" or "trustee" for the client.
- **"Audit exception" requirements.** If a client is a "pooled investment vehicle"<sup>11</sup> and
  - (i) It is subject to an annual audit by an independent public accountant registered with, and subject to inspection by, the Public Company Accounting Oversight Board;
  - (ii) Its audited financial statements are prepared in accordance with U.S. GAAP and are delivered to investors within 120 days of its fiscal year-end (funds of funds are subject to different deadlines); and

<sup>7</sup> See Rule 206(4)-2(d)(7) (defining "related person" as any person, directly or indirectly, controlling or controlled by the adviser, and any person that is under common control with the adviser).

<sup>8</sup> Rule 206(4)-2(d)(2) contains examples of situations where an adviser will be deemed to have custody.

<sup>9</sup> Additional requirements can apply, especially to advisers that maintain client assets with a related person as qualified custodian. See, e.g., Rule 206(4)-2(a)(6) (discussing, *inter alia*, the requirement of such advisers to obtain an internal control report).

<sup>10</sup> A "qualified custodian" generally includes any U.S. bank, U.S. registered broker-dealer, U.S. futures commission merchant and a foreign financial institution that customarily holds customer assets and that segregates customer assets from its own assets. See Rule 206(4)-2(d)(6) (defining "qualified custodian" in more detail).

<sup>11</sup> The audit exception *only applies to pooled investment vehicles*; advisers to managed accounts (no matter how large the account or how sophisticated the client) either need to comply with the additional notice, account statement delivery and surprise examination requirements of the Custody Rule or ensure that they do not have "custody" over the account (by, for example, foregoing the ability to deduct fees and instead submitting invoices to the client). "Pooled investment vehicles" include limited partnerships, limited liability companies or another type of pooled vehicle (and the SEC has confirmed that, for purposes of being able to rely on the audit exception, there is no minimum number of investors that are required to qualify such entities as pooled investment vehicles).

- (iii) It is subject to a final liquidation audit, with its audited financials being distributed to investors promptly after completion, then the adviser is effectively exempt from complying with the notice, account statement delivery and surprise examination requirements detailed below.<sup>12</sup>
- **Requirements for client accounts that cannot rely on the audit exception.** For advisers that cannot satisfy the requirements of the audit exception with respect to certain clients (e.g., managed accounts), three additional requirements are imposed with respect to those clients:
  - (i) *Notice to clients regarding accounts with qualified custodians.* An adviser that opens an account with a qualified custodian on behalf of a client must provide written notification to the affected client (and to investors in any non-audit exception fund client) and include in that notice – and in any subsequent account statements sent by the adviser – a legend urging the client or investor to compare account statements received from the custodian with those sent by the adviser.
  - (ii) *Delivery of account statements.* An adviser must have a reasonable belief, after due inquiry, that each qualified custodian is sending, at least quarterly, account statements directly to clients and investors.
  - (iii) *Annual surprise examination.* An adviser must enter into a written agreement with an independent public accountant to conduct a surprise examination to verify client funds and securities at least once every calendar year.<sup>13</sup>

There are other exceptions from one or more of the requirements above, although they are less commonly utilized by private fund managers.<sup>14</sup>

## II. Custody Rule Self-Assessments Should Address the NEP Risk Alert and the IM Guidance Update

Private fund managers registered as investment advisers have an obligation under Rule 206(4)-7 to adopt and implement written policies and procedures reasonably designed to prevent violations of the Investment Advisers Act (and the rules thereunder). They also have an obligation under that rule to perform an at-least-annual review of the adequacy of these policies and procedures.

The NEP, in its March 2013 Risk Alert, stated that it views the Custody Rule as “one of the most critical rules” under the Investment Advisers Act and that the staff issued the Risk Alert to warn investment advisers of “widespread and varied non-compliance with elements of the Custody Rule.” Given that warning (validated by recent examination experiences), private fund managers should consider the four categories of weaknesses cited by the NEP in the context of a self-assessment of their Custody Rule policies and procedures (either as a directed effort or as part of the annual compliance review). A general outline of how this review could be organized follows:

### A. Ask If You Have “Custody”

In the NEP Risk Alert, OCIE staff cited several situations where advisers failed to recognize they had custody of client funds and securities. The failures ranged from the blatant, such as advisers in possession of physical certificates, to the more nuanced, such as a failure to recognize that a general

<sup>12</sup> It should be noted that if an adviser uses a special-purpose vehicle to facilitate an investment, the adviser has the option to either treat such SPV as a separate client and comply with the audit exception with respect to such SPV or treat the SPV's assets as assets of the pooled investment vehicle and such assets must be considered within the scope of the pooled investment vehicle's financial statements. See *Custody of Funds or Securities of Clients by Investment Advisors* (Dec. 30, 2009), SEC Release No. IA-2968, Section II.F., available at <http://www.sec.gov/rules/final/2009/ia-2968.pdf> (discussing compliance with the Custody Rule with respect to SPVs).

<sup>13</sup> Additional exceptions to the surprise exam requirement are available where an adviser has custody solely because: (i) it has the authority to withdraw fees from a client's account or (ii) a related person has custody, provided that such adviser and such related person are “operationally independent.” See Rule 206(4)-2(b)(3) and (6).

<sup>14</sup> E.g., an adviser may, with respect to shares of certain open-ended mutual funds, use the mutual fund's transfer agent in lieu of a qualified custodian. See Rule 206(4)-2(b)(1).

power of attorney over an account, the ability to pay expenses with account funds or simply holding the position of a general partner constituted “custody.”<sup>15</sup>

In response, private fund managers should review the definition of “custody,” as a manager can have “custody” — even without holding client funds or securities — if it has *any authority to obtain possession* of those assets. The broad grants of authority in many private fund investment management agreements often result in the manager having “custody” of client funds and securities; however, if the relevant agreement does not appear to establish custody (because, for example, the grant of authority is narrow or meaningful restrictions on authority are inserted), before concluding that there is no “custody” of client assets, the manager should carefully review its operational procedures to ensure that it does not have custody in practice through an ability or authority to obtain possession of, or access to, client funds and securities. This review should extend to an examination of all accounts over which the manager or an affiliate serves as general partner, managing member or trustee.

## **B. Ask If Client Assets Are Properly Maintained with a Qualified Custodian**

The NEP Risk Alert reported issues with compliance with the qualified custodian requirement, such as situations where an adviser: (i) held client assets in the adviser’s name or commingled client assets with proprietary or employee assets in one account or (ii) held portfolio security certificates in the *adviser’s* safe deposit box. Accordingly, all private fund managers should review their compliance with the “qualified custodian” requirement and confirm that all accounts and custodial relationships (including physical custody) are titled in the correct client’s name and are properly segregated from manager assets. In performing this analysis, particular attention should be paid to any non-U.S. custodians, as there is a specific prong of the qualified custodian definition that specifically addresses “foreign financial institutions.”<sup>16</sup>

*Exceptions.* Private fund managers, in addition, should also ask more generally: “Are all funds and securities being held with a qualified custodian, and — if not — can we rely on an exception?”

*Privately Offered Securities Exception.* As discussed above, there is an exception to the qualified custodian requirement with respect to certain “privately offered securities,” which are securities that are:

- (i) Acquired from the issuer in a transaction or chain of transactions not involving any public offering;
- (ii) Uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client; and
- (iii) Transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.

It is important to note that managers to pooled investment vehicles that do not comply with the annual audit exception cannot rely on the privately offered securities exception and, therefore, are required to maintain *all* client securities with a qualified custodian.<sup>17</sup>

Traditionally, this narrow exception has only applied to *uncertificated* privately-placed securities with limited transferability and privately offered securities that were certificated needed to be held with a qualified custodian. There was much frustration with this requirement, especially where ownership of a security is recorded on the books of the issuer and the certificate is non-transferable; many advisers felt that applying the qualified custodian obligation in these circumstances does not provide any meaningful

<sup>15</sup> Other issues in this area were noted, such as advisers receiving checks made out to clients and failing to return them promptly, but they are generally less common for private fund managers.

<sup>16</sup> Rule 206(4)-2(d)(6)(iv) includes “[a] foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients’ assets in customer accounts segregated from its proprietary assets” as a prong of the “qualified custodian” definition.

<sup>17</sup> See Rule 206(4)-2(b)(2)(ii) (requiring advisers to pooled investment vehicles to effectively comply with the audit exception to be able to utilize the privately offered securities exception). See Staff Responses to Questions About the Custody Rule, Question VII.2, [http://www.sec.gov/divisions/investment/custody\\_faq\\_030510.htm](http://www.sec.gov/divisions/investment/custody_faq_030510.htm) (the “Custody FAQ”) (discussing the privately offered securities exception in the context of a pooled investment vehicle that is not subject to annual audit).

protections to investors, especially where the fund is subject to an annual audit. In addition, because prime brokers may not be willing to hold certain certificated securities as qualified custodians, advisers often have to incur additional expenses in engaging an additional custodian.

*Changes Resulting from the 2013 IM Guidance Update.* In response to these private fund manager concerns, the Division of Investment Management indicated in its August 2013 Guidance Update that it would “not object” if an adviser does not maintain certificates evidencing privately offered securities with a qualified custodian, provided that:

1. The client is a pooled investment vehicle that complies with the audit exception;
2. The private stock certificate can only be used to effect a transfer or to otherwise facilitate a change in beneficial ownership of the security with the prior consent of the issuer or holders of the outstanding securities of the issuer;
3. Ownership of the security is recorded on the books of the issuer or its transfer agent in the name of the client;
4. The private stock certificate contains a legend restricting transfer; and
5. The private stock certificate is appropriately safeguarded by the adviser and can be replaced upon loss or destruction.

The Division also noted that “[p]artnership agreements, subscription agreements and LLC agreements are not certificates under [the privately offered securities exception] and the securities represented by such documents are privately offered securities provided they meet the other elements of [the exception].”

*Effect on Swap-Related Documentation.* In a related footnote in the Guidance Update, the Division also clarified that “securities that are evidenced by ISDA master agreements that cannot be assigned or transferred without the consent of the counterparty” are privately offered securities under privately offered securities exception and, therefore, are eligible for the relief on having to custody related certificates. This resolves an issue (at least for audited fund vehicles, see next paragraph) that has been the subject of a significant amount of confusion in the asset management and auditing communities.

*Limitation of Relief to Audited Fund Vehicles.* However, investment advisers should note that by the strict language of the guidance this relief is only applicable where “the client is a pooled investment vehicle that is subject to a financial statement audit.” In a footnote that confirms this limited scope was intentional, the Division noted that, “[f]or unaudited pooled investment vehicles and other clients [presumably including managed accounts], a significant benefit of the requirement to maintain funds and securities with a qualified custodian is to allow the assets to be included on account statements that the qualified custodian provides to clients (or investors in the case of a pooled investment vehicle) so the clients (or investors) can monitor transactions and holdings in their (or the pool’s) account.” While not a significant limitation for managers to pooled vehicles (as such managers cannot rely on the privately offered securities exception in any event without complying with the audit exception), this limitation does mean that managers to non-qualifying clients (such as certain managed accounts) will still need to hold these clients’ certificated privately offered securities with a qualified custodian.

### **C. Ask If You Can Rely Upon the Audit Exception**

The NEP Risk Alert reported numerous audit exception-related deficiencies; basically, OCIE found violations of virtually every prong of the audit exception (hopefully not all by the same adviser). The violations included: (i) a failure to use an accountant that was “independent” and/or registered with the PCAOB; (ii) preparing financial statements that were not in accordance with U.S. GAAP; (iii) failing to actually deliver audited financial statements to investors (as opposed to merely making them available upon request) and (iv) not obtaining a final audit upon the liquidation of a pooled investment vehicle.



In addition to deficiencies found in the current set of examinations, the staff noted that some advisers to pooled investment vehicles utilized a non-GAAP accounting standard without satisfying the conditions in the 2003 adopting release that apply when using such alternative standard (which we discuss below).<sup>18</sup>

These four deficiencies provide a good framework for private fund managers to utilize in assessing their compliance with the audit exception requirements:

1. *Is your accountant “independent” and registered with (and subject to regular inspection by) the PCAOB?*

Private fund managers should confirm that their auditor is independent and obtain (and save) confirmation of PCAOB registration and PCAOB inspection status. This may sound like a needless technicality, but it is well worth the time invested given the stakes involved.

2. *Are your pooled investment vehicles’ financial statements prepared annually in accordance with GAAP (or, if they are non-GAAP financial statements, are they reconciled to GAAP and otherwise eligible under the rule)?*

Subject to certain exceptions discussed below, the audited financial statements need to be prepared in accordance with U.S. GAAP. All private fund managers should regularly discuss with their auditors issues that could prevent the issuance of an unqualified audit opinion (as the audit exception may not be available if there are exceptions to U.S. GAAP); early notice of an accounting issue can provide an adviser with the time needed to arrange for the surprise examination and informational deliveries. This is of critical importance for private fund managers launching a new fund who intend to amortize (and not expense) organizational costs and for managers of vehicles holding a material amount of illiquid assets that require fair valuation. We have seen numerous cases where private fund managers, expecting to rely on the audit exception, found out late in the audit process that a qualified audit opinion was to be issued.

Pooled investment vehicles organized outside of the United States, or having a general partner or other manager with a principal place of business outside the United States, may use accounting standards other than U.S. GAAP so long as: (i) the financial statements contain information substantially similar to statements prepared in accordance with U.S. GAAP and the footnotes reconcile any material variations with U.S. GAAP and (ii) the financial statements are otherwise audited in accordance with U.S. Generally Accepted Auditing Standards. Considering the NEP Risk Alert cites non-compliance with this requirement as a material deficiency, private fund managers of vehicles that use an accounting standard other than U.S. GAAP (e.g., International Financial Reporting Standards) should require their auditors to confirm satisfaction with these conditions.

Finally, private fund managers should remember that the audit exception imposes an annual audit obligation. Therefore, a separate audit is required for partial-year stub periods (e.g., for new fund launches on a date other than January 1) in order to rely on the audit exception. As noted above, this can be a critical item for private fund managers to remember when launching new vehicles.

3. *Are your audited financial statements actually delivered to investors (and not merely made available “upon request”)?*

Private fund managers should confirm that their method of delivery satisfies the SEC’s “delivery” requirement; i.e., that an administrator (or other agent) is actually delivering annual audited financial statements to investors in pooled investment vehicles within the time frames prescribed by the rule. Given the variety of client and investor communication channels, “delivery” can be

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<sup>18</sup> See *Custody of Funds or Securities of Clients by Investment Advisors* (Sept. 25, 2003), SEC Release No. IA-2176, n.41, <http://www.sec.gov/rules/final/ia-2176.htm>; *Custody Rule FAQ*, Question VI.5 (providing guidance on when certain non-U.S. advisers and funds can utilize a standard other than U.S. GAAP).

satisfied in a number of ways, but the SEC has made it clear that merely making financial statements available upon request is not “delivery.”

Private fund managers must also ensure they are complying with the SEC’s guidance on electronic delivery if hard copies of the audited financials are not sent to investors.<sup>19</sup> While the SEC’s guidance on electronic delivery<sup>20</sup> does not directly address what is becoming the most common (and perhaps the most secure) method of financial statement delivery for fund investors (i.e., an email from the administrator containing a link to a secure website), we believe this approach should satisfy the delivery obligation.

Irrespective of the method of delivery, the financial statements must be delivered within 120 days (180 days for funds of funds).<sup>21</sup> The SEC has, however, issued an FAQ that provides comfort to advisers who formed a “reasonable belief” that financial statements would be timely delivered, but where actual delivery was delayed by “certain unforeseeable circumstances.”<sup>22</sup>

#### *4. Are all funds that are liquidating and winding up receiving a liquidation audit?*

Advisers winding up a pooled investment vehicle must ensure that they obtain a final audit upon liquidation of that vehicle. While the SEC has not provided much guidance on the definition of “upon liquidation,” we believe that best practices in this area provide for the final audit to be performed after all amounts (subject to reasonable reserves to pay for termination fees and expenses of the auditors) have been distributed to investors and no other assets remain in the vehicle.

While many private fund managers assume that they can contract around the liquidating audit, it is not clear that this is permitted under the Custody Rule as currently interpreted. Similarly, there is no stated exception for vehicles with a small number of investors or for vehicles where the costs of the liquidation audit are disproportionate to the fund’s assets.

#### **D. If You Cannot Rely on the Audit Exception, Are You Complying with the Notice, Account Statement Delivery and Surprise Examination Requirements?**

While the overwhelming majority of private fund advisers rely on the audit exception to address custody issues, not every adviser can comply with the timing or other requirements of the audit exception, which means that the adviser must comply with the notice, account statement and surprise exam requirements of the Custody Rule.

In considering surprise exam logistics, advisers should note that the NEP reported numerous weaknesses with the surprise examination. The most telling was that, for some advisers, the “surprise” examination was not much of a surprise, with the examination being scheduled for the same time each year. Also, the staff noted that a Form ADV-E (the timely filing of which is an element of a successful surprise exam) was often not filed within 120 days of the exams. To address these concerns, private fund managers should have conversations with their accountants to ensure the surprise exam is being conducted in accordance with the Custody Rule and maintain written confirmation from the accountants that the ADV-E has been timely filed.

In addition to the surprise exam, private fund managers that are not relying on the audit exception also need to ensure they are complying with the notice and account statement delivery requirements, as the NEP reported deficiencies with these basic requirements. These managers should take steps to confirm:

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<sup>19</sup> See Custody FAQ, Question IV.1.

<sup>20</sup> See *SEC Interpretation: Use of Electronic Media*, SEC Release Nos. 33-7856, 34-42728, IC-24426, <http://www.sec.gov/rules/interp/34-42728.htm> (providing guidance on use of electronic media).

<sup>21</sup> See also, SEC Custody FAQ, Question VI.8B (extending the delivery date to 260 days after the end of the year with respect to certain funds of funds that invest in unaffiliated funds of funds).

<sup>22</sup> See Custody FAQ, Question IV.9.

(i) that their notices have actually been sent to clients and investors; (ii) that these notices included the proper legends and (iii) that the qualified custodians are actually sending quarterly account statements to clients and investors. Ideally, the private fund manager will receive and preserve duplicates of the statements actually sent by the qualified custodians.

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In light of the NEP Risk Alert and the SEC's recent focus on custody issues during examinations (and the difficult issues that arise under the Custody Rule), private fund managers should invest the time and resources needed to verify their Custody Rule compliance.<sup>23</sup> As we note above, this can be done in any context and at any time, but for many managers it may be convenient to make this a part of the annual compliance examination.

Authored by [Brian T. Daly](#) and [Marc E. Elovitz](#).

As with all such matters, we are available to discuss any questions or concerns you may have in connection with your compliance with the Custody Rule and your related policies and procedures. For questions or additional information regarding this *Alert* or the Custody Rule in general, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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<sup>23</sup> In addition, in connection with this review, advisers should also reassess their responses to Item 9 of Part 1 of their Form ADV.